Sale of the Family Farm and Capital Gains Tax in Chapter 12

Written by:
Susan E. Trent
Rothberg Logan & Warsco LLP
Fort Wayne, Ind.
strent@rlwlawfirm.com

About the Author

Susan Trent is a partner with Rothberg Logan & Warsco LLP in Fort Wayne, Ind.

On Nov. 29, 2011, the U.S. Supreme Court heard oral argument in *Hall v. United States* with regard to the following issue:

> After a post-petition sale of a family farm, may the capital gains tax created be treated as an administrative expense in a chapter 12 reorganization plan?

Background

Susan E. Trent

After filing for chapter 12 relief, the petitioners, Lynwood and Brenda Hall, sold their family farm with bankruptcy trustee consent and court approval for $960,000. Proceeds generated from the sale were designated for creditors of the bankruptcy estate. The capital-gains tax generated was $29,000. Following the sale, the petitioners filed their bankruptcy plan, which classified the capital-gains tax as an administrative expense to be treated as an unsecured claim. The capital-gains tax would be paid *pro rata* with any unpaid balance discharged under 11 U.S.C. § 1222(a)(2)(A).[1]

The Internal Revenue Service (IRS) objected based on 26 U.S.C. § 1399 and took the position that a post-petition capital-gains tax was not an administrative claim pursuant to 11 U.S.C. §§ 507(a)(2) and 503(b) because it was the petitioners' individual obligation. The IRS asserted that the chapter 12 estate cannot incur the tax under 26 U.S.C. § 1399 as "no separate taxable entity" is created.[2] Therefore, the capital-gains tax was not an administrative expense capable of being discharged in chapter 12.

In *In re Hall*, the U.S. Bankruptcy Court for District of Arizona concluded that using a plain-meaning approach that § 1222(a)(2)(A) applied solely to pre-petition taxes accorded priority status under § 507.[3] Critical to its determination was the post-petition timing of the sale. The court noted that chapter 12 is relief afforded to family farmers with regular income and is modeled after chapter 13. It concluded that only those claims that are entitled to priority under § 507 and fall under § 1222(a)(2)(A) may be treated as an unsecured claim not entitled to priority treatment. These were post-petition taxes and did not qualify under § 507(a)(8). The court held that § 507(a)(2) precluded treating the tax as an administrative claim because the chapter 12 estate cannot incur taxes under § 1399 inasmuch as there is no separate taxable entity.[4]

On appeal, the district court[5] followed a line of cases that permitted family farmers to treat post-petition tax both as a liability of the estate and fully dischargeable.[6] The court considered legislative history that demonstrated that Congress intended to provide additional relief to the family farmer by adding § 1222(a)(2)(A) to the Bankruptcy Code. The decision includes an interesting discussion as to statutory ambiguity and drafting and the interplay between the Internal Revenue Code (IRC) and the Code. The court held that the IRC must be read in the context of the goals of the Code in affording relief to family farmers. The district court reversed.[7]

On appeal to the Ninth Circuit Court of Appeals, the Ninth Circuit concluded that the chapter 12 estate was not a taxable entity under 26 U.S.C. §§ 1398 and 1399 and cannot incur a tax. The court was unpersuaded by the reasoning found in *Knudsen*. Notably, the Ninth Circuit drew the analogy that "just because all apples are fruits does not mean that all fruits are apples. Likewise, although all taxes 'incurred by the estate' are 'incurred post-petition,' not all taxes 'incurred post-petition' are 'incurred by the estate.'"[8] Holding that the "text is the law,"[9] the Ninth Circuit reversed.

The Ninth Circuit included a dissent that discussed congressional intent to help family farmers clearly reflected in legislative history and the addition of § 1222(a)(2)(A) to the Code. Judge Richard A. Paez appeared persuaded by *Knudsen* and similar decisions.[10] He noted that those decisions honor congressional intent and "avoid an unwarranted circuit split."[11] The issue is now before the U.S. Supreme Court.[12]

Last in Line

Argument: Family Farmer (Petitioners)

Four main points are made and refined, namely that (1) § 1222(a)(2)(A) applies to post-petition taxes, (2) legislative history supports the application of § 1222(a)(2)(A) to post-petition farm sales, (3) post-petition taxes have administrative-expense priority because the Code and not the IRC controls bankruptcy and (4) proceeds of post-petition sales benefit bankruptcy estates.[13]

The petitioners reasserted their argument that the capital gains tax created from a family farm sale is a § 503(b) administrative-expense claim and has priority under § 507. They further explained that § 1222(a)(2)(A) excepts such tax from priority. They argued that the Ninth Circuit's adverse decision impacts family farmers by requiring a sale of farm assets many months before bankruptcy, without court supervision,

1 Unless expressly noted, all citation references are directed to the Bankruptcy Code. Any references mean the Code as found in title 11 of the U.S. Code.

2 The IRS notes the chapter 7 and 11 exceptions.

3 *In re Hall*, 376 B.R. 741 (Bankr. D. Ariz. 2007).

