

IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE NORTHERN DISTRICT OF IOWA

In Re: )  
ANDERS H. KNUDSEN and )  
CYNTHIA J. KNUDSEN, )  
Debtors. )  
Bankruptcy No. 05-03136  
Chapter 12

**POST- HEARING BRIEF MEMORANDUM OF LAW IN SUPPORT OF THE UNITED STATES' OBJECTION TO CONFIRMATION OF THE CHAPTER 12 PLAN**

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Comes Now, the United States of America, on behalf of the Internal Revenue Service ("IRS"), and in support of its objection to confirmation of the Debtors' 5<sup>th</sup> Amended Chapter 12 plan, files its brief memorandum of law following the confirmation hearing in the above-entitled matter.

**I. PROCEDURAL CASE HISTORY**

The Debtors, Anders and Cynthia Knudsen, (hereafter, "Debtors") filed this bankruptcy proceeding on July 1, 2005, seeking relief under Chapter 12 of the United States Bankruptcy Code. On July 12<sup>th</sup> and 13<sup>th</sup>, 2006, the court held a confirmation hearing on the Fifth Amended Chapter 12 plan and objections filed by the United States and the Chapter 12 Trustee to the plan.<sup>1</sup> The Debtor, Anders Knudsen and Dr. Neil Harl testified on behalf of the Debtors. Howard Hoy, with the Internal Revenue Service, testified on behalf of the United States. The court requested additional briefing as to issues raised in the confirmation hearing.

On February 8, 2006, the United States filed an amended pre-petition claim in this proceeding. Claim 16-1.<sup>2</sup> The United States' claim sets forth an unsecured priority claim in the amount of \$52,440.52 and a general unsecured claim in the amount of

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<sup>1</sup>Objections were filed by other creditors, but were resolved prior to the time of the confirmation hearing.

<sup>2</sup>IRS had filed previous claims which were amended by the IRS. Claim 8-1 was filed on August 11, 2005, was amended by Claim 11-1 filed on August 25, 2005, and by Claim 15-1 filed on November 14, 2005.

\$703.37. In addition, the United States claims a right to set-off in the amount of \$106.46. A portion of the United States' claim is estimated because Debtors have not yet filed the return for the period for which the tax is estimated. The priority claim includes tax and interest to the petition date. Penalties on the taxes for the priority claim are not included in the priority claim, but are included in the United States' unsecured claim.

A Proof of Claim is prima facie correct. Bankr. R. 3001(f). See *Whitney v. Dresser*, 200 U.S. 532 (1906); 4 Collier on Bankruptcy ' 502.02[1] (Matthew Bender 15th Ed. Revised 1999). See also, *In re Fogelberg*, 79 B.R. 368 (Bankr. N.D. Ill. 1986). The United States has not agreed to any treatment of its claim other than as provided for in the Bankruptcy Code.

Debtors have filed a proposed Chapter 12 Plan, the FIFTH AMENDED AND SUBSTITUTED CHAPTER 12 PLAN OF REORGANIZATION, Document 136, filed on June 8, 2006. In that Plan, Debtors propose, under 11 U.S.C. § 1222 (a)(2)(A), that prepetition taxes that arose from the sale of property used in Debtors' farm operation be paid as an unsecured claim and discharged. In their proposed Plan, Debtors also assert that postpetition taxes that might arise from the sale of property used in Debtors' farming operation be paid as an unsecured claim and be discharged pursuant to § 1222 (a)(2)(A) . Further, in their Plan, Debtors also propose a method of allocating the prepetition and postpetition taxes due between (1) taxes that did not arise from the sale of property used in Debtors' farm operation and (2) taxes that did arise from the sale of property used in Debtors' farm operation. Finally, the Debtors also propose to include the sale of hogs raised for sale to the slaughter market (market hogs) with the hogs used for breeding and raising hogs for the market (breeding stock) in those assets sold

as having been “used in” the Debtors’ farm operation as stated in 11 U.S.C. § 1222(a)(2)(A).

