# Farm Bankruptcy – "Stripping," "Claw-Back" and the Tax Collecting Authorities (Update)

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**Note:** This article is an update to my blog article of May 4, 2020 that can be accessed here: https://lawprofessors.typepad.com/agriculturallaw/2020/05/farm-bankruptcy-stripping-claw-back-and-the-tax-collecting-authorities.html

**Overview**

As originally enacted, Chapter 12 did not create a separate tax entity for Chapter 12 bankruptcy estates for purposes of federal income taxation. That shortcoming precludes debtor avoidance of potential income tax liability on disposition of assets as may be possible for individuals who file Chapter 7 or 11 bankruptcy. But, an amendment to Chapter 12 enacted 19 years after Chapter 12 was established made an important change. As modified, tax debt associated with the sale of an asset used in farming can be treated as unsecured debt that is not entitled to priority and ultimately discharged. Without this modification, a farmer faced with selling assets to come up with funds to satisfy creditors could trigger substantial tax liability that would impair the chance to reorganize the farming business under Chapter 12. Such a farmer could be forced into liquidation.

If taxes can be treated as unsecured debt how are taxes that the debtor has already paid to be treated? Can those previously paid or withheld taxes be pulled back into the bankruptcy estate where they are "stripped" of their priority?

Chapter 12 bankruptcy and priority "stripping" of taxes – it's the topic of today's post.

**2005 Modified Tax Provision**

The 2005 Bankruptcy Code allows a Chapter 12 debtor to treat claims arising out of "claims

owed to a governmental unit" as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" to be treated as an unsecured claim that is not entitled to priority under Section 507(a) of the Bankruptcy Code, *provided the debtor receives a discharge. 11 U.S.C. §1222(a)(2)(A).* The amendment attempted to address a major problem faced by many family farmers filing Chapter 12 bankruptcy where the sale of farm assets to make the operation economically viable triggered gain which, as a priority claim, had to be paid in full before payment could be made to general unsecured creditors. Even though the priority tax claims could be paid in full in deferred payments under prior law, in many instances the debtor did not have enough funds to allow payment of the priority tax claims in full even in deferred payments. That was the core problem that the 2005 provision was attempting to address.

Nothing in the 2005 legislation specified *when* the property can be disposed of to have the associated taxes be eligible for unsecured claim status. Of course, to confirm a Chapter 12 plan the taxing agencies must receive at least as large an amount as they would have received had the claim been a pre-petition unsecured claim. On this issue, the United States Court of Appeals for the Eighth Circuit has ruled that a debtor's pre-petition sale of slaughter hogs came within the scope of the provision, and that the provision changes the character of the taxes from priority status to unsecured such that, upon discharge, the unpaid portion of the tax is discharged along with interest and penalties. *In re Knudsen, et al. v. Internal Revenue*

*Service, 581 F.3d 696 (8th Cir. 2009).* The court also held the statute applies to post-petition taxes and that those taxes can be treated as an administrative expense. Such taxes can be discharged in full if provided for in the Chapter 12 plan and the debtor receives a discharge. Upon the filing of a Chapter 12, a separate taxpaying entity apart from the debtor is not created.

That is an important point in the context of the 2005 amendment. The debtor remains responsible for tax taxes triggered in the context of Chapter 12. The amendment, however, allows non-priority treatment for claims entitled to priority under 11 U.S.C. §507(a)(2). That provision covers administrative expenses that are allowed by 11 U.S.C. §503(b)(B) which includes any tax that the *bankruptcy estate* incurs. Pre-petition taxes are covered by 11 U.S.C. §507(a)(8). But, post-petition taxes, to be covered by the amendment, must be incurred by the bankruptcy estate such as is the case with administrative expenses. Indeed, the IRS position is that post-petition taxes are not "incurred by the estate" as is required for a tax to be characterized as an administrative expense in accordance with 11 U.S.C. § 503 (b)(1)(B)(i), and that post-petition taxes constitute a liability of the debtor rather than the estate. See *ILM 200113027 (Mar. 30, 2001).* The U.S. Circuit Courts of Appeal for the Ninth and Tenth Circuits agreed with the IRS position, as did the U.S. Supreme Court. *Hall v. United States, 132 S. Ct. 1882 (2012).*

