"Reorganizing" to Liquidate: Chapter 12 Anomaly

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One favorable aspect of the Bankruptcy Code available to farmers under chapter 12 was enacted during the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Under this provision, a "family farmer"[2] may, at first blush, avoid some, if not all, of the tax generated from the sale of his or her assets.


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However, due to interpretation of some of the finer points of the law, including when the liquidation occurs, what type of asset is sold and an apparent oversight and conflict between the Internal Revenue Code (IRC) and the Bankruptcy Code, a circuit split has developed in the interpretation of this section. Until recently, the Midwestern and predominantly rural circuits had sided with the farmers regarding the dischargability of taxes incurred from the sale of assets in their chapter 12.

There are several distinctions under § 1222(a)(2)(A) that arise during these cases. The first is how to treat capital gains associated with the sale of assets. Arguments exist as to whether the asset is a "capital asset" for liquidation purposes. According to the Internal Revenue Service (IRS), a "capital asset" is an asset used in the trade or business of an individual; in the case of a farmer, land, cattle, etc. may be at issue.[3] Thanks to *In re Knudsen*, and more recently, *In re Ficken* from the Tenth Circuit Bankruptcy Appellate Panel (BAP), *any* asset used in the farm operation is considered a "capital asset" for § 1222(a)(2)(A) purposes. Due to the use of rapid depreciation tables and zero basis in raised livestock, many assets sold as part of the bankruptcy plan are sold at a much higher price than the adjusted basis, triggering significant capital gain and recaptured depreciation. Therefore, this is a powerful provision when able to be applied to farmer's assets across the board.

A critical, secondary argument fostered by the IRS is that the capital gains taxes arising from sales conducted "post-petition" are not dischargeable and must be paid by the farmer. In the post-petition example, the farmer argues that the capital gains taxes are dischargeable as administrative costs of the "estate," arguably created upon filing for bankruptcy. As the reader may be aware, and as is more extensively explained below, the Bankruptcy Code establishes an "estate" in chapter 7 and chapter 11.[4] Certainly historically, chapter 12 and chapter 13 did not establish separate taxable estates and the tax code seems to bolster this posture. Neither BAPCPA nor the tax code explicitly establishes an estate in chapter 12 cases, yet when the revisions are read with congressional intent in mind, § 1222(a)(2)(A) can be read to imply that an estate is created for chapter 12 cases.

Fortunately, the circuit split created by the two interpretations appears to be headed for a resolution: The U.S. Supreme Court has granted *certiorari* to a Ninth Circuit case, *United States v. Hall*.[5] The circuit split and the issues addressed by *Hall* obviously raise difficult questions for the Court to consider. There are basically two lines of cases that have evolved from different circuits interpreting § 1222(a)(2)(A).

Knudsen *and Its Progeny*

In *Knudsen*,[6] various types of the debtors' assets were sold both pre- and post-petition. The IRS attempted to use § 1231 of the IRC, Assets "Used in the Trade or Business," to limit assets to which the provision would apply. Knudsen alleged that all objects used or sold on the farm are "capital assets" under this definition. The IRS argued that the slaughter hogs were similar to inventory held for sale and not a capital asset to be depreciated. The bankruptcy court drew a line between farrow hogs (hogs used for reproduction, etc.) and slaughter hogs. The IRS's argument was that a slaughter hog is not involved in the farm's day-to-day operation, similar to grain that has been harvested. On appeal, the Eighth Circuit disagreed and determined that farm assets used at any point in the lifecycle are within coverage of § 1222(a)(2)(A). Therefore, for dischargeability purposes, it does not matter what type of asset is sold.

The court also held that pre-petition taxes resulting from the sale of assets may be discharged when the asset is sold to "reorganize the farm" for chapter 12. Applying the "best interest" test,[7] the Eighth Circuit determined that requiring farmers to pay all of their priority claims (§ 507(a)(8) claims) before they could receive plan confirmation would eliminate any substantial advantage for the farmer to file.

The court further held that post-petition, pre-confirmation capital gains taxes may be treated as administrative expenses in relation to the "estate" of the chapter 12 farm. Read with congressional intent in mind, the Eighth Circuit determined that BAPCPA implied that an estate is created, despite IRS rules to the contrary. Once establishing an estate, administrative expenses could be attached to it and could be discharged under § 1222(a)(2)(A).