The United States objected to those portions of the Debtors’ proposed Plan which: (1) provided that prepetition taxes that arose from the sale of property used in Debtors’ farm operation be paid as an unsecured claim and be discharged; (2) provided that postpetition taxes that might arise from the sale of property used in Debtors’ farm operation be paid as an unsecured claim and be discharged; and (3) which provided for a method of allocating the prepetition and postpetition taxes due between [1] taxes that did not arise from the sale of property used in Debtors’ farm operation and [2] taxes that did arise from the sale of property used in Debtors’ farm operation. The United States also objected to including market hogs as assets used in farming and the Debtors’ claim that those market hogs were entitled to treatment under § 1222(a)(2)(A) of the Bankruptcy Code.

## II. ARGUMENT

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) was enacted on April 20, 2005 with a general effective date of October 17, 2005. 11 U.S.C. § 1222(a)(2) was changed by BAPCPA , § 1003. The effective date of the changes to § 1222 was April 20, 2005, on cases filed on or after April 20, 2005. The changes, then, are applicable to Debtors’ proceeding. Changes to the other Bankruptcy Code statutes that are applicable to this matter were not effective until October 17, 2005 for cases filed on or after October 17, 2005. BAPCPA, § 1501. This Court, then, must give effect to the changes in 11 U.S.C. § 1222 while retaining the pre-BAPCPA meaning or effect of statutes that did not change. References to § 1222 in this brief will include a qualifier “pre-BAPCPA” or “post-BAPCPA”. References to other statutes are to the statutes in effect before the general BAPCPA effective date, October 17, 2006.

As background to discussing the effect of the change to § 1222(a)(2)(A) on Debtors' proposed Plan, it is appropriate to indicate how the Debtors would have been required to treat the United States' claim prior to BAPCPA 2005 to have confirmed a plan. The United States will show the effect of the change on the treatment of taxes. We will first show the comparison for the pre-petition tax claims, and then we will show the comparison for the post-petition taxes.

#### **A. TREATMENT OF PRE-PETITION CLAIMS UNDER 11 U.S.C § 1222(a)(2)(A)**

##### **1. Treatment Of The United States' Prepetition Tax Claims Prior To the BAPCPA 2005 Change to Section 1222(a)(2)(A)**

Prior to BAPCPA, the applicable portions of 11 U.S.C. § 1222(a)(2) read as follows:

§ 1222. Contents of plan

(a) The plan shall—

(1) . . .

(2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim; and . . .

Prior to BAPCPA, the United States would not have agreed to treatment of its priority claim other than as provided in § 1222(a)(2). Prior to BACCPA 2005, to be confirmed, Debtors' proposed Plan would have had to provide for the full payment, in deferred cash payments, of all claims entitled to priority under 11 U.S.C. § 507. Pre-BAPCPA, 11 U.S.C. § 1222(a)(2). Since the United States' prepetition claim included a claim entitled to priority under the authority of § 507(a)(8), the Debtors would have had to provide for full payment of the United States' priority claim, in the amount of \$52,440.52, or this Court could not confirm the Debtors' Plan pursuant to 11 U.S.C. § 1222(a)(2) . Pre-BAPCPA, the United States' priority claim would have had to be given priority, that is, it

would have had to be paid before Debtors paid any unsecured claimants. 11 U.S.C. § 507(a).

Prior to BAPCPA, 11 U.S.C. § 1228, read, in part, as follows:

§ 1228. Discharge

(a) As soon as practicable after completion by the debtor of all payments under the plan, other than payments to holders of allowed claims provided for under section 1222(b)(5) or 1222(b)(9) of this title [11 U.S.C. § 1222(b)(5) or 1222(b)(9)], 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 [11 U.S.C. § 503] or disallowed under section 502 of this title [11 U.S.C. § 502], except any debt—

(1) provided for under section 1222(b)(5) or 1222(b)(9) of this title [11 U.S.C. § 1222(b)(5) or 1222(b)(9)]; or

(2) of the kind specified in section 523(a) of this title [11 U.S.C. § 523(a)].

