NATIONAL BANKRUPTCY CONFERENCE
A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration

OFFICERS
Chair
RICHARD B. LEVIN
Vice Chair
R. PATRICK VANCE
Secretary
PROF. KATHERINE M. PORTER
Treasurer
EDWIN E. SMITH

CONFEREES
HON. THOMAS L. AMBRO
PROF. DOUGLAS G. BAIRD
MICHAEL ST. PATRICK BAXTER
DONALD S. BERNSTEIN
*RICHARD F. BROUDE
HON. LEIF M. CLARK
*MICHAEL J. CRAMES
*MURRAY DRABKIN
PROF. DAVID G. EPSTEIN
CHAIM J. FORTGANG
PROF. S. ELIZABETH GIBSON
DANIEL M. GLOSBAND
MARCIA L. GOLDSTEIN
ROBERT A. GREENFIELD
HON. ALLAN L. GROPPER
HON. BARBARA J. HOUSER
MARSHALL S. HUEBNER
PROF. MELISSA B. JACOBY
CARL M. JENKS
*JOHN J. JEROME
RICHARDO I. KILPATRICK
PROF. KENNETH N. KLEE
DAVID A. LANDER
JONATHAN M. LANDERS
*HON. JOE LEE
HEATHER LENNOX
E. BRUCE LEONARD
MARC A. LEVINSON
HON. KEITH LUNDIN
HON. RALPH R. MABEY
PROF. RONALD J. MANN
HON. BRUCE A. MARKELL
THOMAS MOERS MAYER
TODD F. MAYNES
PROF. TROY A. MCKENZIE
*HARVEY R. MILLER
HERBERT P. MINKEL, JR.
PROF. JEFFREY W. MORRIS
PROF. EDWARD R. MORRISON
*GERALD F. MUNITZ
SALLY SCHULTZ NEELY
HAROLD S. NOVIKOFF
ISAAC M. PACHULSKI
PROF. RANDAL C. PICKER
JOHN RAO
PROF. ALAN N. RESNICK
HON. BRENDAN L. SHANNON
*RAYMOND L. SHAPIRO
*MYRON M. SHEINFELD
HON. A. THOMAS SMALL
*GERALD K. SMITH
HENRY J. SOMMER
JAMES H.M. SPRAYREGEN
RICHARD S. TODER
*J. RONALD TROST
JANE L. VRIS
HON. EUGENE R. WEDOFF
PROF. JAY L. WESTBROOK
ROBERT J. WHITE
BRADY C. WILLIAMSON
**Senior Conferee*

EMERITUS
HERBERT H. ANDERSON
PAUL H. ASOFSKY
JOHN A. BARRETT
R. NEAL BATSON
H. BRUCE BERNSTEIN
STEPHEN H. CASE
HON. DAVID COAR
RONALD DEKOVEN
DEAN M. GANDY
HON. ROBERT E. GINSBERG
GEORGE A. HAHN
HON. HERBERT KATZ
MORRIS W. MACEY
HON. ROBERT D. MARTIN
PATRICK A. MURPHY
LEONARD M. ROSEN
HON. MARY DAVIES SCOTT
LAWRENCE K. SNIDER
GEORGE M. TREISTER
JOEL B. ZWEIBEL

ADMINISTRATIVE OFFICE
SHARI A. BEDKER

December 5, 2012

The Honorable Charles E. Grassley
United States Senate
Washington, DC 20510

Re: S. 3545 – Family Farmer Bankruptcy Tax Clarification Act of 2012

Dear Senator Grassley:

The National Bankruptcy Conference (NBC) is a voluntary, non-partisan, not-for-profit organization composed of about 60 of the nation's leading bankruptcy judges, professors and practitioners. It has provided advice to Congress on bankruptcy legislation for over 70 years. I enclose a Fact Sheet, which provides further information about the NBC and its members

The NBC has reviewed the "Family Farmer Bankruptcy Tax Clarification Act of 2012 (S. 3545) and is pleased to support the goal of the bill, which is to reduce the burden of capital gains taxes relating to the sale of farm assets when a family farmer seeks financial relief under chapter 12 of the Bankruptcy Code. However, the NBC recommends certain improvements to S. 3545, including revisions that are necessary to realize the goal of the bill.

