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## Supreme Court Denies Financially Distressed Farmers Tax Relief

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Chapter 12 of the Bankruptcy Code is used by financially distressed farmers to reorganize and remain in business. In 2005, Congress amended a key provision to allow farmers to have more control over tax debts caused by the sale of assets that may be necessary for successful reorganization. The intention was to simplify a bankruptcy court's approval of a farmer's reorganization plan and to allow the reorganizing farmer to hold on to more cash in the reorganization process by reducing the priority status of tax debts. However, the Supreme Court has confirmed that the Congressional amendment, as drafted, could not accomplish its helpful goals to farmers because of language that did not comport with existing bankruptcy law.

### Farm Reorganizations

Chapter 12 of the Bankruptcy Code is a provision to help financially distressed farmers reorganize and stay in business. Originally legislated as a temporary measure, Chapter 12 was added to the Bankruptcy Code in 1986 as an emergency response to tightening agricultural credit in the wake of several bank failures. It was eventually made a permanent part of the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005. BAPCPA also served to amend Chapter 12 to allow a financially distressed farmer to treat a tax debt as an unsecured debt rather than have that tax debt considered a priority debt. This amendment is important because if the tax debt is a priority debt, the farmer must show the court that the debt can be paid in full before the court can approve the farmer's reorganization plan. However, the tax debt as an unsecured claim only needs to be paid with funds if they are available and any unpaid balance is discharged. This is important for farmers that must sell substantial assets in the reorganization of their business since the asset sales frequently trigger substantial tax liability. Selling farm property or assets coupled with the obligation to pay the resulting taxes in full could leave the farmer without necessary farm assets or cash to continue as a viable family farm business. This can also make it impossible for the court to approve the farmer's reorganization plan. Accordingly, this amendment allowing the farmer to "downgrade" the priority of an IRS tax debt in a Chapter 12 proceeding can be critical in the farmer's successful use of Chapter 12 to keep the family farm in business.

Since the inception of this amendment in 2005, farmers and the IRS have engaged in significant litigation over the issues of the types and the timing of tax liabilities that will qualify for this downgrade of priority.

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## The Knudsen Case

Both the type and timing of tax liability were at issue in *Knudsen v. U.S.*, 356 B.R. 480 (Bankr. N.D. Iowa 2006). In *Knudsen*, the husband and wife farmers owned a 160 acre hog farm. In 2004, to facilitate a change in suffering business operations, they sold various assets including an inventory of hogs, their breeding stock of hogs, farrow equipment, grain and a livestock trailer. The necessary sale of these assets triggered substantial tax liability for the Knudsens. Still finding themselves in continued financial distress in 2005, they filed for farm reorganization under Chapter 12 shortly after the BAPCPA amendment came into effect. The Knudsens sought to take advantage of the BAPCPA amendment and downgrade their tax liability from priority to unsecured debt status. Seeking to reduce the impact of this move, the IRS argued that the type of tax liability determined whether it could be downgraded in priority. Using language within the amendment, the IRS contended that while the Knudsen's sale of capital assets such as the breeding stock, farrowing equipment and livestock trailer triggered tax liability that qualified for downgrade treatment, the sale of the hog inventory and grain resulted in the recognition of income, which triggered tax that did not qualify for a downgrade. The Knudsens argued that nothing in the amendment language made such a distinction with respect to the type of tax that qualified but only indicated that the assets must be "used in" the farming business. The Eighth Circuit court agreed with the Knudsens.

While the assets sold by the Knudsens were sold before they filed their petition into court for Chapter 12 reorganization, their reorganization plan called for the sale of farm property interests after that point. While the IRS agreed that the amendment could be used for taxes attributable to pre-petition asset sales, the IRS argued it could not be used in connection with post-petition sales and the Knudsens would be liable to pay the full amount of taxes triggered on post-petition sales. Using language in the amendment and under prevailing bankruptcy laws, the IRS argued that in order for a post-petition tax debt to qualify for the downgrade under the BAPCPA amendment, it must be a debt in the name of a separate bankruptcy estate. But under bankruptcy law, a separate bankruptcy estate does not exist with a Chapter 12 reorganization, leaving the Knudsens without the benefit of the ability to downgrade the post-petition tax debt. In contrast, the Knudsens argued that the tax debt downgrade applied to all sales whether before or after the Chapter 12 petition was filed. The Eighth Circuit court agreed with the Knudsens on this point, rejecting the IRS argument regarding the need for a separate bankruptcy estate.

Other federal bankruptcy and Circuit courts, including the Ninth Circuit court with *In re Hall*, 617 F.3d 1161 (9th Cir. Ariz. 2010), continued to decide cases regarding the types and timing issues of tax debts, and whether the BAPCPA amendment could be used. Inconsistent decisions among these courts have led to conflicting law among the Circuits on BAPCPA type and timing issues.

## In re Hall

The Halls, husband and wife farmers, triggered a post-petition tax liability of \$29,000 after selling farm property. Using Congress' amendment to Chapter 12, they sought to use the BAPCPA amendment to change their court-approved plan so that the \$29,000 tax liability would be treated as an unsecured debt rather than as a priority claim. However, the Ninth Circuit agreed with the IRS "separate bankruptcy estate" argument. The Ninth Circuit indicated that because the existing debts continued to belong to the Halls and not any separate bankruptcy estate and because they had a post-petition tax debt, the tax debt had to remain a priority debt and the Halls could not benefit from the amendment and downgrade the debt.

## Supreme Court's Review of Hall and May 14, 2012 Decision

The Supreme Court elected to hear an appeal of *Hall* (U.S. Supreme Court case no. 10-875) in order to resolve some of the conflicting rulings among the Circuit courts. After review, the Supreme Court (in a 5-4 decision) agreed with the Ninth Circuit in Hall, issuing its opinion on May 14, 2012. Accordingly, at least the timing issue has now been resolved. Farmers triggering tax liabilities from post-petition asset sales will not receive any benefit from the BAPCPA amendment that was created by Congress to assist them. The Supreme Court did not touch on the subject of the type of tax that might qualify under the BAPCPA amendment since *Hall* was a case that involved the timing of the tax liability.

When first introducing the amendment language in 1999, Senator Grassley of Iowa indicated the BAPCPA amendment's intention of reducing the priority of taxes in a farm reorganization to free up

capital to help the family farm stay in business. While the Halls were the types of farmers that needed the benefit of the amendment, the Supreme Court's decision made it clear that the BAPCPA amendment will be of no help in providing the necessary tax relief to farmers that sell assets after commencing a Chapter 12 proceeding. This frustrates the very purpose of Chapter 12 and the existing BAPCPA amendment. Congress has some further legislative work to do if farmers like the Halls are to receive any tax relief in an effort to successfully reorganize a family farm by effectively using Chapter 12.

Further information and a detailed analysis of the relevant line of cases on the BAPCPA amendment may be found at <http://www.calt.iastate.edu/bapcpa.html>