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Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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Major Development in Income Taxation of Chapter 12 Bankruptcy Debtors

-by Neil E. Harl* and Joseph A. Peiffer**

The Eighth Circuit Court of Appeals,¹ on September 16, 2009, handed down a decision in the long-running battle between the Internal Revenue Service and Chapter 12 bankruptcy debtors over the meaning of the 2005 amendment to the Bankruptcy Code.² That amendment was to provide relief to Chapter 12 farm and ranch debtors in light of the long-standing favorable treatment given individual debtors under Chapter 7 and Chapter 11 of the Bankruptcy Code.³ Congress had refused to extend the same treatment to individuals filing under Chapter 12 but instead enacted in 2005 a special provision for Chapter 12 filers⁴ that proved to be controversial as to its meaning because of the ambiguities in the language chosen by Congress.⁵ As it turned out, the Chapter 12 solution was more favorable to the debtor than the provisions applicable to Chapter 7 and 11 filers inasmuch as tax claims are treated as unsecured claims even if not paid in full.

The Eighth Circuit decision favors debtors on three important issues-- (1) a Chapter 12 debtor may treat post-petition income taxes imposed on the debtor's income earned during the Chapter 12 proceeding as an administrative expense; (2) pre-petition and post-petition sale of slaughter hogs (and other ordinary income property) are eligible for the special treatment under the 2005 enactment; and (3) the "marginal" method is the correct way to allocate the taxes between the priority and non-priority claims under Chapter 12.

The Eighth Circuit decision involved Chapter 12 cases from Iowa⁶ and Nebraska.⁷ A Kansas case⁸ involves one issue pertaining to the post-petition applicability of the statute. That case, which was similarly decided in the Bankruptcy Court, is on appeal to the Tenth Circuit Court of Appeals in Denver. Also, an Arizona case, in which the District Court reversed the Bankruptcy Court in that state and held in favor of the debtor on the post-petition applicability issue,⁹ is on appeal to the Ninth Circuit Court of Appeal in San Francisco. That means the litigation is not necessarily over with the September 16 decision in *Knudsen*.¹⁰

What the controversy is about

Since enactment of the Bankruptcy Tax Act of 1980,¹¹ individual debtors filing under Chapter 7 (liquidation bankruptcy) or Chapter 11 (reorganization bankruptcy) have been able to avoid income tax liability on asset liquidations in bankruptcy because a new tax

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

** Day, Rettig Peiffer, P.C., Cedar Rapids, Iowa

entity was created at the time of bankruptcy filing.¹² That new entity was responsible for paying the income taxes caused by the liquidation of assets and the triggering of gain.¹³ Unfortunately for the debtor, in most Chapter 7 cases, where there is no equity to pay the taxes and make any distribution to the unsecured creditors, the Chapter 7 trustee often abandons the over-encumbered asset, meaning that the asset would revert to the debtor who would then face the income tax consequences of the disposition after the Chapter 7 discharge. That could be even more severe than would have been the case prior to bankruptcy because of the prospect of recognition of gain to the extent of the entire discharged indebtedness as the property would be subject to non-recourse debt treatment¹⁴ unless the debt was reaffirmed by the debtor.

The new entity feature was not extended to Chapter 12 filers on enactment in 1986¹⁵ nor was it included in any of the extensions of Chapter 12.¹⁶ Moreover, that feature was not included in the 2005 legislation that made Chapter 12 permanent¹⁷ even though the 2005 legislation contained a provision giving some income tax relief for Chapter 12 debtors.¹⁸

In that relief provision, a Chapter 12 debtor was allowed to treat obligations arising out of “claims owed to a governmental unit,” such as income tax on gains or recapture income, as a result of “sale, transfer, exchange, or other disposition of any farm asset used in the debtor’s farming operation” to be treated as an unsecured claim that is not entitled to priority under the Bankruptcy Code, so long as the debtor receives a discharge.¹⁹ That made tax claims dischargeable which is not otherwise the case in most bankruptcies unless the debtor waits for three years after the tax return could last be timely filed to file bankruptcy. In the meantime, IRS and the state departments of revenue pursue the debtor to collect the unpaid taxes.

