By Joseph A. Peiffer[1]

Thirty Years of Asking, "Are We There Yet?"

Congress Rights a Taxing Wrong in Chapter 12

Editor's Note: *For more on this topic, please read the article on p. 12. In addition, read p. 95 for excerpts of the law.*

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President Donald Trump signed H.R. 2266 on Oct. 26, 2017, now enrolled as Pub. L. 115-72. Buried at the end of that law providing assistance for disaster relief is a significant change regarding how family farmers can utilize chapter 12 to de-prioritize tax claims, treating them as unsecured claims. It prevents tax authorities from blocking confirmation of chapter 12 plans. Understanding the seismic nature of this change requires reviewing the bankruptcy options available to family farmers beginning with the farm crisis of the 1980s.

The 1980s were a time for family farmers not experienced since the Great Depression. Beleaguered family farmers (BFFs) shared their stories with Sen. Chuck Grassley (R-Iowa), relating that chapter 11 did not help them save their farms. The problems cited were the absolute priority rule,[2] the expense of creditors' committees and the two-part class votes.[3] Chapter 12 was enacted in response during the waning hours of the 99th Congress in October 1986. Congressional staffers holed up in a conference room of the Hart Senate Office Building in Washington, D.C., with smoke billowing out the doors listening to various constituent groups make pitches for what should be included in the legislation.[4]

Chapter 12 went into effect in late November 1986.[5] After its enactment, much like a child on a car trip, the BFFs were asking, "Are we there yet?," referring to a workable bankruptcy solution to save their farms. Congress and the BFFs believed the answer to the question at that time was, "Yes."

Chapter 12's Tax Problem

Early chapter 12 cases raised a significant question: How would the income taxes occasioned by the sale of farm assets by the BFFs both pre- and post-petition be satisfied? The sale of assets to "right-size" a farming operation during the case generated significant capital gains taxes payable as an administrative expense (a second priority).[6] However, the BFFs did not have enough cash flow to pay the taxes in full.

Consequently, the answer to the BFFs' question became, "We're not there yet," and the plans were not confirmable. Given Congress's rush to leave Washington, the drafters lacked the time to run the proposed legislation by the Senate Finance Committee to consider tax questions. Then, the 1986 election saw the balance of power in the Senate change parties. The new leadership had little desire to fix the leftover tax problem faced by the BFFs.

Suggestions to address the problem included reducing the secured creditors' claims to pay the tax claims — an approach that the bankers' lobby rejected. From the enactment of chapter 12 until S. 260, when the Safeguarding America's Farms Entering the Year 2000 Act was introduced by Sen. Grassley and cosponsors in early 1999, no bill had been introduced to address the problem. S. 260 resulted from a suggestion that the tax claims of the family farmer be de-prioritized.[7] Congress's solution was to add § 1222(a)(2)(A). Sen. Grassley's judiciary aide was advised that the proposed language would not survive a U.S. Supreme Court review. The answer to the BFFs' question next became, "I hope so."

S. 260 was incorporated in H.R. 833, the Bankruptcy Reform Act of 2000. During the spring of 2000 at a breakfast, Sen. Grassley answered questions of 30 people about H.R. 833 without notes. One attendee reminded him that many BFFs needed immediate relief from the tax burdens of "right-sizing" their operations. Sen. Grassley responded by instructing his judiciary staffer to change the bill making the tax provision effective upon enactment. Congress passed H.R. 833 by a veto-proof margin. Unfortunately for the BFFs, it was pocket-vetoed by then-President Bill Clinton due to unrelated issues.

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2 11 U.S.C. § 1129(b)(2)(B)(ii).

3 The confirmation requirement in a chapter 11 for approval from greater than half the class votes and more than two-thirds in amount of the creditors voting for the plan allowed a single undersecured creditor to defeat many farm chapter 11s. *See* 11 U.S.C. § 1126(c).

4 Requests by creditors' groups to include a provision similar to § 1111(b) and shared appreciation were considered and discarded by the drafters in favor of a modified chapter 13 on steroids to help save the BFFs. Insight regarding the drafting of chapter 12 was provided by Sen. Grassley's Judiciary Committee counsel, Mr. Gerdano.

5 Pub. L. No. 99-554, "Bankruptcy Judges, United States Trustee, and Family Farmer Bankruptcy Act of 1986."

6 11 U.S.C. § 507(a)(2).

7 De-prioritizing the tax claims was suggested by the author in December 1999. The legislative drafters were unwilling to consider allowing chapter 12 debtors to utilize a short tax year allowed by 26 U.S.C. § 1398(d), which would have ensured that post-petition tax claims would be administrative expense claims so they could be easily de-prioritized by changes to § 1222(a)(2).