**2017 Legislation**

H.R. 2266, signed into law on October 26, 2017, contains the Family Farmer Bankruptcy Act (Act). The Act adds 11 U.S.C. §1232 which specifies that, "Any unsecured claim of a governmental unit against the debtor or the estate that arises before the filing of the petition, or that arises after the filing of the petition and before the debtor's discharge under section 1228, as a result of the sale, transfer, exchange, or other disposition of any property used in the debtor's farming operation"… is to be treated as an unsecured claim that arises before the bankruptcy petition was filed that is not entitled to priority under 11 U.S.C. §507 and is deemed to be provided for under a plan, and discharged in accordance with 11 U.S.C. §1228. The provision amends 11 U.S.C. §1222(a)(2)(A) to effectively override the U.S. Supreme Court decision in *Hall.* As noted above, in *Hall* the U.S. Supreme Court held that tax triggered by the post-petition sale of farm assets was *not* discharged under 11 U.S.C. §1222(a)(2)(A). The Court held that because a Chapter 12 bankruptcy estate cannot incur taxes by virtue of 26 U.S.C. §1399, taxes were not "incurred by the estate" under 11 U.S.C. §503(b) which barred post-petition taxes from being treated as non-priority. The 2017 legislation overrides that result. The provision was effective for all pending Chapter 12 cases with unconfirmed plans and all new Chapter 12 cases as of October 26, 2017.

**Computational Issues**

The 2005 provision also makes no mention of *how* the amount of priority and non-priority tax claims is to be computed. Operationally, if a Chapter 12 bankruptcy filer has liquidated assets used in the farming operation within the tax year of filing or liquidates assets used in the farming operation after Chapter 12 filing as part of the Chapter 12 plan, and gain or depreciation recapture income or both are triggered, the plan should provide that there are will be no payments to unsecured creditors until the amount of the tax owed to governmental bodies for the sale of assets used in the farming operation is ascertained. The dischargeable tax claims are then added to the pre-petition unsecured claims to determine the percentage distribution to be made to the holders of pre-petition unsecured claims as well as the claims of the governmental units that are being treated as unsecured creditors not entitled to priority. That approach assures that all claims that are deemed to be unsecured claims would be treated equitably.

**Methods of computation.** To accurately determine the extent of the priority tax claim under the non-priority provision, it is necessary to directly relate the priority tax treatment to the income derived from sources that either satisfy the non-priority provision or do not satisfy it. There are two basic approaches for computing the priority and general dischargeable unsecured tax claims – the proportional method or the marginal allocation method. The proportional method (which is the IRS approach) divides the debtor's ordinary farming income by the debtor's total income and then multiplies the total tax claim by the resulting fraction. That result is then subtracted from the debtor's total tax liability with the balance treated as the non-priority part of the tax obligation. Conversely, under the marginal approach, the debtor prepares a pro-forma tax return that omits the income from the sale of farm assets. The resulting tax liability from the pro forma return is then subtracted from the total tax due on the debtor's actual return. The difference is the tax associated with the sale of farm assets that is entitled to non-priority treatment.

A shortfall of the IRS' proportional method is that it merely divides the debtor's tax obligation by applying the ratio of the debtor's priority tax claim to the debtor's total income and then divides the total tax claim. That mechanical computation does not consider any deductions and/or credits that impact the debtor's final tax liability, and which are often phased out based on income. Instead, the proportional method simply treats every dollar of income the same. The result is that the proportional method, as applied to many debtors, significantly increases the debtor's adjusted gross income and the priority non-dischargeable tax obligation. The proportional method makes no attempt to measure the type of income, or what income "causes" any particular portion of the tax claim.

The marginal approach was adopted by Eighth Circuit in the *Knudsen* case as well as the Bankruptcy Court in *In re Ficken, 430 B.R. 663 (Bankr. D. Colo. 2009).* The appropriate tax allocation method was not at issue in either of the cases on appeal. The Kansas bankruptcy court also rejected the IRS approach in favor of the marginal method. The most recent court decision on the issue has, like earlier cases, rejected the proportional method in favor of the marginal method. *In re Keith, No. 10-12997, 2013 Bankr. LEXIS 2802 (Bankr. D. Kan. Jul. 8, 2013).*

**What About Withheld Tax?**

Under the 2005 amendment (and the 2017 legislation) taxes triggered by the sale, exchange, etc., of assets used in farming can be stripped of there priority status in a Chapter 12 farm bankruptcy. However, the debtor's method for computing the taxes not entitled to priority involves utilization of the debtor's total tax claim. That means that taxes that have already been withheld or paid through estimated payments should be refunded to the debtor's bankruptcy estate, where it becomes subject to the priority/non-priority computation, rather than being offset against the debtor's overall tax debt (with none it subject to non-priority treatment). Of course, the IRS and state taxing authorities object to this treatment.

