Supreme Court in *Hall* Complicates Bankruptcy Tax Planning

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This article analyzes the Supreme Court's holding in *Hall v. United States*, in which the Court interpreted the meaning of the term ''incurred by the estate,'' which is critical to determining whether tax liabilities are dischargeable in a bankruptcy proceeding.

In a 5-4 decision, the Supreme Court decided in *Hall v. United States* whether post-petition taxes incurred on a sale of farm assets in a bankruptcy proceeding under chapter 12 of the Bankruptcy Code[1] are eligible for discharge. The majority opinion, by Justice Sonia Sotomayor, holds that the discharge depends on whether the tax liability is deemed incurred by the individual debtor or by the bankruptcy estate.[2] Because the estate created in a chapter 12 proceeding is not separately taxable, any taxes incurred on a sale of assets after the petition for bankruptcy is filed remain an individual debtor's independent responsibility. Therefore, the majority concluded, capital gains taxes on this type of sale cannot be discharged and retain their priority status. In a vigorous dissent, Justice Stephen Breyer argued for a more expansive interpretation of taxes ''incurred by the estate'' that would facilitate the reorganization of financially troubled farms.

The import of *Hall* is not limited to family farms filing for bankruptcy under chapter 12. Because bankruptcy filings made by corporations and partnerships under chapters 7 and 11[3] and individuals under chapter 13[4] do not create separately taxable estates, the holding of the case must also be considered by businesses and individuals filing for bankruptcy under those chapters.

Bankruptcy Overview

The Bankruptcy Code provides various options to a debtor that is unable to repay its debts.[5] The proceedings may take the form of a chapter 7 liquidation, in which all assets are sold and any proceeds are distributed to the creditors. Debtors that want to avoid liquidating and prefer to remain in business (usually corporations and partnerships but occasionally also individuals) may under some conditions file for chapter 11 reorganization instead. In those proceedings, the debtor proposes a plan to keep the business alive and pay creditors over time. An additional option is available to individuals with a regular income, who have the option to file under chapter 13. Chapter 13 allows the individual to retain her property and pay specified debts over time. Individuals who qualify as a ''family farmer'' or ''family fisherman'' also have the option to file under chapter 12. Chapter 12 is less complicated and eliminates many of the barriers those debtors would face under chapter 11 or 13.

The tax consequences of filing for bankruptcy vary depending on the type of petition filed and whether the debtor is an individual. The IRC provides that if an individual debtor files for either a chapter 7 or 11 proceeding, the bankruptcy estate will be treated as *a separately taxable entity* for

[1]Title 11 of the U.S. Code, as amended, referred to as the Bankruptcy Code.

[2]*Hall v. United States*, 132 S. Ct. 1882 (2012), *Doc 2012-10263*, *2012 TNT 94-16* (interpreting 11 U.S.C. section 503(b)(1)(B)(i)).

[3]Section 1399.

[4]*Cf.* section 1399; Internal Revenue Manual section 4.8.2.10.4.1.3(3) (*rev'd* 2012).

[5]Additional information is *available at* http://www.uscourts.gov/FederalCourts/Bankruptcy.aspx.

income tax purposes.[6] In other cases, for example when the debtor is not an individual (that is, a partnership or corporation files for bankruptcy), or when an individual files under chapter 12 or 13, no separate entity is created for income tax purposes.[7] The distinction is important, because a bankruptcy estate that is treated as a separate entity will succeed to the individual's assets, liabilities, and some of her tax attributes[8]; the bankruptcy estate's obligation to file tax returns will generally fall on the trustee in bankruptcy and no longer on the debtor[9]; and finally, transfers between the debtor and the estate will generally be tax free.[10]

Priority of Pre- and Post-Petition Taxes

As part of the bankruptcy process, a bankruptcy court determines the relative priority of the debtor's outstanding debts and which debts will be eligible for discharge. The Bankruptcy Code grants eighth priority[11] and non-dischargeability for some pre-petition tax claims. This priority will be granted, for example, to income taxes, property taxes, and employment taxes to the extent the taxes were due in the three-year period before the date of the petition for bankruptcy and were assessed within 240 days of the same date.[12]

Post-petition tax claims, on the other hand, whether secured or unsecured, receive what appears to be a higher, second priority.[13] To achieve this status, a claim must qualify as an administrative expense of the estate. However, administrative expenses that are claims "owed to a governmental unit that arises as the result of the sale of . . . any farm asset . . . shall be treated as an unsecured claim not entitled to priority."[14] This reduces these claims from second priority to general unsecured status,[15] potentially eligible for discharge. To qualify as an administrative expense, these taxes must be incurred by the bankruptcy estate.[16] An apparent prerequisite for this is a bankruptcy estate that is regarded as a separate taxable entity in the first place. *Hall* turns on the meaning of "incurred by the estate."