4 Id. at 746.

5 *Hall v. United States (In re Hall)*, 393 B.R. 857 (D. Ariz. 2008).

6 Cases holding that § 1222(a)(2)(a) applies to post-petition transactions and to the taxes arising from such transactions are *In re Knudsen*, 389 B.R. 643 (N.D. Iowa 2008) and, *on appeal*, 581 F.3d 686 (8th Cir. 2009); and *In re Schlake*, 378 B.R. 899 (Bankr. D. Neb. 2007). *See also Towers for Pacific-Atlantic Trading Co. v. United States*, 64 F.3d 1292, 1298-1301 (9th Cir. 1995) (chapter 11).

7 *Hall v. United States (In re Hall)*, 393 B.R. 857, 864 (D. Ariz. 2008).

8 *United States v. Hall*, 617 F.3d 1161 (9th Cir. 2010).

9 Id. at 1165.

10 Judge Paez also noted *In re Flicken*, 430 B.R. 663 (10th Cir. B.A.P. 2010), as persuasive. On appeal, the *Flicken* court made reference to the decision of *In re Dawes*, 652 F.3d 1236 (10th Cir. 2011). The Dawes' submitted an *amici brief* in Hall.

11 *Hall*, 617 F.3d at 1168.

12 *Hall v. United States*, 131 S.Ct. 2960 (U.S. 2011).

13 *Brief for Petitioner* at 10, 22, 33, 34 and 39. *Hall v. United States*, 131 S.Ct. 2960 (U.S. 2011) (No. 10-875).

for § 507(a)(8) to apply. They argued that the Ninth Circuit's interpretation results in hardship for family farmers and leads to an illogical result.[14]

The petitioners noted the legislative history behind the addition of § 1222(a)(2)(A) for the creation of an exception favoring family farmers and enabling post-petition sales of farm assets, confirmation of plans and the discharge of taxes created as a result of sales. The petitioners argue that the Ninth Circuit's position gives the IRS "veto power" over family farmer reorganization when downsizing is necessary, but that taxes created from the sale of farm assets may be sizeable.[15]

The petitioners argued that under the Ninth Circuit's interpretation, the relevant Code provisions are "winding rather than strictly constructed." If Congress intended only pre-petition taxes to be excepted by § 1222(a)(2)(A), the petitioners argued, it would have only referred to § 507(a)(8) claims and not generally referred to "all priority claims." The petitioners also referred to *United States v. Noland*[16] where the IRS filed a tax claim including penalties that occurred after the bankruptcy filing but before conversion to chapter 7. The petitioners contended that the Supreme Court had decided that post-petition tax penalties were entitled to administrative-expense priority. The petitioners also cited to a number of authorities for the proposition that taxes are incurred by a bankruptcy estate.[17] The petitioners further highlighted to the Court that the principal sponsor of the legislation, Sen. Chuck Grassley (R-Iowa), advocated for years for capital-gains tax reform in chapter 12 cases.

They advocated that the IRC deals with the assessment of taxes while the Code deals with the payment of claims for taxes assessed as a result of the sale of bankruptcy estate assets. The estate benefits from their sale and, therefore, it makes sense for the bankruptcy estate to pay the taxes. Permitting the discharge of these taxes furthers the goals of the Code.

Argument: IRS (Respondents)

The argument of the IRS centers on two main points: specifically, (1) a chapter 12 plan is limited to pre-petition claims only and (2) post-petition income taxes are not administrative expenses because they cannot be incurred by a chapter 12 estate. Referring to § 1227(a), the IRS argues that a chapter 12 plan is limited to pre-petition debts. The IRS noted that in chapter 12 practice, the payment of income taxes is included in the analysis of determining the debtor's disposable income for payment to creditors through a reorganization plan but is not addressed in the plan. The IRS further asserts that the modeling between chapters 12 and 13 further supports its position in as much as § 1305 expressly provides that post-petition tax claims are treated as pre-petition claims. If post-petition tax claims were automatically treated as pre-petition claims in chapter 12, the Code would reflect as much.[18]

The IRS further argued that even if post-petition administrative expenses are contemplated, the chapter 12 estate cannot incur the tax because the filing of the case does not create a "separate taxable entity" under 26 U.S.C. §§ 1398 and 1399. The IRS provides citation to the *IRS Manual* on various points.[19]

continued on page 78

[14] *Brief for Petitioner* at 7-10 and 32. *Hall v. United States*, 131 S.Ct. 2989 (U.S. 2011) (No. 10-875).
[15] *Brief for Petitioner* at 9. *Hall v. United States*, 131 S.Ct. 2989 (U.S. 2011) (No. 10-875).
[16] 517 U.S. 535, 537, 541-42 (U.S. 1996).
[17] *In re C.J. Knight Realty Corp.*, 501 F.2d 62, 66 (3d Cir. 1974); *United States v. Sampsell*, 269 F.2d 631, 634-35 (9th Cir. 1959).
[18] *Brief for Respondent* at 5, 14, 20 and 31-34. *Hall v. United States*, 131 S.Ct. 2989 (U.S. 2011) (No. 10-875).
[19] *Internal Revenue Manual*, 25.17.12.9.3(1).