The Internal Revenue Service had argued that the 2005 law did not apply to ordinary income property such as slaughter hogs or grain produced for sale, rather it applied only to property eligible for capital gain treatment such as farmland, machinery and breeding stock. That was because of the language “. . . used in the debtor’s farming operation” which the IRS sought to have interpreted in light of the language used in I.R.C. § 1231.²⁰ The IRS view was that the only property eligible for the special rule was property in line for capital gain treatment such as farmland, machinery and breeding stock. The Eighth Circuit Court of Appeals, agreeing with the district court, held that the provision applied to income whether it came from ordinary income property or assets eligible for capital gain treatment. The Eighth Circuit also agreed that the income taxes could be treated as administrative expenses, which cleared the way to the taxes being subject to discharge if not paid. Thus, sales or other dispositions of farm assets used in the debtor’s farming or ranching operation that occur during the year of filing or after filing the bankruptcy petition qualify for the favorable tax treatment in Chapter 12.

The Eighth Circuit took a position whether, on the allocation of taxes between those eligible for the special treatment and those taxes that were not eligible for the 2005 provision, the calculation should be made using the pro rata

approach (favored by the IRS) or whether the figuring should be done using the marginal approach (which gives a break to the debtor). The Eighth Circuit found the language in the statute to be ambiguous and invoked a long-standing rule of construction that ambiguous provisions should be construed in favor of the debtor.²¹ That meant the marginal approach could be used by the taxpayer as opposed to the pro rata approach favored by IRS. In *Knudsen* the difference in approaches to the calculation methodologies exceeded \$40,000.

What lies ahead

The Eighth Circuit decision in *Knudsen v. IRS*²² perhaps settles the issues in the Eighth Circuit area (Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota and South Dakota) unless the case is subject to rehearing or is appealed to the U.S. Supreme Court. That is always a possibility but it is highly unlikely that the Supreme Court would hear the case.

The cases now on appeal to the Ninth and Tenth Circuit Courts of Appeal are expected to produce decisions within the next few months on the issue of applicability to post-petition transactions, not on the other issues covered by *Knudsen*. If both agree with the *Knudsen* decision, that may be the end of the litigation with respect to applicability of the provision to post-petition transactions. If either or both courts hold in favor of the Internal Revenue Service, that would raise the odds that the Supreme Court might ultimately resolve the conflict in the Circuits.

Opportunity for lenders and farmers alike

In many circumstances where the farm or ranch operation is overburdened with debt and is not cash flowing, secured lenders could suggest to the borrower that they could partially or totally liquidate now, pay the net proceeds to the secured lender and then utilize Chapter 12 to deal with the income taxes that typically accompany the liquidation of a farming operation. In a partial liquidation, the farmer would streamline the operation, making it cash flow, so that it could service the remaining indebtedness and use Chapter 12 to deal with the taxes. To make the deal more attractive and further entice the struggling borrower to liquidate now, the lender should consider the exemptions to which the farmer would be entitled in bankruptcy and offer to allow the farmer to keep that amount of property as well as some additional funds to pay the farmer’s bankruptcy attorney fees. In so doing, the secured lender could well net more money more quickly and also get the under-performing loan off the books. This could be a win-win for the farm borrower and for the lender.

ENDNOTES

¹ *Knudsen v. Internal Revenue Service*, No. 08-2820 (8th Cir. 2009).

² Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005). See 11 U.S.C. § 1222(a)(2). See generally 5 Harl, *Agricultural Law* § 39.04[2][b][ii] (2009); 13 Harl, *Agricultural Law* § 120.08[9][a] (2009); 2 Harl, *Farm Income Tax Manual* § 9.05[7] (Matthew Bender 2009 ed.). See also Harl, “District Court in *Knudsen* Holds for the Debtors in Chapter 12 Case,” 19 *Agric. L. Dig.* 101 (2008); Harl and Peiffer, “Bankruptcy Court Interpretation of Chapter 12 Rules,” 17 *Agric. L. Dig.* 185 (2006).

³ See I.R.C. § 1398(a).

⁴ 11 U.S.C. § 1222(a)(2)(A).

⁵ E.g., *In re Knudsen*, 356 B.R. 480 (Bankr. N.D. Iowa 2006), *aff'd and rev'd*, 389 B.R. 643 (N.D. Iowa 2008).

⁶ *In re Knudsen*, 389 B.R. 643 (N.D. Iowa 2008).

⁷ *In re Schilke*, 2008 U.S. Dist. LEXIS 68176 (D. Neb. 2008).

