

Find this info and more at [AskFrost.com](https://www.AskFrost.com) 

As COVID-19 continues to increase unemployment and lower commodity prices, farm revenue diminishes—increasingly threatening farmers’ ability to repay debt. Unfortunately, this means that farm bankruptcies are projected to increase. As such, more attention is being directed to Chapter 12 farmer and fishermen bankruptcies as a way to help them restructure their debt and remain in operation.

Very recently, on April 29, 2020, a bankruptcy court prevented the Internal Revenue Service (IRS) from applying an offset to the debtors’ 2018 tax refund against debtors’ 2016 and 2018 tax liabilities in a confirmed Chapter 12 bankruptcy plan. The *In re Richards* court determined that:

“Section 1232 taxes are to be treated as a dischargeable, pre-petition tax under §1232(a)(1). Therefore, the setoff was not among mutual, pre-petition obligations as required under §553.”¹

The case is a noteworthy victory for debtors in that it reminds us during these chaotic times that Chapter 12 bankruptcy significantly curtails the IRS’s ability to offset. However, *In re Richards* should also encourage farmers considering Chapter 12 to consult with a professional given the

particularly unique nature of Chapter 12. Even in this recent case—an overall win—since the debtors’ reorganization plan was not more carefully created to provide that post-petition tax refunds would remain “property of the estate,” the court declared that it was unable to order the refund to be paid to the bankruptcy estate. Instead, the court noted that the debtors were free to modify their plan.

Background

The enactment of Chapter 12 bankruptcy in 1986² enabled “financially distressed family farmers and fishermen to propose and carry out a plan to repay all or part of their debts.”³ However, as originally enacted, it failed to create a new and



separate tax entity upon bankruptcy filing, which is very helpful in avoiding potential income tax liability when assets are liquidated in a reorganization. The result of this omission was that farmers often incurred substantial taxable gains or depreciation recapture when forced to sell low basis assets to satisfy creditors, creating large priority claims which ultimately prevented the confirmation of Chapter 12 plans.

After many years, modifications were finally enacted, which offered some relief to farmers facing this predicament. First, in 2005, legislation was enacted that was intended to provide struggling farmers with the ability to downsize and restructure without paying resulting taxes in full.

Specifically, before clarification from a subsequent act in 2017, legislation in 2005 added 11 U.S.C. §1222(a)(2)(A), which provided that a debtor could treat amounts arising out of claims “owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor’s farming operation, [. . .] as an unsecured claim that is not entitled to priority under section 507,” provided the debtor receives a discharge.⁴

Unfortunately, the intent behind the 2005 legislation was thwarted by case law, which picked up on the fact that the legislation failed to specify when the property disposal may occur for the associated taxes to qualify for unsecured claim status. The Supreme Court in *Hall v. United States* determined that capital gains taxes are only treated as general unsecured claims if the sale occurred in the tax year preceding the filing of the bankruptcy case—not if the sale occurred during the bankruptcy.⁵

Thus, the Additional Supplemental Appropriations for Disaster Relief Requirements Act of 2017 added 11 U.S.C. §1232, which effectively overrode *Hall v. United States*, clarifying that Chapter 12 debtors can sell property during the bankruptcy process and receive favorable capital gains treatment.⁶ Specifically, 11 U.S.C. §1232 provides 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—



- shall be treated as an unsecured claim arising before the date on which the petition is filed;
- shall not be entitled to priority under section 507;
- shall be provided for under a plan; and
- shall be discharged in accordance with section 1228.

In re Richards

In May of 2018, Debtors (a married couple) filed Chapter 12. In October of 2018, their reorganization plan was confirmed. According to the confirmed plan, the IRS’s priority claims for 2016 and 2017 were \$0 and \$5,681, respectively. Although no tax liability was due yet for 2018, “the plan provided that there would be additional liquidation of farm assets in 2018 and occurring during the pendency of the case that would qualify for treatment under §1232.”⁷ Moreover, the plan was clear that it was the only means by which “any and all claims” were to be paid post-petition, and that it would not curtail the exercise of an 11 U.S.C. §553 valid right of setoff.⁸

Debtors sold farm assets in 2018 and prepared a pro forma 2018 income tax return. The pro forma return showed that Debtors were entitled to a refund in the amount of \$6,414.

Thereafter, in October of 2019, the IRS amended its claim to reflect that it had offset the 2018 refund against Debtors’ 2018 unsecured §1232 taxes. Later at a hearing on the objection, it was claimed that the IRS had applied the refund to the 2016 priority taxes and the 2018 unsecured §1232 taxes.

Debtors objected, arguing that the confirmed plan prohibited the setoff and requested the court to order the IRS to issue the 2018 refund to them.

The court first considered 11 U.S.C. §553, which can act to preserve the IRS’s ability to offset a debtor’s tax liability

ty against a debtor’s tax refund. The court concluded that the IRS’s offset in this case failed to satisfy the 11 U.S.C. §553 requirements. Specifically, the court stated that “the setoff was not among mutual, pre-petition obligations as required under §553.”⁹ Rather, the IRS took a post-petition refund and applied it to prepetition debt.

Ultimately, the court ruled that the IRS’s offset violated the reorganization plan, but the court was unable to order the refund to be paid to Debtors. Since the plan lacked language providing that post-petition tax refunds remain “property of the estate,” the court could only advise Debtors that they were free to modify their reorganization plan.

Conclusion

The accumulating pandemic-induced pressures on farmers is projected to increase Chapter 12 filings. As we’ve described, Chapter 12 can significantly curtail the IRS’s ability to offset; however, Debtors can save themselves a great deal of trouble by engaging professionals who are experienced with the Chapter 12 provisions for farmers—such as ensuring that a plan is created from the beginning that will require the IRS to pay any refund shown as owed to a debtor on a pro forma return.

Editor’s Note: Chapter 12 has unique applicability for fishermen, as well—although not all provisions applicable to farmers are also available to fishermen. Still, it is certainly a viable option for struggling fishermen who need to restructure their debt and remain in operation.

If you have questions or concerns regarding Chapter 12 bankruptcy, call Frost Law today at (410) 862-2806 or fill out our contact form.

Footnotes

1. *In re Richards*, No. 18-03418-RLM- 12, 6 (Bankr. S.D. Ind. Apr. 29, 2020).
2. Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986).
3. <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-12-bankruptcy-basics>.
4. Added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1003, 119 Stat. 23 (2005), effective on enactment, April 20, 2005.
5. 566 U.S. 506 (2012).
6. Pub. L. No. 115-72, §1005, applicable to any bankruptcy case (1) that is pending on October 26, 2017, in which a plan has not been confirmed and an order of discharge has not been entered; and (2) any bankruptcy case commencing on or after October 26, 2017.
7. *In re Richards*, No. 18-03418-RLM- 12, at 3.
8. *Id.*
9. *Id.* at 6.

More Resources on [AskFrost.com](https://www.AskFrost.com)



CARES Act Relief – Federal Contractor Relief

Federal contractor relief is summarized below. You can jump to specific sections by using the links below.
SummarySection ...

[CONTINUE READING](#)



Should You Consider Bankruptcy? Five Things You Should (or Shouldn't) Do!

Have you lost your job? Have your hours been drastically cut at work? Do you own a business that is struggling to make ends meet? ...

[CONTINUE READING](#)



Guidance for Self-Employed Schedule C Needing a PPP Loan

Executive Summary ✓ New interim final rule providing PPP guidance for self-employed Schedule C filers ✓ Outlines PPP loan ...

[CONTINUE READING](#)