from page 29

The IRS distinguished *Noland* on the basis that the case involved employment taxes and not income taxes. The IRS further distinguished *Noland* in as much as it concerned a chapter 11 debtor. Chapter 7 and 11 debtors are responsible for post-petition taxes and filing of returns even though they are not a separate taxable entity pursuant to 26 U.S.C. §§ 6012(b)(3) and 6151(a). The IRS countered the petitioners' argument by stating that Sen. Grassley's comments and the legislative history do not specifically address this particular issue, nor does § 1222(a) technically accomplish the result.

Amici Curiae *Briefs Supporting Family Farmers*

Two *amici curiae* briefs were submitted in support of the Petitioners. The first brief was submitted by three professors with significant expertise in agriculture, bankruptcy and tax law.[20] The *amici* began with:

> If the only tool you have is a hammer, you tend to see every problem as a nail.[21]

The professors proceed to analogize the IRC to the "hammer" referenced. The *amici* take issue with the Code being addressed through the "lens of the IRC."

It is clear that protecting the family farmer was important to Congress. On the other hand, the IRS's position, namely that although Congress wanted to protect family farmers, they simply may have not drafted it quite right, has credence given the role of the respective branches of government.

In addition to supporting the arguments of the petitioners, the significance of the *amici* is its emphasis on the real-life examples of the problems faced by family farmers.[22] The *amici* included five stories of real farming families facing significant personal, agricultural and global economic adversity. The brief provided statistics, including noting that 2,682 chapter 12 cases have been filed since the enactment of Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). The *amici* also asserted that the Ninth Circuit's decision can extend to any governmental claim of any governmental unit including but not limited to government claims associated with the Farm Service Agency (FSA) in which family farmers participate extensively, which is problematic. The second *amici curiae* brief was submitted by counsel for another family farmer who is seeking review by the Supreme Court of the identical issue.[23]

Transcript of Oral Argument to the Supreme Court[24]

The questions asked by the justices include—but are not limited to—whether the legislature actually included language technically sufficient to accomplish the intent to afford relief to the family farmer. Inquiry is made relative to the payment of taxes by the debtor with estate assets and the effect and scope of the bankruptcy discharge.

Information is also sought relative to the length of typical chapter 12 and 13 cases. At least one justice noted that his understanding is that these cases do not span two to three years. The petitioner noted that the instant case was filed in

[20] Neil E. Harl is the Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics at Iowa State University. **Jack F. Williams** is a Professor of Law at Georgia State University College of Law. Robert Hinrichsen is a retired Professor of Business Law at the University of Northern Iowa.

[21] Brief of *Amici Curiae* Professors, page 2, citing to Abraham Maslow (1908-70).

[22] As a resident of the Great Hoosier State, the author is reminded of a song written by John Mellencamp/George Green, "Rain on the Scarecrow" (Mercury Records 1985) (remastered 2005).

[23] *Brief for Donald W. Dawes and Phyllis C. Dawes as Amici Curiae Supporting Petitioners at 2, Hall v. United States*, 131 S.Ct. 2969 (U.S. 2011) (No. 10-875).

[24] The transcript is subject to final review.

2005. Concern is expressed regarding the ability of family farmers to confirm a chapter 12 plan.

Another set of critical issues raised by the Court concerns the estate's status as a separate taxable entity and its ability to incur taxes. The petitioner raised the difference between a taxable entity as defined by the IRC and the bankruptcy estate as conceptualized by the Code. The petitioner noted nuances between the various bankruptcy chapters relative to assets constituting property of the estate and identifies differences in case processes depending on the chapter filed.

The IRS was also asked a variety of questions by the justices. One of the points made by the IRS is that the $29,000 capital gains tax in *Hall* could be set aside from the $960,000 sale. The Court noted the broader implications of the case where funding and confirmation issues exist due to the tax. The Court noted that the exception codified in § 1222(a)(2) has little practical benefit for family farmers if construed consistently with the IRS position.

The IRS conceded that Sen. Grassley's comments indicate the intent to protect the family farmer, but the drafting does not permit that result. The IRS also detailed the revisions over time to the Code and how those amendments and changes are important to consider in understanding legislative intent.

Final Thoughts

After reviewing all of the pleadings, briefs and the transcript of oral argument, it will be interesting to read the ultimate analysis. It will be instructive not just in chapter 12 cases, but in the way the decision may reflect the thinking of the Court on very fundamental issues of strict construction vs. balancing the broader considerations evident in practice, in the record and in legislative history and comment. It is clear that protecting the family farmer was important to Congress. On the other hand, the IRS's position, namely that although Congress wanted to protect family farmers, they simply may have not drafted it quite right, has credence given the role of the respective branches of government. ■