Tax claims that do not qualify for priority as pre-petition expenses under the conditions described above may potentially be discharged, which means that the debtor will be permanently relieved of the obligation to pay them. For income tax purposes, a debtor will be deemed to realize "discharge from indebtedness income" to the extent of the amount of the discharge that is subject to tax at applicable marginal rates. However, the IRC exempts this income from tax, if the discharge is granted by a court or under a plan approved by a court.[17]

Hall v. United States

The taxpayers in *Hall* were conducting a financially distressed farming business and had petitioned for bankruptcy relief under chapter 12. They had sold farm property shortly after filing the petition and had proposed paying off any outstanding liabilities with the proceeds from the sale. The IRS objected and asserted a $29,000 capital gains tax on the sale. The taxpayers then proposed to treat the capital gains tax as an administrative expense that is a claim owed to a governmental unit as the result of a sale of a farm asset, and thus, an unsecured claim to be paid to the extent of any funds available, with a discharge of the balance.[18] The IRS again objected and asserted that the claim was not dischargeable and would, therefore, remain unaffected by the bankruptcy process.

Generally, a plan of reorganization in chapter 12 bankruptcy proceedings must provide for full payment of all priority claims. However, employing an exception that would treat taxes as administrative expenses strips tax claims from the priority they otherwise have.[19] If the exception applies, tax claims are downgraded to general, unsecured claims that can be fully discharged with less than full payment.

The debtors sold their property after the petition date, so the priority (and, therefore, eligibility for discharge) of these taxes ultimately depended on whether they were deemed incurred by the bankruptcy estate. Sotomayor's opinion, joined by Chief Justice John Roberts and Justices Antonin Scalia, Clarence Thomas, and Samuel Alito, reasoned that for a tax to be "incurred by the estate" the estate itself should be liable for the tax. Because the IRC

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[6]IRC section 1398(a).

[7]IRC section 1399.

[8]11 U.S.C. section 541(a)(1) and IRC section 1398(g).

[9]11 U.S.C. section 704(a)(8); 11 U.S.C. section 1106(a)(1) and (6); IRC section 6012(b)(4).

[10]Section 1398(f).

[11]The seven types of debt with higher priority are (1) domestic support obligations, (2) administrative expenses, (3) claims in involuntary bankruptcy petitions under chapters 7 and 11, (4) employee wages, (5) unpaid contributions to employee benefit plans, (6) claims by a grain producer or fisherman, and (7) consumer deposits.

[12]11 U.S.C. section 507(a)(8)(A)(i) and (ii).

[13]Behind claims for domestic support obligations.

[14]11 U.S.C. section 1222(a)(2)(A). Section 1222(a)(2) refers to 11 U.S.C. section 507. 11 U.S.C. section 507(a)(2) addresses "administrative expense" and refers to 11 U.S.C. section 503(b). 11 U.S.C. section 503(b)(1)(B)(i) contains the "incurred by the estate" language in question. Hence, a series of somewhat abstruse cross-references are the foundation of *Hall*.

[15]*Id*.

[16]11 U.S.C. section 507(a)(2) (referencing 11 U.S.C. section 503(b)); *Hall*, 132 S. Ct. at 1886.

[17]Sections 61(a)(12) and 108(a)(1)(A).

[18]11 U.S.C. section 1222(a)(2)(A); *Hall*, 132 S. Ct. at 1885.

[19]11 U.S.C. section 1222(a)(2).

makes only specified bankruptcy estates liable for federal income taxes, whether the post-petition capital gains taxes had priority depended on the particular chapter of the Bankruptcy Code under which the proceedings were filed. Because a chapter 12 proceeding does not create an estate that is treated as a separate entity for income tax purposes, the plain language of the statute required treating the $29,000 in capital gains taxes as post-petition taxes that were neither collectible nor dischargeable in the chapter 12 plan. They remained an independent responsibility of the debtors.