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BAPCPA's Fix Tested in Court

In 2005, then-President George W. Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).[8] Immediately, the special de-prioritization tax provisions of § 1222(a)(2)(A) were available to the BFFs. The first case to utilize § 1222(a)(2)(A), *In re Knudsen*, was filed in the Northern District of Iowa.[9] Questions surrounding § 1222(a)(2)(A) were daunting. Since neither debtors' counsel nor the Internal Revenue Service (IRS) had faced litigating a new statute, they collaborated to identify potential issues. An IRS attorney, IRS special procedures agent and debtors' counsel met and spent the afternoon whiteboarding potential issues, including the following:

- Which "farm assets" qualified for the special tax provision?;
- What did the term "used in" mean?;
- What was the debtor's "farming operation?"; and
- How was the tax to be de-prioritized to be calculated?

While they did not agree on the answers to these questions, they outlined the parameters of their disagreements. Primarily, the IRS proposed utilizing a proportional methodology to calculate the tax that could be de-prioritized, while debtors' counsel proposed using a marginal methodology adapted from a special-use valuation method used in estate tax. The proportional method valued each type of tax proportionately, resulting in a higher-priority, nondischargeable tax. The marginal methodology resulted in a lower-priority, nondischargeable and a much higher de-prioritized dischargeable tax.

In *Knudsen*, debtors' counsel faced the question of how to ensure that the IRS would be forced to litigate its issues with the plan at the confirmation hearing rather than attacking the plan after confirmation. The plan delineated the marginal methodology for the assets sold in the tax year before the filing. The plan was feasible without the further sales of assets; however, it was more feasible if additional land was sold, provided that the income taxes could be de-prioritized and discharged in the chapter 12. Given debtors' counsel's belief that § 1222(a)(2)(A) would not survive a strict statutory interpretation to de-prioritize taxes on post-petition sales, the plan provided that there would be no post-petition sales unless there was a final court ruling that the tax occasioned by the post-petition sale of land would qualify for de-prioritization and discharge.

In July 2006, Hon. William Edmonds held a three-day confirmation hearing in *Knudsen* and denied confirmation of the plan.[10] He held that the debtors could only treat capital gains taxes owing on the disposition of capital assets of the farm, not their market hogs; the tax claims subject to § 1222(a)(2)(A) would be discharged upon completion of the payments under the plan; and the debtors could sell assets post-petition and have the taxes qualify for treatment under § 1222(a)(2)(A). After this ruling, the answer to the BFFs' question then became, "I'm not sure."

The Knudsens and IRS both appealed Judge Edmonds' ruling. District Court Judge Mark W. Bennett heard the three-and-a-half hour appellate argument and reversed the bankruptcy court's ruling denying plan confirmation.[11] Among other things, Judge Bennett held that the portion of the federal tax debt to be paid in full as a priority tax claim and the portion to be treated as a mere unsecured claim was to be determined utilizing the "marginal method" of allocation; post-petition sales of farm assets qualified for treatment as an unsecured claim; and taxes on income earned by the debtors during their chapter 12 case were taxes "incurred by the estate," even though the chapter 12 estate was not a separate taxable entity.

The IRS appealed Judge Bennett's decision to the Eighth Circuit Court of Appeals. The Circuit Court ruled on several issues, including that § 1222(a)(2)(A) was not restricted to pre-petition claims owed to creditors, and that taxes on post-petition sales qualified for de-prioritization.[12] After this ruling, the answer to BFFs' question in the Eighth Circuit was, "Yes, we have arrived."

Supreme Court Weighs In

Dark clouds were on the horizon in the Ninth Circuit, however, where the bankruptcy court in *In re Hall*[13] held that the post-petition sale of the Halls' farm, which generated a significant tax, did not qualify for de-prioritization. In *Hall*, the bankruptcy court relied on *In re Brown*,[14] a chapter 13 case in which the debtor sold his interest in rental real estate to his ex-spouse after confirmation of his chapter 13 plan, which provided for payment of 100 percent of the unsecured claims. If the chapter 13 trustee were required to pay the capital gains taxes due to the Commonwealth of Massachusetts and the federal government, there would have been insufficient funds to pay the balance of the unsecured claims in full.

The bankruptcy court in *Hall* adopted *Brown*'s reasoning in determining that the analysis in *Knudsen* was flawed regarding the post-petition applicability of § 1222(a)(2)(A). The debtor in *Hall* faced the prospect of being liable for the capital-gains taxes generated by the post-petition sale of the farm. On appeal, the district court reversed the bankruptcy court.[15] The district court's decision was appealed to the Ninth Circuit, which affirmed the bankruptcy court's ruling.[16] Thus, the next answer to the Ninth Circuit BFFs' question was, "No."