(b) At any time after the confirmation of the plan and after notice and a hearing, the court may grant a discharge to a debtor that has not completed payments under the plan only if—

(1) the debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable;

(2) the value, as of the effective date of the plan, of property actually distributed under the plan on account of each allowed unsecured claim is not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under chapter 7 of this title [11 U.S.C. §§ 701 et seq.] on such date; and

(3) modification of the plan under section 1229 of this title [11 U.S.C. § 1229] is not practicable.

(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 [11 U.S.C. § 1222(b)(5) or 1222(b)(9)]; or

(2) of a kind specified in section 523(a) of this title [11 U.S.C. § 523(a)].

Prior to BAPCPA, the applicable portions of 11 U.S.C. § 523(a), read as follows:

§ 523. Exceptions to discharge

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required—

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

The United States' priority claim is a priority claim under the authority of 11 U.S.C. § 507(a)(8). Pre-BAPCPA, the Debtors would have had to fully pay the United States' prepetition priority claim or they would not receive a discharge of the priority claim. 11 U.S.C. §§ 507(a)(8); 523(a)(1)(A); 1228(c)(2). Since the claim would have been a priority claim under § 507(a)(8), it would have been an exception to discharge under § 523(a)(1)(A) and would not have been discharged unless fully paid as part of a confirmed Chapter 12 Plan.

2. Treatment Of The United States' Prepetition Tax Claims After the BAPCPA 2005 Change to Section 1222(a)(2)(A)

After BACCPA, the applicable portions of 11 U.S.C. § 1222(a) read as follows:

§ 1222. Contents of plan

(a) The plan shall—

(1) . . .

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

The United States has not agreed to treatment of its priority claim other than as provided in § 1222(a)(2). After BACCPA 2005, the Debtors' proposed Plan may treat the United States' priority claim as an unsecured claim, but only if Debtors receive a discharge. In order to receive a discharge, Debtors must comply with pre-BAPCPA 11 U.S.C. § 1228, as quoted above.

Under BAPCPA 2005, it is not clear whether Congress intended for the United States' claims, formerly entitled to priority [and still entitled to priority if Debtor does not receive a discharge], to be "reclassified" from "priority" claims to "unsecured" claims. The United States asserts that it does not matter whether or not Congress intended to reclassify the claims or not and also asserts that all of the United States claims, listed as priority on its proof of claim, are not dischargeable.

3. This Court Cannot Confirm Debtor's Proposed Plan if Congress DID Intend That the United States' Claims be Reclassified

If Congress did intend that the United States' priority claims should be

reclassified from priority status to unsecured status, then this court still cannot confirm Debtors' proposed Plan under the provisions of 11 U.S.C. § 1225(a)(4). Section 1225(a)(4) reads as follows:

§ 1225. Confirmation of plan

(a) Except as provided in subsection (b), the court shall confirm a plan if—

(1) . . .

(4) the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date; . . .

If Congress did intend that the United States priority claims be reclassified, then the claims listed as priority on the United States' claim are reclassified to unsecured claims for plan purposes. If those claims are unsecured claims, then Debtors must pay on those reclassified claims at least as much as the United States would receive on those claims in a Chapter 7 case. But, in a Chapter 7 case, those claims would be entitled to priority payment ahead of unsecured claims. Debtors' proposed Plan, at Liquidation Analysis Schedule 1A, shows that in a Chapter 7 complete liquidation, Debtors would have \$98,089.00 available to pay the United States' priority claim of \$52,440.53. Debtors, then, can fully pay the priority claim in a Chapter 7 and therefore must fully pay the priority/unsecured claim in this Chapter 12. This Court cannot confirm Debtors' proposed Plan because Debtors do not propose to fully pay the United States' priority claim in the proposed Plan as required by 11 U.S.C. § 1225(a)(4).