Background

In 2005, Congress amended Section 1222(a) of the Bankruptcy Code in an attempt to reduce the burden of capital gains taxes on a family farmer who sells assets during a chapter 12 case. It did so by providing that those taxes would lose their priority status under section 507 of the Bankruptcy Code, be treated as general unsecured claims, and be discharged. However, the Internal Revenue Service focused on the statutory language, rather than its purpose, and took the position that the amendment affected only taxes "incurred by the estate." Because, under the Internal Revenue Code, no separate taxable estate is created in a chapter 12 case, the IRS argued that a capital gains tax arising from a postpetition asset sale in a chapter 12 case is outside the scope of the amendment.

The U.S. Supreme Court resolved this issue in the IRS's favor in a 5-4 decision in *Hall v. United States*, 132 S. Ct. 1882 (2012). The majority concluded that taxes arising from the sale of assets during a chapter 12 case are not "incurred by the estate," because no separate taxable estate is created in a chapter 12 case. As a result, the 2005 amendment could apply only to capital gains taxes incurred prepetition. Senator Grassley has recently introduced S. 3545 to reverse the result in *Hall*.

While the NBC supports the goal of S. 3545, we believe that, like the 2005 amendment, it may be subject to interpretation that would defeat its purpose. Accordingly, we recommend certain improvements to make the bill effective and propose draft amendments to accomplish that.

PMB 124, 10332 MAIN STREET • FAIRFAX, VA 22030-2410 • TEL: 703-273-4918 • FAX: 703-802-0207
E-mail: info@nbconf.org • Website: www.nationalbankruptcyconference.org

Recommended Improvements to S. 3545

(1) *The new Code provisions added by S. 3545 should not be placed in section 1222.*

Section 1222 of the Bankruptcy Code, entitled "Contents of Plan," includes a list of provisions that are mandatory for chapter 12 plans and a list of provisions that are optional. S. 3545 places almost all provisions relating to tax claims arising from the sale of assets in section 1222, including provisions that do not relate to the contents of a plan. Most notably, S. 3545 adds new subsection (e) to section 1222 to provide new procedures and time limits for filing a proof of claim by the government or, if the government does not file a proof of claim, by the debtor or the trustee. Similarly, S. 3545 would add a new paragraph 1222(e)(3) on the allowance and disallowance of claims. The NBC recommends that such provisions not be placed in section 1222. Although section headings are not dispositive, we are concerned that the scope of the provisions that the amendment proposes might be construed narrowly if placed in section 1222. We suggest that, instead of amending section 1222 and other sections as set forth in the bill, the bill be revised to add a new section 1232, entitled "Tax on the Disposition of Property Used in a Farming Operation," that would put in one place the provisions governing this kind of tax claims arising from the sale of assets. It would also be necessary to make certain conforming or technical amendments to sections 1222(a), 1228, and 1229.

(2) *Revision of the "best interest of creditors" requirement in section 1225(a)(4).*

Under section 1225(a)(4) of the Bankruptcy Code, a chapter 12 plan cannot be confirmed unless each holder of an unsecured claim will receive under the plan a distribution that is not less in value, as of the effective date of the plan, than the amount that would be paid on the claim if the estate of the debtor were liquidated under chapter 7. This is commonly referred to as the "best interest of creditors" requirement. In a chapter 7 case, assets owned by the debtor would become property of the estate, and any tax claim arising from the sale of such assets during a chapter 7 case would be entitled to administrative expense priority under section 503(b)(1)(B) and 507(a)(2) of the Bankruptcy Code. Any tax arising from prebankruptcy asset sales would be entitled to priority under section 507(a)(8) of the Code. In either event, such taxes would have to be paid in full before general unsecured creditors would be entitled to any distribution in the chapter 7 case. For that reason, under section 1225(a)(4), unless its claim was paid in full, the IRS would be able to object successfully to confirmation of a chapter 12 plan if, as is intended by S. 3545, tax claims arising from asset sales are to be treated as nonpriority unsecured claims in the chapter 12 case. Therefore, the NBC recommends that the legislation modify the application of section 1225(a)(4) with respect to tax claims arising from the sale of assets to accommodate treatment of such claims as nonpriority unsecured claims. The draft below addresses this through proposed section 1232(b).