Iowa bankruptcy case. The issue of how to handle withheld taxes was at issue in a recent case. *In In re DeVries, No. 19-0018, 2020 U.S. Bankr. LEXIS 1154 (Bankr. N.D. Iowa Apr. 28, 2020),* the debtors, a married couple, filed an initial Chapter 12 reorganization plan that the bankruptcy court held to be not confirmable. The debtors filed an amended plan that required the IRS and the Iowa Department of Revenue (IDOR) to refund to the debtors' bankruptcy estate withheld income taxes. The taxing authorities objected, claiming that the withheld amounts had already been applied against the debtor's tax debt as 11 U.S.C. §553(a) allowed. The debtors claimed that the 2017 legislation barred tax debt arising from the sale of assets used in farming from being offset against previously collected tax. Instead, the debtors argued, the withheld taxes should be returned to the bankruptcy estate. If withheld taxes weren't returned to the bankruptcy estate, the debtors argued, similarly situated debtors would be treated differently.

The debtors sold a significant amount of farmland and farming machinery in 2017, triggering almost a $1 million of capital gain income and increasing their 2017 tax liability significantly. The tax liability was offset to a degree by income tax withholding from the wife's off-farm job. Their amended Chapter 12 plan called for a refund to the estate of withheld federal and state income taxes. In the fall of 2019, the debtors submitted pro forma state and federal tax returns as well as their traditional tax returns for 2017 to the bankruptcy court in conjunction with the confirmation of their amended Chapter 12 plan. The pro-forma returns showed what the debtors' tax liability would have been without the sale of the farmland and farm equipment. The pro-forma returns also showed, but for the capital gain, the debtors would have been entitled to a full tax refund of the taxes already withheld from the wife's off-farm job.

The court was faced with the issue of whether 11 U.S.C. §1232(a) entitled the bankruptcy estate to a refund of the withheld tax. The IRS and IDOR claimed that 11 U.S.C. §553(a) preserved priority position for tax debt that arose before the bankruptcy petition was filed. The court disagreed, noting that 11 U.S.C. §1232(a) deals specifically with how governmental claims involving pre-petition tax debt are to be treated – as unsecured, non-priority obligations. But the court noted that 11 U.S.C. §1232(a) does not specifically address "clawing-back" previously withheld tax. It merely referred to "qualifying tax debt" and said it was to be treated as unsecured and not entitled to priority. Referencing the legislative history behind both the 2005 and 2017 amendments, the court noted that the purpose of the priority-stripping provision was to help farmers have a better chance at reorganization by de-prioritizing taxes, including capital gain taxes. The court pointed to statements that Sen. Charles Grassley made to that effect. The court also noted that the 2017 amendment was for the purpose of strengthening (and clarifying) the original 2005 de-prioritization provision by overturning the result in *Hall* to allow for de-prioritization of taxes arising from both pre and post-petitions sales of assets used in farming. Accordingly, the court concluded that 11 U.S.C. §1232(a) overrode a creditor's set-off rights under 11 U.S.C. §553(a) in the context of Chapter 12. The debtors' bankruptcy estate was entitled to a refund of the withheld income taxes.

On appeal, the bankruptcy appellate panel for the Eighth Circuit reversed. *In re DeVries, 621 B.R. 445 (8th Cir. B.A.P. 2020).* The appellate panel determined that 11 U.S.C. §1232(a) is a priority-stripping provision and not a tax provision and only addresses the priority of a claim and does not establish any right to or amount of a refund. As such, nothing in the statue authorized a debtor's Chapter 12 plan to require a taxing authority to disgorge, refund or turn-over pre-petition withholdings for the benefit of the bankruptcy estate. The statutory term "claim," the court reasoned, cannot be read to include withheld tax as of the petition date. Accordingly, the statute was clear and legislative history purporting to support the debtor's position was rejected.

