By Susan E. Trent

Hall Creates Chapter 12 Booby Trap

Editor's Note: *For more analysis of this case, see ABI Podcast 115 (http://podcast.abi.org/647), featuring* ***Susan M. Freeman*** *(Lewis and Roca LLP; Phoenix), who represented the petitioner in the U.S. Supreme Court.*

This article discusses the U.S. Supreme Court's May 14, 2012, decision in *Hall v. United States*[1] sustaining the Internal Revenue Service's (IRS) position concerning the liability of a chapter 12 debtor for capital gains taxes. The decision is significant because it adds an additional timing consideration for attorneys to consider in effectively representing the chapter 12 debtor. Until a legislative correction is enacted, chapter 12 attorneys can avoid significant tax implications by carefully considering tax consequences (and potentially conducting farm sales) in advance of filing for chapter 12 relief.

Susan E. Trent
Rothberg Logan & Warsco LLP
Fort Wayne, Ind.

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

Factual and Procedural Background

Lynwood D. and Brenda A. Hall owned a 320-acre farm. After filing for chapter 12, they sold their farm through bankruptcy. The sale price of the farm exceeded the Halls' adjusted tax basis, which resulted in income taxes of $29,000. The Halls' plan proposed to treat these taxes as an unsecured claim under 11 U.S.C. § 1222(a)(2)(A). The IRS objected and took the position that the taxes were an individual, nondischargeable obligation that should be paid from nonbankruptcy assets.

After filing for chapter 12 relief, the petitioners, the Halls, 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 § 1222(a)(2)(A).[2]

The 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 family farmers' 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.[3] Therefore, the capital gains tax was not an administrative expense capable of being discharged in chapter 12.

The U.S. Bankruptcy Court for the District of Arizona[4] concluded, using a plain-meaning approach, that § 1222(a)(2)(A) applied solely to pre-petition taxes accorded priority status under § 507. 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 unsecured claims 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.

On appeal, the U.S. District Court[5] followed a line of cases that permitted family farmers to treat post-petition taxes 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 Bankruptcy 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.

On appeal to the U.S. Court of Appeals for the Ninth Circuit, 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

1 *Hall v. United States*, 182 L.E.2d 840 (U.S. 2012).
2 Unless expressly noted, all citation references are directed to the Bankruptcy Code as found in title 11 of the U.S. Code. The Internal Revenue Code is sometimes referred to as the "IRC."
3 The IRS notes the chapter 7 and 11 exceptions.
4 *In re Hall*, 376 B.R. 741 (Bankr. D. Ariz. 2007).
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 696 (8th Cir. 2009); and *In re Schilke*, 379 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 bankruptcy).

continued on page 76

analogy that "just because all apples are fruits does not mean 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.'"[7] Holding that the "text is the law,"[8] the Ninth Circuit reversed.

The Ninth Circuit decision included a dissent that discussed congressional intent to help family farmers clearly reflected in legislative history and the addition of § 1222(a)(2)(A). Judge Richard A. Paez appeared persuaded by *Knudsen* and similar decisions,[9] noting that those decisions honor congressional intent and "avoid an unwarranted circuit split."[10] On Nov. 29, 2011, the Supreme Court heard oral argument,[11] and on May 14, 2012, it rendered its decision in *Hall*.

Brief Summary of the Argument

Family Farmer (Petitioners)

Four main points are made and refined, namely: (1) § 1222(a)(2)(A) applies to post-petition taxes; (2) the 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 Bankruptcy Code, and not the Internal Revenue Code, controls bankruptcy; and (4) proceeds of post-petition sales benefit bankruptcy estates.

IRS (Respondents)

The IRS centers its argument 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 argued 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 asserted that the modeling between chapters 12 and 13 further supports its position.

Further Support for the Family Farmer

The *amici* emphasize the real-life examples of the problems faced by family farmers and include five stories of real farming families facing significant personal, agricultural and global economic adversity. The *amici* provided statistics including noting that 2,682 chapter 12 cases have been filed since the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).

Oral Argument Before the Supreme Court

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

Information was also sought relative to the length of typical chapter 12 and 13 cases. At least one of the justices noted that his understanding was that these cases do not span two to three years. In response, the petitioner highlighted to the Court that the instant case was filed in 2005. Concern was expressed by the Court regarding the ability of family farmers to confirm a chapter 12 plan if the position of the IRS was sustained by the Court.

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

The IRS was also asked a variety of questions by the Court. 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 that the broader implications of the case where funding and confirmation issues exist due to the tax, and noted that the exception codified in § 1222(a)(2) has little practical benefit for family farmers if construed to be consistent with the IRS position.

