Hall v. U.S.: Chapter 12 Debtors Liable for Post-Petition Taxes « Consider Chapter 13

BY CONSIDER CHAPTER 13, ON JUNE 3RD, 2012

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In a 5-4 decision issued on May 14, 2012,[1] the U.S. Supreme Court ruled that federal income taxes resulting from the post-petition sale or disposition of farm assets are not "incurred by the estate" under section 503(b) of the Bankruptcy Code (all "section" references are to the Bankruptcy Code unless otherwise indicated) and, thus, are neither collectible nor dischargeable in a Chapter 12 plan. Because the Chapter 12 estate is not a separate taxable entity, the Court found the debtor, not the trustee, is liable for such taxes and files the corresponding tax return. The Court's decision resolves the conflict between two federal courts of appeal — the Ninth Circuit's decision in Hall, the reasoning of which the Supreme Court primarily adopts, and the Eighth Circuit's decision in Knudson v. IRS, which interpreted the Bankruptcy Code as not expressly prohibiting a Chapter 12 estate from incurring taxes as administrative expenses within the meaning of section 507(a)(2).

Facts

In Hall, the petitioners filed for bankruptcy under Chapter 12 and sold their family farm shortly thereafter. The petitioners' plan of reorganization was based on using the farm sale proceeds to pay off their liabilities. However, the Internal Revenue Service (hereinafter, "IRS") objected to the plan, asserting a claim of $29,000 in federal income taxes arising from the sale. Accordingly, petitioners amended their reorganization plan, treating the federal income tax as a general, unsecured claim to be paid out of any remaining funds, resulting in the discharge of any taxes left unpaid after all funds had been exhausted. The IRS immediately objected, arguing that taxes arising out of a post-petition farm sale are neither collectible nor dischargeable in a Chapter 12 bankruptcy; rather, the debtors are individually responsible for the taxes. The Bankruptcy Court agreed with the IRS, concluding that a Chapter 12 estate is not a separate taxable entity under Internal Revenue Code (hereinafter, "IRC") sections 1398 and 1399, and, thus, cannot "incure" taxes under section 503(b). Upon review, the District Court reversed, doubting the relevance of the IRC sections in interpreting section 503(b) and concluding that Congress intended section 1222(a)(2)(A) to cover petitioners' post-petition taxes. As previously discussed, the Ninth Circuit reversed.

Analysis

The Supreme Court addressed the issue of post-petition tax liability on three primary fronts: (i) the meaning of "incurred by the estate" under section 503(b); (ii) the framework of section 346 and IRC sections 1398 and 1399; and (iii) the modeling of Chapter 12 on Chapter 13 and the established interpretations and practices under the latter.

1. Meaning of "incurred by the estate" under section 503(b)

The Court announced that the resolution of the case turned on the meaning of section 503(b)(1)(B), which makes "any tax . . . incurred by the estate" into an administrative expense entitled to priority under section 507(a)(2). Under section 1222(a)(2)(A), section 507 claims of governmental units arising from the sale or other disposition of farm assets in a Chapter 12 plan are treated as unsecured claims that are dischargeable and payable in full provided the debtor receives a discharge. Accordingly, the term "incurred by the estate" is crucial for discharge.

The Court stated that "[a] tax incurred by the estate is a tax for which the estate itself is liable." Under IRC sections 1398 and 1399, only certain bankruptcy estates are liable for federal income taxes. IRC section 1398 provides that Chapter 7 and 11 estates are liable for taxes, accompanied by the trustee's responsibility to file an estate income tax return. However, unless IRC section 1398 applies, IRC section 1399 provides that "no separate taxable entity shall result from the commencement of a [bankruptcy] case." Accordingly, the Court concluded that no separate taxable estate arises in Chapter 12 and 13 cases, precluding the collection and discharge of any post-petition taxes in the Chapter 12 plan. Without an estate to "incure" the tax, any post-petition income taxes as well as tax return filings are the responsibility of the Chapter 12 debtor.

2. Interplay between section 346 and IRC sections 1398 and 1399

To buttress its section 503(b) interpretation, the Court also relied on section 346. Before revisions to the section in 2005, section 346(b)(1) of the 1978 Bankruptcy Code provided that with respect to state and local taxes the estate, and not the individual debtor, in Chapter 7 and 11 cases was liable. Section 346(d) further provided that the debtor, not the estate, in a Chapter 13 bankruptcy was liable for state and local taxes. Accordingly, the Court was persuaded that these two provisions illustrated a "chapter-specific division of tax liabilities between the estate and the debtor." In addition, the Court explained that Congress applied this same chapter-specific framework to federal taxes when IRC sections 1398 and 1399 were enacted in the Bankruptcy Tax Act of 1980. As previously explained, these IRC sections "clarified" that Chapter 13, and later Chapter 12, estates were not separately taxable.