4. This Court Cannot Confirm Debtor's Proposed Plan if Congress DID NOT Intend That the United States Claims be Reclassified

If Congress did not intend that the United States' priority claims should be

reclassified from priority status to unsecured status, then this court cannot confirm Debtors' proposed Plan, which proposes that the prepetition priority claim be discharged. The United States has objected to the Plan for the reason that the Plan proposes that non-dischargeable prepetition tax claims be discharged.

Section 523(a) provides that claims entitled to priority under § 507(a)(8) are excepted from discharge. 11 U.S.C. §§ 1228(a)(2); 523(a)(1)(A). If Congress did not intend that the United States priority claim be reclassified, then the claims are still prepetition priority claims under the provisions of 11 U.S.C. § 507(a)(8) and are excepted from discharge under § 523(a)(1)(A). This Court cannot confirm Debtors' proposed Plan which proposes to discharge those priority taxes over the objection of the United States.

#### **B. TREATMENT OF POSTPETITION CLAIMS UNDER 11 U.S.C §1222(a)(2)(A)**

##### **1. Treatment Of The United States' Postpetition Tax Claims Before BAPCPA 2005 Change to Section 1222(a)(2)(A)**

Pre-BAPCPA 2005, the Debtors' postpetition tax liabilities would not have been the liability of the bankruptcy estate but would have been Debtors' personal liability and would not have been discharged. Since the provisions of Chapter 12 were taken from, and are similar to, provisions in Chapter 13, we look to the payment scheme for taxes as contained in Chapter 13 cases for an interpretation of the payment scheme for taxes in Chapter 12.

The bankruptcy statutes were generally intended to affect only pre-petition claims. Pre-BAPCPA § 101(4) defined the term "claim" as the "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured . . . .". Pre-BAPCPA § 101(9) defined a "creditor" as an "entity which has a

claim against the Debtor that arose at the time of or before the Order for Relief concerning the Debtor . . . . " Pre-BAPCPA § 501 was applicable to all bankruptcy cases and provides that a creditor may file a proof of claim. A debtor could file a proof of claim for the creditor only when the creditor failed to timely file a proof of claim. See, Pre-BAPCPA 11 U.S.C. § 501(c); Bankruptcy Rule 3004. With certain exceptions, which would not have been applicable here, post-petition claims were generally not allowable in bankruptcy cases, including Chapter 13 cases. See, pre-BAPCPA 11 U.S.C. § 502(b). *In re Glover*, 107 B.R. 579, 580-581 (Bankr. S.D. Ohio 1989).

Pre-BAPCPA, the collection of post-petition tax debts in an individual's Chapter 12 proceeding, an individual's Chapter 13 proceedings and an individual's Chapter 11 case were all different. In a Chapter 11 proceeding, postpetition, pre-confirmation taxes were administrative expenses which must be paid on the plan's effective date. 11 U.S.C. § 1129(a)(9)(A). In a Chapter 13 proceeding, the postpetition creditor could elect, under 11 U.S.C. § 1305, to file a claim for postpetition taxes and have the debtor pay the postpetition tax claim through the Chapter 13 plan. There was no equivalent provision in Chapter 11 or Chapter 12.

Although postpetition tax creditors could choose to participate in a bankruptcy by filing a claim under 11 U.S.C. § 1305, such participation was not mandatory. Further, a debtor could not file a claim for postpetition taxes on behalf of a creditor and thus force the postpetition creditor to participate in the plan. See, *In re Epstein*, 200 B.R. 611, 614 (Bankr. S.D. Ohio 1996); *In re Haith*, 193 B.R. 341, 343 (Bankr. N.D. Ala. 1995); *In re Hudson*, 158 B.R. 670, 673 (Bankr. N.D. Ohio 1993); *In re Glover*, 107 B.R. 579 (Bankr. S.D. Ohio 1989); *In re Dickey*, 64 B.R. 3 (Bankr. E.D. Va. 1985); *In re Hester*, 63 B.R. 607 (Bankr. E.D. Tenn. 1986); *In re Hefner*, 32 B.R. 382 (Bankr. W.D.N.Y. 1983); *In re Nowak*, 17 B.R. 860 (Bankr. N.D. Ohio 1982).