**Indiana bankruptcy case.** *In re Richards, 616 B.R. 879 (Bankr. S.D. Ind. 2020)* was decided the day after *DeVries.* In re Richards involved debtors, a married farm couple, who filed Chapter 12 bankruptcy in 2018 after suffering losses from negative weather events and commodity market price declines during 2013 through 2015. The primary lender refused to renew the loan which forced liquidation of the farm's assets in the spring of 2016. During 2016, the debtors sold substantially all of the farm equipment, vehicles and other personal property assets as well as grain inventory. The proceeds were paid to the primary lender as well as other lenders with purchase money security interests in relevant assets. After filing Chapter 12, the debtors sold additional farmland. The asset sales triggered substantial income tax obligations for 2016, 2017 and 2018 tax years. The debtors Chapter 12 plan made no mention concerning whether off-farm earnings, tax withholdings or payments the debtors voluntarily made to the IRS, or a claim or refund would remain property of the bankruptcy estate after Plan confirmation. The plan did, however, divide the debtors federal tax obligations into 1) tax liabilities for income arising from the sale, transfer, exchange or other disposition of any property used in the debtors' farming operation "Section 1232 Income"; and 2) tax liabilities arising from other income sources – "Traditional income." Tax liabilities associated with Traditional Income would retain priority status, but taxes associated with Section 1232 Income would be de-prioritized (regardless of when the liability was incurred) and treated as general unsecured claims that would be discharged upon Plan completion if not paid in full. The debtors would pay directly the tax liability associated with Traditional Income incurred after the Chapter 12 filing date. Under the Plan, unsecured claims would be paid on a "pro rata" basis using the "marginal method" along with other general unsecured claims. The Section 1232 taxes would be computed by excluding the taxable income from the disposition of assets used in farming from the tax return utilizing a pro forma tax return.

The Plan was silent concerning how the Debtors' withholding payments and credits for each tax year were to be applied or allocated between any particular tax year's income tax return and the corresponding pro forma return. The IRS filed a proof of claim for the 2016 and 2017 tax years in the amount of $288,675.43. The debtors objected to the IRS's claim, but did seek to reclassify $5,681 of the IRS claim as general unsecured priority status. The IRS failed to respond, and the court granted the debtors approximately $280,000 in tax relief for 2016 and 2017. The debtors then submitted their 2018 federal and state returns showing a tax liability of $58,380 and their pro forma return for 2018 excluding the income from the sale of farm assets which showed a tax liability of $3,399.

The debtors, due to withholding and estimated tax, inadvertently paid $9,813 to the IRS during 2018. The claimed $6,414 was an overpayment and listed that amount on the Pro Forma return as a refund. The IRS amended its proof of claim and asserted a general unsecured claim of $42,200 for the 2018 tax year (excluding penalties and interest). The IRS claimed that none of the debtors' tax liability qualified for non-priority treatment under 11 U.S.C. §1232, and that it had a general unsecured claim for $42, 220 for the 2018 tax year. To reach that amount, the IRS allocated tax withholdings and credits of $9,813 to the assessed tax due on the debtors' pro forma return which reduced that amount to zero, and then allocated the remaining $6,414 of withholdings, payments and credits to the outstanding tax liability of $48,634. IRS later added $6,347 of net investment income tax that the debtors had reported on their return but IRS had excluded due to a processing error. The debtors objected to the IRS's claim and asserted it should not be increased by neither the $6,414 overpayment or the $6,347 of net investment income tax. The debtors sought to adjust the IRS claim to $54,981 and have the court issue a refund to them of $6,414 or reduce distributions to the IRS until the refund obligation had been satisfied. The IRS objected on the basis that the court lacked jurisdiction to compel the issuance of a refund or credit of an overpayment, and that the debtors were not entitled to the refund or credit of the overpayment shown on the pro forma return as a matter of law.

The court sustained the debtors' objection to the extent the 2018 refund was applied to the IRS's claim in a manner other than provided for under the confirmed plan. Specifically, the court held that the IRS has exercised a setoff that was not permitted under 11 U.S.C. §553 which violated the plan's bar against any creditor taking any action "to collect on any claim, whether by offset or otherwise, unless specifically authorized by this Plan." But, the court held that it lacked jurisdiction to compel the issuance of a refund or credit of an overpayment and that the debtors were not entitled to the refund or credit of overpayment as a matter of law. This was because, the court determined, the refund was not "property of the estate" under 11 U.S.C. § §542 and 541(a).