(3) *Revision of the "hardship discharge" under Section 1228(b).*

Section 1228(b) of the Bankruptcy Code provides for a discharge of debts despite the debtor's failure to complete payments under a chapter 12 plan when such failure is due to circumstances for which the debtor should not justly be held accountable. However, such a "hardship discharge" is not available unless the value of property actually distributed to each unsecured creditor is not less than the amount that would have been paid to the creditor if the estate of the debtor had been liquidated under chapter 7. As discussed above, prepetition and postpetition tax claims arising from asset sales would be entitled to priority treatment in a

chapter 7 case and, therefore, a hardship discharge under section 1228(b) would not be available to debtors if, as is intended by S. 3545, such tax claims are treated as general unsecured claims under a chapter 12 plan. For that reason, the NBC recommends that the legislation modify the application of section 1228(b) to permit a hardship discharge for debtors who have made actual distributions on tax claims arising from the sale of assets that were not less than the amount that would have been paid on them as nonpriority unsecured claims if the estate had been liquidated in a chapter 7 case. The draft below also addresses this through proposed section 1232(b).

(4) *Provide that the exception from discharge in section 1228(b)(2) and (c)(2) does not apply to tax claims arising from asset sales.*

Under section 1228(a)(2) and (c)(2) of the Bankruptcy Code, debts are not dischargeable in a chapter 12 case if they are of a kind specified in section 523(a). Section 523(a)(1) renders nondischargeable a tax of a kind that is entitled to priority under Section 507(a)(3) or 507(a)(8). As a result, priority tax claims are not dischargeable in a chapter 12 case. Therefore, the NBC recommends that chapter 12 be amended to provide expressly that a tax claim arising from the sale of assets is dischargeable, which is one of the purposes of S. 3545. Sections 1232(c), 1228(b)(2) and 1228(c)(2) of the draft below, read together, so provide.

(5) *Provide clarity as to the end date when tax claims arising from assets sales by the debtor are no longer subject to nonpriority treatment under S. 3545.*

S. 3545 treats both a prepetition and a postpetition tax claim arising from an asset sale as prepetition nonpriority unsecured claims, but does not provide a date after bankruptcy when sales are no longer given such treatment. To avoid uncertainty as to when S. 3545 treatment no longer applies with respect to asset sales occurring postpetition, the NBC recommends that the bill clarify that it applies to asset sales occurring before the debtor obtains a discharge under section 1228. Except in cases involving a hardship discharge, a discharge in chapter 12 cases is granted after the completion of all payments under the plan. If the case is dismissed or converted to a case under a different chapter before the debtor obtains a discharge, the provisions of S. 3545 would not be applicable after such dismissal or conversion because there will no longer be a chapter 12 case.

(6) *Clarifying how the amount of the allowed prepetition unsecured tax claim arising from the sale of assets is to be determined and the application of tax attributes.*

We note that both the 2005 amendment to section 1222 and S. 3545 seems to require that the entire tax claim arising from a capital gain event during the postpetition period be treated as a general unsecured prepetition claim. It is unclear to us from this formulation whether tax attributes, such as loss carryforwards, that the debtor may have incurred before filing for bankruptcy are to be used to reduce or eliminate any such claim. Nor is it clear to us whether losses generated by the debtor during the case, either from operations or from losses on other asset sales, are supposed to be taken into account in determining the amount of the prepetition nonpriority unsecured tax claim.

We recommend that consideration be given to including language in the bill to make it clear how tax attributes incurred by the debtor before the bankruptcy filing are to be used in calculating the amount of the unsecured nonpriority prepetition tax claim arising from the sale

of assets. One approach would be to require that prepetition tax attributes be used in calculating the amount of the unsecured nonpriority prepetition tax claim arising from an asset sale. For example, if the debtor incurred a capital loss in 2010 of $100, filed under chapter 12 in 2012, and generates a capital gain of $250 in 2013, the amount of the claim that would be subject to new proposed section 1232(a)(1) would be based on a net capital gain amount of $150, if the 2010 capital loss can be carried forward to 2013. There are two reasons for adopting this approach. First, it would be consistent with the substantial body of law generally requiring a debtor to treat its tax attributes in such a way as to maximize the recovery to the creditors (other than the taxing authorities), rather than generating or protecting a tax benefit to be enjoyed by the debtor post-emergence. See, e.g., *In re Russell*, 927 F.2d 413 (8th Cir. 1991) (taxpayer's waiver of carryback period under IRC Section 172(b)(3) is subject to avoidance by trustee under Bankruptcy Code sections 548 and 549). In these circumstances, if the statute were read to require the postpetition tax claim to be calculated on a gross basis, without offset by any tax attributes flowing from the debtor's prepetition years, the result would be to maximize the dilution suffered by non-governmental unsecured creditors, while conferring on the debtor the potential to shelter income going forward, the very result blocked in the *Russell* case. Second, even though, under the IRS rules, there is no separate taxable entity created in a chapter 12 case, it is at least arguable that the prepetition tax attributes flowing to the debtor after the filing are property of the debtor that should be preserved and used for the benefit of the creditors. See, e.g., *In re Prudential Lines*, 928 F.2d 565 (2d Cir. 1991) (parent corporation enjoined from taking worthless stock deduction with respect to subsidiary stock where subsidiary's prepetition tax attributes would be eliminated by such an election).