In addressing the 2005 amendments to section 346, the Court concluded that such amendments only "crystallized" the parity between the Bankruptcy Code and the IRC with respect to tax liability. Accordingly, whenever there is a separately taxable estate for federal income tax purposes it is also the case for state and local taxes under section 346(a); if no separate taxable estate for federal purposes, then likewise no taxable estate for state and local purposes under section 346(b). In a footnote, the Court examined legislative history, confirming its conclusion that Congress has historically viewed section 346 as "defining which estates were separate taxable entities.

The Court acknowledged that Congress added section 1222(a)(2)(A) at the same time it revised section 346, instituting an exception to the priority classification scheme. Nevertheless, the Court concluded that section 1222(a)(2)(A) did not "purport to redefine which claims are otherwise entitled to priority, much less alter the underlying division of tax liability between the estate and the debtor in Chapter 12 cases." The dissenting justices, at last discussed, completely disagreed with this majority view.

3. Using Chapter 13 to construe Chapter 12 provisions

Citing a prominent bankruptcy treatise and lower court decisions, the Court adopted their recognition that Chapter 12 was modeled on Chapter 13, therefore Chapter 13 provisions and interpretative case law are relevant authority for resolving Chapter 12 issues. Both Chapters require full payment of all claims entitled to section 507 priority, both are treated similarly under IRC sections 1398 and 1399, and courts have similarly reasoned that post-petition taxes are not "incurred
by the estate" under section 503(b) in either Chapter 12 or Chapter 13 cases. IRS Chief Counsel advice and other internal IRS guidelines similarly treat post-petition taxes as falling outside the purview of section 503(b). The Court also referenced section 1305 as further support that post-petition income taxes are not automatically collectible in a Chapter 13 case without a proof of claim (as required under that section).

Perhaps most revealing about the Court’s comparison of Chapters 12 and 13 is the time it spent discussing how any conflicting reading of section 503(b) for Chapter 12 purposes would “disrupt established Chapter 13 practices.” Observing that “Chapter 13 filings outnumber Chapter 12 filings six-hundred-fold,” the Court cautioned that holding for this Chapter 12 petitioner “would mean that, in every Chapter 13 case, the Government could ignore §1305 and expect priority payment of post-petition income taxes in every plan.”

The attorney for the petitioners noted after the decision the majority’s disregard for the petitioner’s argument that Chapter 12 is a “hybrid between Chapter 11 and 13” and has more similarities to Chapter 11 because farm reorganizations are more akin to business reorganizations (a “rarity” in Chapter 13 cases).[2] She also discussed the petitioners’ contention that administrative priority would only apply to taxes incurred in the brief administration period, after the petition is filed and before the confirmation of the plan. The Court’s dissenters in Hal agreed and did not “see the harm” in treating taxes incurred during this brief period as administrative expenses in both Chapter 13 and 12 cases.[3]

Dissent

Among more technical arguments, the dissenting justices primarily argued that the majority’s opinion contravenes Congress’s Intent. The purpose of Chapter 12, noted the dissent, was to assist family farmers engulfed in economic difficulty in reorganizing their debts without sacrificing their farms. Consistent with this purpose, section 1222(a)(2)(A) was enacted to treat certain tax claims as ordinary, unsecured claims, dischargeable in whole or in part as part of a Chapter 12 plan. The dissent argued that the majority’s opinion belies Congress’s original intent, quoting the amendment’s sponsor, Senator Charles Grassley: Section 1222(a)(2)(A) “takes this power away from the I.R.S. [power to veto a farmer’s reorganization plan] by reducing the priority of taxes during [Chapter 12] proceedings. This will free up capital for investment in the farm, and help farmers stay in the business of farming.”[4]

Conclusion

Clearly the Hall decision has potentially far-reaching impact on Chapter 12 bankruptcies. The inability of farmers to either cover post-petition taxes with Chapter 12 plan assets/funds or to discharge any of those taxes will likely lead to greater reluctance to utilize Chapter 12 for debt relief. Chapter 11 could become a better alternative, since the estate is considered taxable and liable for post-petition taxes under both the IRC and the Bankruptcy Code. However, Chapter 11 involves a more complicated process, requiring creditor consent to the plan in addition to other obstacles.[5] Furthermore, the Hall interpretation of section 503(b) will likely apply to other taxes, besides capital gains taxes on the sale of farm assets.[6] These and a myriad of other practical issues raised by Hall will likely be addressed in future cases. But, because Hall appears to directly contradict at least Senator Grassley’s intent with respect to some of the Chapter 12 provisions at issue in the case, the truly interesting development will be Congressional reaction to the Hall decision and potential legislation in response.

[3] Id.
[6] Id.

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