⁸ *In re Dawes*, 382 B.R. 509 (Bankr. D. Kan. 2008), *aff'd*, 09-1 U.S. Tax Cas. (CCH) ¶ 50,280 (D. Kan. 2009).

⁹ *In re Hall*, 393 B.R. 857 (D. Ariz. 2008).

¹⁰ See note 1 *supra*.

¹¹ Pub. L. No. 96-589, § 3(a)(1).

¹² I.R.C. § 1398(a), (c)(1).

¹³ *Id.*

¹⁴ Ltr. Rul. 8918016, January 31, 1989 (unsecured portion of mortgage obligation discharged in bankruptcy; remaining obligation of mortgage obligation treated as non-recourse which is subject to income tax regardless of fair market value of property).

¹⁵ Pub. L. No. 99-554, 100 Stat. 3105 (1986), adding 11 U.S.C. § 1201 *et seq.*

¹⁶ See 13 Harl, *Agricultural Law* § 120.08 (2009).

¹⁷ Pub. L. No. 109-8, § 1001, 119 Stat. 185 (2005), effective July 1, 2005.

¹⁸ *Id.*

¹⁹ 11 U.S.C. § 1222(a)(2).

²⁰ I.R.C. § 1231(a)(3)(A), (b)(1).

²¹ *Knudsen v. IRS*, No. 08-2820 (8th Cir. 2009).

²² No. 08-2820 (8th Cir. 2009).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

FEDERAL TAX

DISCHARGE. The debtor was self-employed as a realtor for 2000 through 2006 and did not pay income taxes on earnings. The debtor did not file a return for 2002 until April 18, 2004, more than six months after the expiration of an extension. The debtor filed for Chapter 7 on April 30, 2007 and sought discharge of the taxes owed. The IRS argued that the taxes for 2004 through 2006 were non-dischargeable under Section 523(a)(1)(A) and 507(a)(8) since the returns were due less than three years before the filing of the bankruptcy case. The IRS argued that the 2002 taxes were nondischargeable under Section 523(a)(1)(B)(i) because no return was filed, inasmuch as late filed return did not constitute a valid return. The court agreed with the court in *In re Creekmore*, 401 B.R. 748 (Bankr. N.D. Miss. 2008), that a late return did not constitute a valid return for purposes of Section 523(a)(1)(B)(i). This result occurs because of an undesignated amendment to Section 523(a) by BAPCPA 2005 (Pub. L. No. 109-8) which defines an untimely return as not a return for purposes of Section 523 unless the debtor complies with I.R.C. § 6020(a). Section 6020(a) requires that the taxpayer supply the IRS with sufficient information to create a return and the taxpayer signs the return prepared by the IRS. The court held that the 2000 and 2003 tax liabilities were dischargeable because the IRS failed to prove that the debtor intended to evade payment of taxes. ***In re Links, v. United States*, 2009-2 U.S. Tax Cas. (CCH) ¶ 50,631 (Bankr. N.D. Ohio 2009).**

FEDERAL FARM PROGRAMS

CROP INSURANCE. The FCIC has issued proposed regulations amending the common crop insurance regulations, apple crop insurance provisions to provide policy changes, to clarify existing policy provisions to better meet the needs of insured producers, and to reduce vulnerability to program fraud, waste, and abuse. The proposed changes will be effective for the 2011 and succeeding crop years. **74 Fed. Reg. 46023 (Sept. 8, 2009).**

DISASTER ASSISTANCE. The FSA has adopted as final regulations implementing specific requirements for the Emergency Assistance for Livestock, Honeybees, and Farm-Raised Fish Program and the Livestock Forage Disaster Program authorized by the Food, Conservation, and Energy Act of 2008 (2008 Farm Bill). Eligible LFP and ELAP losses must have occurred on or after January 1, 2008, and before October 1, 2011. The final regulations specify how LFP and ELAP payments are calculated, what losses are eligible, and when producers may apply for payments. **74 Fed. Reg. 46665 (Sept. 11, 2009).**

MEAT AND POULTRY PRODUCTS. The FSIS has issued an advance notice of proposed rulemaking to assist the agency in defining the conditions under which it will permit the voluntary claim "natural" to be used in the labeling of meat and poultry products. After considering comments on the "natural" claim submitted by the public in response to a Federal Register notice that the agency issued on December 5, 2006, and the comments presented at a public meeting held by the agency on December