To allow a debtor to force a postpetition creditor to participate in the plan and delay collection of its postpetition debts for the duration of the debtor's plan (up to five years) would have been inequitable. See, *In re Mason*, 45 B.R. 498 (Bankr. D. Or. 1984). This result would have been even more inequitable in the case of an involuntary creditor such as the Internal Revenue Service.

Pre-BAPCPA, the government could choose to either file a § 1305 claim, and collect the post-petition taxes through the Chapter 13 bankruptcy plan, or could choose not to file a § 1305 claim, and collect the post-petition taxes from the Chapter 13 debtor after discharge. A Chapter 13 debtor was not permitted to file a proof of claim on behalf of the tax creditor who did not file one. 11 U.S.C. § 502(i) did not allow for the treatment of post-petition tax claims as if they were pre-petition claims. The tax creditor had control on whether to voluntarily participate in the Chapter 13 plan. *In re Hudson*, 158 B.R. 670, 674 (Bankr. D. Ohio 1993).

Pre-BAPCPA, only debts that "have been provided for by" a Chapter 13 plan or "disallowed under section 502" were discharged under § 1328(a). See 11 U.S.C. § 1328(a). Therefore, if a tax creditor chose not to file a claim under § 1305(a), the claim was not discharged. *In re Wilkoff*, 87 A.F.T.R.2d (RIA) 2266, 2001 Bankr. LEXIS 124 (Bankr. D. Pa. 2001); *In re Dunn*, 83 B.R. 694 (Bankr. D. Neb. 1988).

Pre-BAPCPA, § 1228(a) provided a more limited discharge than does § 1328(a). However, § 1228(a) also provided for a discharge of administrative expenses allowed under § 503, a provision that is not contained in 1328(a). The United States asserts that the post-petition taxes here are not administrative expenses and, therefore, would not have been dischargeable under the authority of § 1228(a).

The applicable portion of pre-BAPCPA 11 U.S.C. § 503 reads as follows:

§ 503. Allowance of administrative expenses

(a) An entity may timely file a request for payment of an administrative expense, or may tardily file such request if permitted by the court for cause.

(b) After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title [11 USCS § 502(f)], including—

(1) (A) the actual, necessary costs and expenses of preserving the estate including wages, salaries, or commissions for services rendered after the commencement of the case;

(B) any tax--

(i) incurred by the estate, except a tax of a kind specified in section 507(a)(8) of this title [11 USCS § 507(a)(8)]; or

(ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates ended before or after the commencement of the case; and

(C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph;

Postpetition taxes in an individual's Chapter 12 case were not incurred by the bankruptcy estate but are incurred by the Debtors through their use of the bankruptcy estate. The postpetition taxes, then, will not be taxes "incurred by the estate" but will be taxes incurred by the individuals.

Like a Chapter 13 case, confirmation of a Chapter 12 Plan vests all property of the estate in the debtor. Courts have found that § 503 administrative expense status is not available to postpetition tax claims in a Chapter 13 case, and whether or not the taxes were incurred before or after confirmation. They found that § 503(b)(1)(B) does provide that taxes "incurred by the estate" can be administrative expenses. However, because confirmation of the Chapter 13 plan vested all the property of the estate in the debtor and released the estate from all claims and interests of the creditors, postconfirmation taxes are incurred by the debtor and are not administrative expenses under § 503(b)(1). 11 U.S.C. §§ 503(b)(1), § 1327(b) & (c); *In re Gyulafia*, 65 B.R. 913, 916 (Bankr. D. Kan. 1986).