The IRS conceded that Sen. Chuck Grassley's (R-Iowa) comments indicated Congress's intent to protect family farmers but maintained that 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.

The Supreme Court Decision in *Hall*

In a 5-4 decision sustaining the position of the IRS, the Supreme Court ruled that the tax resulting from the post-petition sale of the family farm is neither collectible from nor a dischargeable administrative expense of the estate because the chapter 12 estate is not a separately taxable entity. The family farmer is responsible for filing the returns and for payment of the taxes under IRC §§ 1398 and 1399.[12]

Justice Sotomayor delivered the opinion of the Supreme Court and was joined by Chief Justice Roberts and Justices Scalia, Thomas and Alito. The majority found that the arguments made by the petitioners and those reflected in the dissent were unpersuasive given the statute's "plain language, context and structure."[13] First, the majority noted that the petitioners' argument that the phrase "incurred by the estate" had a "temporal" meaning (*e.g.*, the estate cannot incur liability until it exists) was insufficient because the text of the statute does not provide

7 *United States v. Hall*, 617 F.3d 1161 (9th Cir. 2010).
8 *Id.* at 1165.
9 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*.
10 *Hall*, 617 F.3d at 1168.
11 *Hall v. United States*, 131 S.Ct. 2989 (U.S. 2011).
12 *Hall v. United States*, 182 L.Ed.2d 840, 844 (U.S. 2012).
13 *Hall* at 845 (U.S. 2012).

any basis for focusing on *when* liability is incurred.[14] The text simply focused on what happens if liability can be incurred by the estate.

Second, the majority also found the notion that the estate should simply be considered "merged" to be equally unpersuasive because of Congress's "longstanding efforts to distinguish between when tax liabilities are borne by the debtor or borne by the estate."[15] The majority further found as inapposite the corporate cases the petitioners cited that treated taxes as administrative expenses because "corporate debtors have long been singled out by Congress for special responsibilities."[16]

Lastly, the majority found that while the purposes of 11 U.S.C. § 1222(a)(2)(A) may have been to afford family farmers "robust relief," Congress needed to "enact a provision to enable post-petition income taxes to be collected in the Chapter 12 plan in the first place."[17] The majority discussed the compelling policy reasons for permitting the collection and discharge of taxes through the chapter 12 process, but it found that it is "not for us to rewrite the statute," thereby inviting Congress to change the law.[18]

Justice Breyer authored the dissent in which Justices Kennedy, Ginsburg and Kagan joined. The dissent focused primarily on the congressional intent behind the amendment to § 1222(a); namely, to enable family farmers to treat capital gains tax claims as unsecured claims. The dissenting justices pointed out that the majority's holding would enable the government to collect the tax debt in full outside the bankruptcy proceeding and could jeopardize family farmers; future income and assets to a point where the chapter 12 workout was no longer viable. The dissent simply and plainly stated that "Congress did not intend this result."[19] They further stated that the majority interpretation of the relevant language "denies the Amendment its intended effect."[20] In one of its most emphatic statements, the dissent stated that the interpretation adopted is not demanded by the Code, particularly where the interpretation "reduces Congress' Amendment to rubble."[21]

Avoiding the Booby Trap of *Hall*

Simply put, bankruptcy counsel will have to conduct a detailed tax analysis before filing chapter 12 for family farmer clients. If a liquidation is contemplated, the timing of both the sale and the bankruptcy will have to be carefully orchestrated to eliminate uncollectible and nondischargeable post-petition taxes, which may threaten ultimate reorganization.

If there are no significant taxes anticipated, a practitioner can proceed with filing. If, on the other hand, taxes are significant, a pre-petition sale of assets in the tax year prior to an anticipated bankruptcy filing will have to be coordinated.

In theory, coordinating the timing of a pre-petition sale and subsequent bankruptcy filing should be easily surmountable—but only if you ignore the day-to-day hardships and realities faced by family farmers generally. Bankruptcy counsel will also have to be mindful of clear communications with his or her client's secured creditors; even a small family farmer typically has significant secured debt. In the partial-sale context, for example, a secured creditor likely needs to understand from chapter 12 counsel that the two-step process of the pre-petition sale followed by the chapter 12 filing is part of the debtor's overall reorganization plan and not an indication that reorganization prospects have diminished over time. abi

14 *Id.* at 845.
15 *Id.* at 852.
16 *Id.* at 853.
17 *Id.* at 854.
18 *Id.* The majority does not appear to address the pragmatic observation made by the dissent regarding the potential problem of insufficient assets and future income to fund unsecured creditors if a large post-petition tax obligation exists.
19 *Id.* at 856.
20 *Id.* at 857.
21 *Id.* at 864.