Following this line of decision-making, bankruptcy courts, district courts and

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1 Special thanks to Kyle D. Ritchie in his research and synthesizing of these often-circular cases.
2 An individual (and spouse) engaged in a farming operation that has aggregate debts of under $3,237,000 and the income from the farming operation accounts for at least 50 percent of the farmer's gross income. 11 U.S.C. § 101(18) (2011).
3 I.R.C. § 1231 (2009).
4 11 U.S.C. § 541(a); I.R.C. §§ 1398(a), (f), 1399 (2009).
5 *United States v. Hall*, 617 F. 3d 1161 (9th Cir. 2010), *cert. granted* (2011).
6 581 F.3d 696 (8th Cir. 2009).
7 *In re Knudsen*, 356 B.R. 480 (Bankr. N.D. Iowa 2005), *aff'd, In re Knudsen*, 581 F.3d 696, 715 (8th Cir. 2009), *see also United States v. Villanueva-Sotelo*, 515 F.3d 1234, 1243 (8th Cir. 2008) ("[The court] may seek guidance in the statutory structure, relevant legislative history, [and] congressional purposes expressed in the statute.") The court looked to H.R. Conf. Rep. No. 958, 99th Cong., 2d Sess. 48 (1986).

the BAP in the Eighth and Tenth Circuits have applied the "post-petition" analysis, and allowed the tax associated with post-petition sales of assets to be discharged, to assets such as real property and cattle in *Gartner*,[8] *Dawes*[9] and *Ficken*,[10] respectively. The courts reasoned that requiring a farmer to develop a reorganization plan in its entirety before filing, and requiring the farmer to actually sell assets prior to filing a chapter 12, deprives the farmer of the benefit of the breathing space afforded by the automatic stay. The timing of a filing is often as much dictated by external forces and pressures from creditors as much as the debtor's own desire to file. In other words, this line of cases draws no distinction between what type of asset is sold or whether it is sold pre- or post-petition.

Hall, Smith *and* Dawes

The second line of cases draws a sharp distinction between assets sold pre-petition vs. post-petition. The seminal case holding that the assets have to be sold pre-petition in order to obtain § 1222(a)(2)(A) treatment is *United States v. Hall*. It is a Ninth Circuit case and was recently granted *certiorari* by the U.S. Supreme Court.[11] The Ninth Circuit rejected the analysis of the Eighth Circuit in *Knudsen* and established its own analysis of the "post-petition" capital gains tax issue. IRC § 1399 states that "no separate taxable entity shall result from the commencement of a case under title 11 of the [U.S.] Code except in any case to which section 1398 applies." IRC § 1398 only includes chapter 7 and 11 cases. By this analysis, the Court determined that a chapter 12 estate is not a taxable entity, and therefore cannot "incur" a tax and cannot reap the benefit of § 1222(a)(2)(A). When analyzing Congress' intent, the Court reasoned that the exclusion of an explicit creation of an estate in a chapter 12 meant that Congress did not want the provision to apply to "post-petition" taxes incurred due to resale of assets. Therefore, the debtor incurs the debt personally and is thus personally liable. Simply listing it in a proposed reorganization plan is insufficient to convert the claim to unsecured status; the capital asset must be sold "pre-petition" to receive a discharge.

Following *Hall*, the Third Circuit in *Smith* ruled that "post-petition" taxes are outside of the chapter 12 filing and are not dischargeable.[12] *Smith* involved a dairy farmer who was struggling to make chapter 12 payments through the plan due to fluctuations in the dairy market. The farmer sought to sell his cattle post-petition and post-confirmation as a way to satisfy his debt payments. In other words, his original plan to reorganize did not work and he needed to liquidate. The court determined, similar to *Hall*, that the taxes resulting from the sale of assets are not dischargeable if incurred post-petition and applied the "plain meaning" of the statutory language in its determination. Furthermore, the court found that the debtor's efforts to modify a confirmed chapter 12 plan were not for any of the approved reasons set forth in 11 U.S.C. § 1229(a) (*i.e.*, they were not seeking to increase or decrease the amount of payments to a particular class and were not seeking to extend or reduce the time for payments). The debtor instead was seeking to modify the plan by adding the IRS as a new creditor.

There is obviously a lot of disagreement among the various courts with regard to the extent that BAPCPA was intended to help a chapter 12 farmer. It is likely that the Hall *decision will define the broader reach of the § 1222(a)(2)(A) provisions. What remains to be seen is whether the Supreme Court will address some of the finer points.*

Despite no cases on point, the court relied on chapter 13 decisions disallowing such an amendment to the plan and used this timing as another reason to distinguish the case from *Knudsen* and similar cases. In addition, the court found the reasoning for the proposed amendment to the confirmed plan to be "not in good faith." The amendment sought to sell and distribute the farm assets previously proposed to be retained. The chapter 12 amendments in BAPCPA seem to be centered on making it easier for farmers to partially reorganize, while paring down, so they can continue their farming operation. This decision seems particularly anomalous to the spirit of BAPCPA. It also can be circumvented by dismissing, liquidating and refiling.