In another context, but relevant to this case, the Eighth Circuit and this Court (Judge Kilburg) have found that a Chapter 13 bankruptcy estate may still exist after plan confirmation but still only to the extent of a debtor's assets needed to fund the Chapter 13 Plan. *Security Bank of Marshalltown, Iowa v. Nieman*, 1 F.3d 687 (8<sup>th</sup> Cir. 1993); *In re Truelove*, 74 A.F.T.R.2d Para. 5089 (Bankr. N.D. Iowa 1994). The Security Bank case and the Truelove cases are relevant because they show the extent to which a bankruptcy estate may exist after Plan confirmation.

Here, Debtor is proposing to grant § 503 administrative status to postpetition taxes when the Chapter 12 bankruptcy estate will have ceased to exist. Pre-BAPCPA, this Court would have denied administrative status and denied confirmation of Debtors' proposed Plan for the reason that the United States had not filed a request for administrative status and for the reason that the bankruptcy estate would have ceased to exist and, therefore, postpetition taxes could not be actual and necessary costs or expenses of preserving the Chapter 12 bankruptcy estate. 11 U.S.C. § 503(b)(1).

The postpetition tax scheme in a pre-BAPCPA individual Chapter 12 case was similar to both the corporate Chapter 11 postpetition tax scheme and the individual Chapter 13 postpetition tax scheme in which a § 1305 claim was not filed. In a corporate Chapter 11 proceeding, the postpetition taxes were the liability of the corporation and were not discharged. As discussed above, the postpetition taxes in a Chapter 13 proceeding in which a § 1305 claim was not filed were the liability of the Chapter 13 Debtor and were not discharged. Contrast a corporate Chapter 11 proceeding and a Chapter 13 proceeding with an individual's Chapter 11 proceeding. In the individual's Chapter 11 proceeding, the bankruptcy estate is a separate taxable entity from the individual. 26 U.S.C. § 1398. The income earned by the individual's Chapter 11 bankruptcy estate is taxed as an administrative expense to the bankruptcy

estate. The separate income of the individual Chapter 11 debtor is taxed to the individual.

In the present case, Debtors are attempting to pay the postpetition taxes, as administrative expenses, through their Chapter 12 Plan and to discharge their postpetition tax liability as part of their Chapter 12 Plan. But, because the postpetition taxes would not be "incurred by the estate, the postpetition taxes would not be pre-BAPCPA administrative expenses and would not be an "allowed" expense under pre-BAPCPA § 503. Since the postpetition taxes would not have been administrative expenses, they would not have been discharged under the provisions of pre-BAPCPA 1228(a).

In addition, since Chapter 12 does not contain a provision similar to § 1305, the situation in a pre-BAPCPA Chapter 12 proceeding is similar to the situation in a Chapter 13 proceeding in which a § 1305 claim is not filed. Debtors are attempting to include the postpetition taxes in their Chapter 12 Plan, an act which has the same result as if a Debtor, rather than the tax authority, filed a § 1305 claim and attempted to pay the § 1305 claim through a Plan. But, Debtors would not be allowed to file a § 1305 claim for the United States in a Chapter 13 proceeding and they should not be allowed to, in effect, file a postpetition claim for taxes in their Chapter 12 proceeding by including the postpetition taxes in their Plan over the objection of the United States. The United States, not the Debtors, has control of whether to allow the post-petition taxes to be paid through a Plan. *In re Hudson*, 158 B.R. 670, 674 (Bankr. S.D. Ohio 1993). Pre-BAPCPA, this Court would not have confirmed a Chapter 12 Plan which included payment of postpetition taxes over the objection of the United States.

Pre-BAPCPA, the United States would have objected to inclusion of the postpetition taxes in Debtors' Chapter 12 Plan. Following the postpetition tax schemes

in a corporate Chapter 11 and a Chapter 13 proceeding, this Court would not have confirmed Debtors proposed Chapter 12 Plan.

