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EXPENSES IN BANKRUPTCY

— by Neil E. Harl*

A major issue with farm bankruptcies, as with other bankruptcies, is how to handle the costs of bankruptcy.[1] The fact that a farm or small business bankruptcy nearly always has non-business aspects as well as a business dimension adds to the complexity of the determination as to what is deductible.

Administrative expenses

In general, the expenses of administering a bankruptcy estate are deductible.[2] Income tax generated on sale or disposition of property by the bankruptcy estate is a liability of the bankruptcy estate and is paid as an administrative expense.[3] The deductible amounts include the trustee's fee[4] as well as expenses allowed as a cost of bankruptcy estate administration.[5]

In general, the determination of whether any amount paid or incurred by the bankruptcy estate is allowable as a deduction or credit is made as if the amount were paid or incurred by the debtor and as if the debtor were engaged in the same trade, business or activity as before commencement of the bankruptcy case.[6]

Business portion of bankruptcy fees

A problem of allocation arises if a bankruptcy has both business and non-business components to the bankruptcy. In a 2000 case, *Catalano v. Comm'r*,[7] the debtor's personal bankruptcy was proximately caused by liabilities arising from the law firm of which the debtor was the owner.[8] The debtor was allowed to deduct an allocable portion of bankruptcy fees as a business expense.[9] In 1988, the debtor had purchased a residence which was financed in part by a nonrecourse loan secured by a lien on the residence. In 1994, the debtor was named as a defendant in a number of law suits arising from the law practice and both the debtor and the debtor's law firm each filed for Chapter 11 bankruptcy.[10]

The debtor incurred $46,462 for legal fees, accounting costs and U.S. Trustee's fees. The Tax Court allowed a business deduction for $41,574 of the costs. The court said that the determination as to whether an expense is a deductible trade or business expense or a non-deductible personal, living or family expense depends on the origin of the claims giving rise to the fees.[11] In *Catalano v. Comm'r*,[12] 93.79 percent of the debtor's liabilities in bankruptcy were business liabilities; thus, the court concluded, the debtor's bankruptcy was "proximately caused" by the business liabilities.[13] The court invoked a formula which had been applied in an earlier case[14] allowing a debtor to deduct a percentage of the bankruptcy fees paid equal to the ratio that the claims of the debtor's business creditors bore to the total claims.[15] That formula produced a deduction of 93.79 percent of the total, substantiated bankruptcy fees as a business expense. Thus, the debtor was allowed to claim a business deduction for $41,574 of

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the bankruptcy costs (93.79 percent times $44,327, the total amount paid in the year in question, 1995).[16]

In *Cox v. Comm'r*,[17] the husband was a corporate employee. The wife opened a western wear store which failed the following year. The spouses each filed Chapter 7 bankruptcy. The combined debts totaled $163,819 of which $159,822 was attributable to the wife's western wear store. The issue before the Tax Court was whether the $1500 attorney's fee (reduced from $5,000) was deductible as a business expense.

The court said the key question is whether the claim *arises in connection with* the taxpayer's profit-seeking activities.[18] Accordingly, the court concluded that the bankruptcies were caused by the failure of the western wear business. Thus, the debtors were entitled to deduct an amount which bore the same ratio to the $1500 fee as the claims of the business creditors ($159,822) bore to the total claims of creditors ($163,819). The Tax Court rebuffed the argument by the Internal Revenue Service that the "fresh start" from bankruptcy was a personal benefit and, therefore, no portion of the fees was deductible. The court agreed that the fresh start was a *consequence* of the bankruptcies, not the cause, and thus was irrelevant to the determination of deductibility.[19] A 1963 U.S. Supreme Court case, *United States v. Gilmore*,[20] had resolved that issue. The court said that the question of whether legal expenses incurred in divorce proceedings attributable to the former spouse's claim to controlling stock interests in three corporations were deductible was properly based on the test of whether the claim arose in connection with the taxpayer's profit-seeking activities, not the consequences which might result from failure to defeat the claim.[21]

FOOTNOTES

1 See generally 5 Harl, *Agricultural Law* § 39.04[2][a][ii] (1999).
2 I.R.C. § 1398(h)(1).
3 *In re* Wills, 46 B.R. 333 (D. Md. 1985).
4 I.R.C. § 1398(h)(1); 11 U.S.C. § 123.
5 11 U.S.C. § 503.
6 I.R.C. § 1398(e)(3).
7 T.C. Memo. 2000-82.
8 *Id.*
9 *Id.* See I.R.C. § 162.
10 *Id.*
11 *Id.*
12 See note 7 *supra*.
13 *Id.*
14 Cox v. Comm'r, T.C. Memo. 1981-552.
15 *Id.*
16 Catalano v. Comm'r, T.C. Memo. 2000-82.
17 T.C. Memo. 1981-552.
18 *Id.*
19 See United States v. Gilmore, 372 U.S. 39, 49 (1963).
20 *Id.*
21 *Id.*

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

PERMISSIVE USE. The defendants' predecessor in interest received the land by patent from the U.S. and constructed a fence near the boundary to separate the land from the neighboring public land. The neighboring land was eventually conveyed to the predecessor in interest to the plaintiff's property; however, the fence remained between the properties, even though the fence was constructed on the plaintiff's property, creating a 7.3 acre strip not on the defendant's deed. The defendant's daughter constructed a residence on one acre within the disputed strip. The disputed strip was otherwise undeveloped. When a survey showed the true boundary line, the plaintiff sought to quiet title in the disputed strip. The defendants argued that title to the disputed strip passed to them by adverse possession or by boundary acquiescence. The court found that the fence was never intended to be placed on the boundary line because the fence was simply barbwire stretched from tree to tree in an irregular fashion. The court noted that property transferred from the government always had straight line boundaries. The court held that the fence was merely a fence of convenience, constructed merely to separate the land from public land. The court held further that a fence of convenience created a permissive use of the property within the fence and beyond the true boundary line; therefore, no adverse possession could occur. However, the court allowed title in the one acre with the residence to pass by adverse possession because the construction of a residence exceeded the permissive use evidenced by the fence and created a use open and hostile to the true title. **Kimball v. Turner, 993 P.2d 303 (Wyo. 1999)**.

BANKRUPTCY

GENERAL-*ALM* § 13.03[8].*

EXEMPTIONS.

HOMESTEAD. The debtors owned an 80 acre farm which was split for mortgage loan purposes into a 20 acre

**Agricultural Law Manual* (ALM).