Most recently, the Tenth Circuit disregarded the BAP decision in *Ficken* by accepting the *Hall* line of reasoning in deciding *Dawes*.[13] *Dawes* was a case where the IRS executed a forced sale of eight parcels of land as part of a filed, confirmed chapter 12 plan. Note that the debtors' intentions, even "pre-petition," was to sell the assets to satisfy the IRS debt. Consistent with *Knudsen* and *Hall*, the bankruptcy court held that the timing of the sale was immaterial. However, the Tenth Circuit held, following the reasoning in *Hall*, that since the asset was not actually sold pre-petition, the capital gains tax associated with it was not dischargeable. The Tenth Circuit decision in *Dawes* reversed the district court's findings and focused again on the statutory construction, similar to *Hall*.

In addition, the court reasoned that just because a debt could be incurred post-petition does not mean that it is incurred by an estate. Chapter 13 explicitly allows the government the option of having post-petition taxes treated as part of the bankruptcy proceeding.[14]

When the government has a choice of how to treat the expenses, no mandatory estate is created. This distinction is a major difference between chapter 13 and 12 in the Bankruptcy Code. The court reasoned that since the Code grants this flexibility to the governmental unit, any reading of § 503 that limits that flexibility is incorrect. Allowing the debtor the right to choose to discharge the capital gains tax, therefore, would be wrongful.

The Gartner *Options*

The facts of *Gartner* raise interesting questions about strategy for possibly first filing a chapter 13, or even another chapter 12. *Gartner* involved a debtor who commenced his proceeding by filing under chapter 13 and selling farmland resulting in a taxable gain. The debtor then converted to chapter 12 and treated the capital gains as unsecured claims through the plan as "post-petition" taxes. However, in a circuit where "post-petition" taxes are not dischargeable, § 348(a) disallows use of the conversion by keeping the petition date the same as when the chapter 13 was filed. Thus all pre-conversion liquidations are post-petition.

8 *In re Gartner*, 2008 Bankr. LEXIS 3525 (Bankr. D. Neb.).
9 *In re Dawes*, 382 B.R. 509 (Bankr. D. Kan. 2008), *aff'd*, 415 B.R. 815 (D. Kan. 2009), rev'd, 2011 U.S. App. LEXIS 12477 (10th Cir.).
10 *In re Ficken*, 430 B.R. 663 (10th Cir. B.A.P. 2010), *rev'd*, 2011 U.S. App. LEXIS 17473 (10th Cir. Aug. 22, 2011).
11 *Hall*, 617 F.3d 1161.
12 *In re Smith*, 2011 Bankr. LEXIS 749 (Bankr. W.D. Pa.).
13 *In re Dawes*, 2011 U.S. App. LEXIS 12477 (10th Cir.).
14 11 U.S.C. § 1305(a)(1).

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A farmer always has an alternative to avoid the "post-petition" capital gains taxes. First, the debtor could always dismiss the original chapter 13 (or prior chapter 12) and refile under chapter 12, which would allow the "pre-petition" capital gains taxes to be discharged and would be in accordance with the case law in the Eighth, Ninth and Tenth Circuits. The problems facing the debtor-farmer would relate to the time and money wasted to refile. Redundant 341 meetings, filing fees and other meaningless repetitions make this a less desirable route to take unless the situation specifically calls for it. However, if *Hall* is affirmed, It may be the only option for many debtors.

Awaiting Hall....

There is obviously a lot of disagreement among the various courts with regard to the extent that BAPCPA was intended to help a chapter 12 farmer. It is likely that the *Hall* decision will define the broader reach of the § 1222(a)(2)(A) provisions. What remains to be seen is whether the Supreme Court will address some of the finer points. Will the Court continue to protect "pre-petition" capital gains taxes as the Eighth, Ninth and Tenth Circuits have? Will the Court protect the classification of all assets used in the farm operation? Will the Court lend an opinion as to what method is desired for a farmer-debtor to sell capital assets? Time will only tell. One interesting note: Between 1994 and 2003, the Ninth Circuit was either reversed or vacated approximately 80 percent of the time when the Supreme Court granted *certiorari*.[15] ■

[15] Harvard Law Review Association, "Nine Justices, Ten Years: A Statistical Retrospective," 118 *Harv. L. Rev.* 510 (2004).