Now we will show the changes to the Bankruptcy Code that were included in BAPCPA 11 U.S.C. § 1222(a)(2)(A) and discuss whether those changes affect whether Debtors must provide for the United States' postpetition tax liabilities in their Chapter 12 Plan.

2. Treatment Of The United States' Postpetition Tax Claims After the BAPCPA 2005 Change to Section 1222(a)(2)(A)

A review of the Bankruptcy Code shows that the only applicable statute that was effective prior to the petition date, July 1, 2005, was 11 U.S.C. § 1222(a)(2). The changes to §§ 501, 502, 503, 1129, 1228, 1305, and 1328 were not effective until October 17, 2005.

The United States asserts that the change to § 1222(a)(2)(A) did not in any way affect the manner in which postpetition taxes are reported and paid. The bankruptcy statutes are generally intended to affect only pre-petition claims. As in the pre-BAPCPA period, § 101(4) defines the term "claim" as the "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured . . . .". As in the pre-BAPCPA period, § 101(9) defines a "creditor" as an "entity which has a claim against the Debtor that arose at the time of or before the Order for Relief concerning the debtor . . . ." As in the pre-BAPCPA period, § 501 is still applicable to all bankruptcy cases and provides that a creditor may file a proof of claim. A debtor could file a proof of claim for the creditor only when the creditor fails to timely file a proof of claim. See, 11 U.S.C. § 501(c); Bankruptcy Rule 3004. With certain exceptions, which are not applicable here, postpetition claims are generally not allowable in bankruptcy cases,

including Chapter 13 cases. See, 11 U.S.C. § 502(b). *In re Glover*, 107 B.R. 579, 580-581 (Bankr. S.D. Ohio 1989).

Congress knows how to be specific when providing for postpetition tax liabilities in a bankruptcy proceeding. In 1978, Congress passed 11 U.S.C. § 1305 which provided for payment of postpetition taxes in a Chapter 13 proceeding. In § 1305, Congress specified how the postpetition taxes would be treated in a plan.

Congress could have, but did not, include in post-BAPCPA 1222, or in any other applicable statutes, specific language which would have made it clear that the use of the word “claim” in § 1222(a)(2)(A) did not follow the general rule that the Bankruptcy Code only applies to prepetition claims but, instead, also applied to postpetition tax claims. Since Congress did not clearly indicate that § 1222(a)(2)(A) applied to postpetition taxes, this Court should not deviate from the general rule to make § 1222(a)(2)(A) apply to postpetition claims.

The change to § 1222(a)(2)(A), then, does not affect the postpetition tax scheme since the postpetition taxes here are in no manner entitled to priority under § 507.

Therefore, the same tax scheme that was used pre-BAPCPA will apply to the postpetition taxes here. That scheme was:

1. Debtors must timely file all postpetition income tax returns and timely pay all postpetition tax liabilities. 26 U.S.C. § 6071, 6072, 6151.
2. Debtors’ postpetition tax liabilities are not administrative expenses of the bankruptcy estate. 11 U.S.C. § 503.
3. This Court cannot confirm Debtors’ Chapter 12 Plan over the objection of the United States because the proposed Plan includes payment of the postpetition taxes in the Plan. *In re Hudson*, 158 B.R. 670, 674 (Bankr. S.D. Ohio 1993).

4. Debtors' postpetition taxes are not dischargeable. *In re Wilkoff*, 87 A.F.T.R.2d (RIA) 2266, 2001 Bankr. LEXIS 124 (Bankr. D. Pa. 2001); *In re Dunn*, 83 B.R. 694 (Bankr. D. Neb. 1988).

### C. ALLOCATION OF TAXES

In their Plan of Reorganization, Debtors also propose a method of allocating the prepetition and postpetition taxes due between (1) taxes that did not arise from the sale of property used in Debtors' farm operation and (2) taxes that did arise from the sale of property used in Debtors' farm operation. The United States objected and the issue became part of the litigation at confirmation.