Although it may be cold comfort for individual debtors seeking a fresh start in chapter 12 bankruptcy proceedings, the Supreme Court's holding in *Hall* means that taxpayers who, after filing the petition, are selling their assets at a loss should be able to deduct or (more likely) carry forward that loss for income tax purposes.

Analysis

Breyer's dissent reasoned that the Court should have read the statute in a way that would better have achieved its purpose of enabling the Bankruptcy Court to treat some tax claims as ordinary unsecured claims and provide the debtor with a fresh start.

The dissent asserts that its preferred result is justified by interpreting "incurred by" to have a temporal meaning: incurred while the bankruptcy estate is in existence. An analogy Breyer used is that an employee using a company's credit card incurs costs for which his employer is liable.[20] Similarly, the bankruptcy estate incurred the capital gains tax for which the debtor is liable. The majority rejects this interpretation and holds that the estate must be regarded as a taxpayer to incur any tax. This debate could have been avoided if Congress had either referred to (1) "taxes realized by the estate for its own account" or (2) "taxes arising in connection with the operations of the estate."

Breyer's other line of argument is that a broad interpretation of "incurred by" is appropriate in light of the pertinent legislative history. His dissent refers to a quotation from Senate Finance Committee member Chuck Grassley, R-Iowa, to support this interpretation:

> Farmers often face a crushing tax liability if they need to sell livestock or land in order to reorganize their business affairs. . . . The IRS must be paid in full for any tax liabilities generated during a bankruptcy reorganization. If the farmer can't pay the IRS in full, then he can't keep his farm. This isn't sound policy. [The amendment] takes this power away from the IRS by reducing the priority of taxes.[21]

The majority rejects the significance of this legislative history on two grounds. First, the statutory language in view of the majority is clear, and "ambiguous legislative history" should not be permitted to "muddy clear statutory language."[22] Second, the senator's statement concerned an unenacted bill (with similar statutory language to the enacted version) introduced before the enactment of the legislation in question.[23]

The decision also shows that filing for bankruptcy may entail traps for the unwary. A well-informed debtor seeking to file for bankruptcy, or a creditor seeking to force its debtor into involuntary bankruptcy, should first examine the filing options that are available and compare the particular tax consequences of filing for bankruptcy relief.[24]

In addition to informing him about the benefits of filing for chapter 12 bankruptcy protection, Hall's advisers should have communicated the risk that a sale of farm assets can give rise to capital gains taxes that are either, depending on whether the sale takes place before or after the petition is filed, (1) non-dischargeable pre-petition taxes or (2) post-petition taxes that would be part of a bankruptcy estate not treated as a separately taxable entity for tax purposes. If the main concern was the taxation of the built-in gain embedded in Hall's farm assets, he should have been advised of his option to file for chapter 11 bankruptcy protection. If Hall had filed under chapter 11, the bankruptcy estate would have been a separately taxable entity that would have incurred the capital gains that would have been discharged.[25]

The general lesson from *Hall* is that individuals and family farms that are financially troubled should elect to file for bankruptcy under chapter 7 or 11, rather than chapter 12 or 13, if they have post-petition taxes they want to have discharged. Unfortunately, many individuals and family farms will decide which bankruptcy chapter to proceed under based on considerations like out-of-pocket

[20]*Hall*, 132 S. Ct. at 1898.

[21]*Id.* at 1896 (quoting 145 *Cong. Rec*. 1113 (1999)).

[22]*Id.* at 1892 (quoting *Milner v. Dept of Navy*, 131 S. Ct. 1259, 1276 (2011)).

[23]*Id.* at 1893.

[24]11 U.S.C. section 346 aligns the treatment of state and local income tax liabilities with the treatment of any federal tax liability under the IRC. Debtors filing for bankruptcy protection should also ensure that they receive the benefit of discharge of state and local taxes.

[25]Section 1398(b)(1).

costs and the likely duration of the proceeding, rather than nuanced tax planning. Those who select chapter 12 or 13 will find that more of their resources are absorbed by post-petition taxes than will those who have the insight or luck to select chapter 7 or 11.