With a split in the circuits regarding the post-petition de-prioritization of governmental claims, the Supreme Court granted *certiorari* to *Hall v. United States*.[17] On May 14, 2012, in a 5-4 ruling containing a strong dissent, the Court decided *Hall v. United States*.[18] It affirmed the Ninth Circuit's

8 Pub. L. 109-8.
9 The author had the privilege of serving as debtors' counsel.
10 *In re Knudsen*, 356 B.R. 480 (Bankr. N.D. Iowa 2006).
11 *In re Knudsen*, 389 B.R. 643 (N.D. Iowa 2008).
12 *Knudsen v. Internal Revenue Serv.*, 581 F.3d 696 (8th Cir. 2008).
13 375 B.R. 741 (Bankr. D. Ariz. 2007).
14 No. 05-41071, 2006 Bankr. LEXIS 3156 (Bankr. D. Mass. Nov. 20, 2006).
15 *United States v. Hall*, 393 B.R. 857 (D. Ariz. 2008).
16 *United States v. Hall*, 617 F.3d 1161 (9th Cir. 2010).
17 564 U.S. 1003 (June 13, 2011).
18 132 S. Ct. 1882 (2012).

decision, holding that the taxes arising from the post-petition sale of the Hall's farm did not qualify for de-prioritization because no separate bankruptcy estate[19] was created in a chapter 12. The Court stated, "Certainly, there may be compelling policy reasons for treating post-petition income tax liabilities as dischargeable. But if Congress intended that result, it did not so provide in the statute. Given the statute's plain language, context, and structure, it is not for us to rewrite the statute, particularly in this complex terrain of interconnected provisions and exceptions enacted over nearly three decades.... As the Court of Appeals noted, 'Congress is entirely free to change the law by amending the text.'"[20]

After the Supreme Court's ruling in *Hall*, the answer for all BFFs' question again was, "No."

The Legislative Response

Suggestions to amend the Bankruptcy Code to rectify the effects of *Hall* were presented to Sen. Grassley the afternoon that *Hall* was decided. Beginning in June 2012, Senate staffers, Ms. Freeman (the attorney who argued *Hall*) and the Knudsens' counsel discussed corrective legislation. In September 2012, Sens. Grassley and Al Franken (D-Minn.) introduced S. 3545, which was referred to the Senate Finance Committee, where it died when the 112th Congress adjourned.

In the next Congress, Sens. Grassley and Franken introduced S. 1427, the Family Farmer Bankruptcy Clarification Act of 2013. This bill provided a legislative basis to allow family farmers to utilize chapter 12 to de-prioritize taxes incurred on the disposition of farm assets and treat them as pre-petition general unsecured claims. However, this bill also died in committee, as did successor bill S. 194 in the 114th Congress.

With persistence, on May 25, 2017, Sens. Grassley and Franken introduced S. 1237, the Family Farmer Bankruptcy Clarification Act. It was assigned to the Senate Judiciary Committee in the current Congress.

In early August 2017, Sens. Grassley and Ranking Democrat Christopher Coons (D-Del.) discussed their legislative wants. Sen. Coons wanted the House-passed bankruptcy judges bill that made the temporary bankruptcy judgeships in Delaware (and other districts) permanent, and Sen. Grassley wanted *Hall* reversed.[21] Interestingly, a White House press release referred to the disaster-relief appropriations and the bankruptcy judges' provisions, but ignored the chapter 12 provisions of the bill.

Again, the BFFs are asking, "Are we there yet?," and the answer this time is, "We hope so." The resulting compromise included a five-year extension of the temporary judgeships together with the legislative reversal of *Hall*. abi

19 A separate bankruptcy estate is established by 26 U.S.C. § 1398(d) for debtors that can have a short tax year.
20 132 S. Ct. 1893.

21 After Congress's August recess, S. 1107 (the Senate version of the Bankruptcy Judges Bill with the anti-*Hall* language included) passed the Senate by unanimous consent. The Administrative Office of the U.S. Courts (AOUSC) found issues in the judgeship language, however. To address these problems, the Senate utilized House bill H.R. 136, which had passed the House earlier. The AOUSC's preferred language was added, and S. 1107 passed, then was sent to the House for action. On Oct. 12, 2017, H.R. 2266 passed the House. The House utilized S. 1107 as a vehicle to attach the hurricane and wildfire supplemental appropriations bill. It was then sent to the Senate, which passed it on Oct. 24, 2017, with an 82-17 vote after significant parliamentary gamesmanship. Two days later, President Trump signed the bill into law.