**Note:** While the Indiana bankruptcy court claimed it lacked authority to force the IRS to issue a refund based on a "property of the estate" argument, that argument leads to a conclusion that is counter to the intent and purpose of I.R.C. §1232. How is 11 U.S.C. §1232 to be operative if a court says it can't enforce it? Certainly, filing a Notice of intent concerning the priority stripping of 11 U.S.C. §1232 taxes with the court asserting the debtors' right to receive the tax refund would have teed-up the issue more quickly, one wonders whether a judge intent on negating the impact of 11 U.S.C. §1232 would have decided differently.

Later, the court held that the overpayment reflected on the pro forma return was "property of the estate" and withdrew its prior analysis of 11 U.S.C. §§542 and 505(a)(2)(B). Thus, the court allowed the IRS's 2018 general unsecured tax claim in the amount of $54,981 and ordered the Trustee to pay distributions to the debtors until the overpayments had been paid to the debtors.

The IRS appealed, claiming that the bankruptcy court erred in allowing the IRS's proof of claim in the amount of $54,981 rather than $48,567, and ordering the IRS to issue the debtors a refund or credit of any overpayment in the amount of $6,414. Specifically, the IRS asserted that 11 U.S.C. §1232 did not provide the debtors any right to an "overpayment" or "refund" because it only applies to "claims" - tax liability after crediting payments and withholdings. The IRS based its position on *DeVries.* However, the appellate court in *In re Richards, No. 1:20-cv-027030SEB-MG, 2021 U.S. App. LEXIS 188154 (7th Cir. Sept. 30, 2021),* noted distinctions with the facts of *DeVries.* Here, the sale of property at issue occurred *post-petition* and involved a claim objection after the Plan had already been confirmed. The appellate court noted that the IRS did not object to the terms of the Plan, and under 11. U.S.C. §1232 the debtors were entitled to deprioritize all post-petition Sec. 1232 liabilities, not just a portion. The application of the marginal method resulted in a tax liability of $54,981 to be paid in accordance with Sec. 1232. The non-Sec. 1232 tax liability was $3,399. The debtors inadvertently paid $9,813 to the IRS and were entitled to a refund of $6,414 which the IRS could not apply against the Sec. 1232 liabilities in calculating its proof of claim.

The appellate court also determined that the refund amount was "property of the estate" under 11 U.S.C. §1207(a)(2). The appellate court noted that the debtors' off-farm earnings became property of the estate at the time the Plan was confirmed and became subject to the terms and payment requirements of the Plan. The Plan directed the use of the off-farm earnings during the life of the Plan and specifically provided that off-farm earnings could not be used to pay tax liabilities associated with the sale of farm assets used in farming – the Sec. 1232 liabilities. Thus, the appellate court concluded what the debtors' position was consistent with *In re Heath, 115 F.3d 521 (7th Cir. 1997)* because the $6,414 refund was part of a payment made from off-farm earnings necessary to fund the Plan's payment obligations.

**Conclusion**

*Devries* and *Richards* are important cases for practitioners helping farmers in financial distress. 11 U.S.C. §1232 is a powerful tool that can assist making a farm reorganization more feasible. The Indiana case is a bit strange. In that case, the debtors were also due a refund for 2016. A pro-forma return for that year showed a refund of $1,300. Thus, the issue of a refund being due for pre-petition taxes could have been asserted just as it was in the Iowa case. Another oddity about the Indiana case is that the 2018 pro-forma (and regular) return was submitted to the IRS in March of 2019. Under 11 U.S.C. §1232, the "governmental body" has 180 days to file its proof of claim after the pro forma tax return was filed. The IRS timely filed tis proof of claim and later filed an amended proof of claim which was identical to the original proof of claim. The IRS filed an untimely proof of claim in one of the other jointly administered cases.

Procedurally, in the Indiana case, a Notice regarding the use of 11 U.S.C. §1232 should have been filed with the court to clarify the dates of Notice to the IRS (and other governmental bodies) of the amount of the priority non-dischargeable taxes and 11 U.S.C. §1232 taxes to be discharged under the plan. That is when the issue of the refund would have been raised with the IRS. However, there was no Notice of the filing of the pro-forma return with the court.

**Note:** Going forward, Chapter 12 reorganization plans should provide that if a pro-forma return shows that the debtor is owed a refund the governmental bodies will pay it.

It is also important to remember that if the debtor does not receive a Chapter 12 discharge, the taxing bodies are free to pursue the debtor as if no bankruptcy had been filed, assessing and collecting the tax as well as all penalties and interest allowed by law including any refunds the taxing bodies are forced to make based on § 1232. Competent bankruptcy counsel that appreciates tax law is a must.