We recognize that this approach (the application of prepetition loss carryforwards to reduce capital gains on postpetition asset sales) is not without problems. It creates greater complexity compared to a system in which the amount of the tax claim is calculated on a gross basis, without regard to loss carryforwards. For example, the IRS may argue that it needs to have an opportunity to audit the prepetition years in which the loss carryforwards were created, in order to be able to decide whether it wishes to challenge the debtor's calculation of the amount of the tax on the gain from a postpetition asset sale that, in a chapter 12 case, will be treated as an unsecured prepetition claim. While similar disputes could arise if carryforwards were not taken into account, the focus would basically be on the debtor's basis in the property sold, a much simpler matter than the determination of loss carryforwards. In addition, it may not be possible for the bankruptcy court to resolve the issue under section 505(b) of the Bankruptcy Code because that section requires the filing of a tax return, which would not occur here because the calculation would be on a *pro forma* basis. Perhaps the disputed claims process would be sufficient to resolve such issues, despite the fact that section 505(b) is not available.

We also recommend that consideration be given to the question of whether losses generated during the postpetition period (including the year in which the filing takes place) should be treated as reducing the amount of the claim that will be treated as a prepetition unsecured nonpriority claim under S. 3545. There would appear to be two reasons for not adopting such an approach. First, there is a reasonable argument that attributes generated after the filing (or in the year of the filing) are not property of the debtor that should be devoted to satisfaction of prepetition creditors' claims, because the losses did not exist immediately before the filing, and therefore the rationale of *Prudential Lines* does not apply. Second, and on a more practical basis, mechanical problems would arise if postpetition tax results were used to reduce or eliminate capital gains from sales occurring postpetition. It would generally be impossible to

calculate the amount of the debtor's operating or capital losses for the year of the sale until that year is closed and a tax return is filed. For example, if a calendar-year farmer sold a herd of cattle at a gain of $400 in February 2013, it generally would not be possible until 2014 to determine whether the farmer will also generate losses during 2013 that might reduce or eliminate the gain on the cattle sale. Thus, if a netting approach is adopted, we suggest that S. 3545 provide for a *pro forma* calculation in which the gain from the asset sale will be netted against available loss carryforwards from prior years, but without regard to any other taxable items that might arise during the year in question. It is true that if the debtor in the example above incurs a loss during 2013, the loss would ordinarily offset the gain from the asset sale (and thus reduce or eliminate the dilution to non-governmental creditors resulting from the operation of S. 3545). However, in the interest of simplicity and administrability, it may make sense to ignore postpetition losses.

Recommended draft of amendments to chapter 12 in lieu of the amendments provided under S. 3545.

Based on the reasons stated above, the NBC recommends that the amendments to chapter 12 provided under S. 3545 be replaced with the following amendments (striking deleted language and underlining new language proposed to be added to the existing Bankruptcy Code):

Section 1232. Tax on the Disposition of Property Used in a Farming Operation

(a)[(1)][1] 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 real or personal 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, subject to the provisions of section 1228 of this title, shall be discharged.

[(2) The allowed amount of an unsecured claim of a governmental unit as described in subsection (a)(1) that arises after the filing of the petition shall be determined by treating the sale event giving rise to such claim as the only taxable event occurring during the applicable taxable year and by reducing the amount of such claim to reflect any tax attributes (such as capital or ordinary losses or tax credits) that were incurred by the debtor before the filing of the petition and that are available to reduce capital gain income in the applicable taxable year.]

(b) For purposes of applying sections 1225(a)(4) and 1228(b)(2) to a claim described in subsection (a) of this section, the amount that would be paid on such claim if the estate of the debtor were liquidated in a case under chapter 7 of this title shall be the amount that would be paid by the estate in a chapter 7 case if the claim were an unsecured claim arising before the date on which the petition was filed and were not entitled to priority under section 507.

(c) For purposes of applying sections 523(a), 1228(a)(2) and 1228(c)(2) to a claim

---

[1] The bracketed material (the designation of paragraph (1) and the text of paragraph (a)(2)) should be included only if, as discussed in item (5) of "Recommended Improvements to S. 3545" (above), it is determined that any prepetition tax attributes should be used mandatorily to calculate the amount of the prepetition unsecured claim arising from the sale of assets, and that losses generated during the postpetition period (including the year in which the filing takes place) should not reduce the amount of such claim.

described in subsection (a) of this section, such claim shall not be treated as a claim of a kind specified in section 523(a)(1) of this title.

(d)(1) A governmental unit may file a proof of claim for a claim described in subsection (a) that arises after the date on which the petition is filed.

(2)(A) Except as provided in subparagraph (B), the trustee or debtor may file a proof of claim for a claim described in subsection (a) that arises after the date on which the petition is filed, if the creditor has not filed a proof of such claim under paragraph (1) within 120 days after the date on which the claim arises.

(B)(i) For a claim described in subsection (a) that is a tax for which a return is due, the debtor or the trustee may file proof of such claim if the debtor or trustee has provided notice as described in subparagraph (ii) and the governmental unit has not filed a proof of claim under paragraph (1) within 180 days after the date on which the debtor or trustee provides the notice.

(ii) Notice as described in this clause is notice by the debtor or the trustee—

(I) indicating the intent to file the applicable claim;

(II) setting forth the amount of the claim;

(III) including a copy of the filed return relating to the claim; and

(IV) delivered to the governmental unit at the address determined in accordance with section 505(b)(1).

(3) A claim filed under paragraph (1) or (2) shall be allowed under section 502(a), (b), or (c), or disallowed under section 502(d) or 502(e), the same as if the claim had arisen before the date of the filing of the petition.

Section 1222. Contents of Plan

(a) The plan shall—

(1) provide for the submission of all or such portion of future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan;

(2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507, ~~unless—~~

~~(A) the claim is a claim 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, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such manner only if the debtor receives a discharge; or~~

~~(B)~~ unless the holder of a particular claim agrees to a different treatment of that claim;

(3) if the plan classifies claims and interests, provide the same treatment for each claim or interest within a particular class unless the holder of a particular claim or interest agrees to less favorable treatment; ~~and~~

(4) notwithstanding any other provision of this section, a plan may provide for less than full payment of all amounts owed for a claim entitled to priority under section 507(a)(1)(B) only if the plan provides that all of the debtor's projected disposable income for a 5-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan; and

(5) subject to section 1232, provide for the treatment of any claim by a governmental unit of a kind described in section 1232(a).

Section 1228 Discharge[2]

(a) Subject to subsection (d), as soon as practicable after completion by the debtor of all payments under the plan, and in the case of a debtor who is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, after such debtor certifies that all amounts payable under such order or such statute that are due on or before the date of the certification (including amounts due before the petition was filed, but only to the extent provided for by the plan) have been paid, other than payments to holders of allowed claims provided for under section 1222(b)(5) or 1222(b)(9) of this title, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan, allowed under section 503 of this title, or disallowed under section 502 of this title, except any debt—

(1) provided for under section 1222(b)(5) or 1222(b)(9) of this title; or

(2) of a kind specified in section 523(a) of this title, except as provided in section 1232(c).

* * * *

(c) A discharge granted under subsection (b) of this section discharges the debtor from all unsecured debts provided for by the plan or disallowed under section 502 of this title, except any debt –

(1) provided for under section 1222(b)(5) or 1222(b)(9) of this title; or

(2) of a kind specified in section 523(a) of this title, except as provided in section 1232(c).

Section 1229. Modification of Plan After Confirmation

(a) At any time after confirmation of the plan but before the completion of payments under such plan, the plan may be modified, on request of the debtor, the trustee, or the holder of an allowed unsecured claim, to —

(1) increase or reduce the amount of payments on claims of a particular class provided for by the plan;

(2) extend or reduce the time for such payments; ~~or~~

(3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan; or

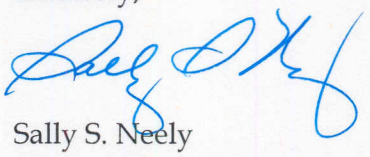
(4) provide for the payment of a claim described in section 1232(a) that arose after the date on which the petition was filed.

---

[2] This includes the technical amendment in S. 3545 that adds two commas to the section, which are needed. To conform to current U.S. Code style, it would also be appropriate to strike "of this title" each place it appears.

If you have any questions regarding the NBC analysis or recommendations contained herein, please feel free to contact the undersigned.

Sincerely,



Sally S. Neely
Chair, Committee on Legislation
Direct Line: 213-896-6024
Email: sneely@sidley.com

Enc.
cc: Mr. Nathan Hallford