In 2004, Debtors sold breeding stock and market hogs and began a custom feeding operation. The Form 4797 included in Debtors' 2004 amended tax return, Form 1040X, included the sale of breeding stock for an alleged gain of \$34,577.00. Exhibit 2 and 64. The gain on the Form 4797, included with Debtors' 2004 Form 1040X, was carried forward to the Schedule D and would normally go to Line 13 of the Form 1040. Debtors included the gain in the adjusted gross income (AGI) change on the Form 1040X. In 2004, Debtors also sold a livestock trailer and farrowing equipment, as shown from line 19 of the Form 4797 attached to Debtors' amended return. That sale was carried forward to the Schedule D and would normally go to line 14 of the Form 1040. Debtors also included in the AGI change from the sale of the trailer and farrowing equipment on the Form 1040X. The total gain on sale of farm assets reported by Debtors in 2004 was \$56,236.00.00, of which \$34,577.00 was from the sale of breeding stock and \$21,659.00 of which was from the sale of the livestock trailer and farrowing equipment.

In their proposed Plan, Debtors proposed a method for computing the amount of

the gains taxes and included a pro-forma Form 1040 showing the calculations. Debtor labeled the pro-forma Form 1040 as the "Fed 2004 Sec. 1222(a)(2)(A) Return", a copy of which is attached as Schedule 5 to Debtors proposed Plan and filed as Exhibit 7. On that pro-forma Form 1040, Debtors have simply removed the gains income from the taxable income and computed the tax on the remainder.

Insolvency Advisor Howard Hoy prepared a worksheet to determine what portion of the total tax for 2004 that is due to, or related to, the \$56,236.00 gain on sale of farm assets by Debtor in 2004. He also provided testimony as to the information contained therein. Mr. Hoy's worksheet is at Government Exhibit A.

On their pro-forma Form 1040, Debtors have simply removed the gains income from the taxable income and computed the tax on the remainder. Debtors' methodology is not correct. Debtors proposed methodology results in Debtors being taxed at a lower rate than the rate used to compute Debtors' actual income, which includes both non-gains and gains taxes. Under Debtors' proposal, Debtors ignore the principle that every taxable dollar of their income in a year is equal for taxation and that a dollar of non-gains income is taxed at the same rate as a dollar of gains income. In other words, Debtors' simple removal of the gains income from taxable income resulted in a proposed tax on the non-gains income at a lower rate than the rate that actually applied to Debtors' total taxable income. Debtors are attempting to get an advantage by using a lower tax rate and ignoring the reality that the applicable tax rate is a higher rate.

Debtors' pro forma Form 1040 is also not correct in that they attempt to gain an advantage for Debtors by applying all of the \$8,000.00 payment on their 2004 tax liability to the non-gains taxes. Debtors ignored the fact that they did not designate the payment in any manner. In addition, there is no provision in the Internal Revenue Code that allows taxpayers to designate a payment to only pay that portion of their tax liability

that arose from a certain source of income. A taxpayer's tax liability cannot be divided based on the source of the income. Debtors, then, incorrectly allocated the payment to that portion of their 2004 tax liability due on non-gain income.

In computing their proposed taxes on gain on sale on their pro forma return, Debtors also ignored the information they reported on their amended income tax returns, Form 1040X. On the Form 1040X, Debtors elected to revoke a Section 179 election. Instead of using the non-gain income reported on their latest filed return, the Form 1040X, Debtors used the non-gains income reported on their original return. But, Debtors' current tax liability is based on the Form 1040X.

Mr. Hoy's worksheet, Exhibit A, corrects for Debtors' incorrect proposed allocation. Mr. Hoy used the information on the Form 1040X and the gain on sale of farm assets is fully carried forward to the Form 1040/1040X and would be part of the Adjusted Gross Income. Using Mr. Hoy's proposed allocation, each dollar of gain is taxed at the same rate as each dollar of other types of income such that each dollar of gain results in the same increase in tax as a dollar of other income.

Using the Form 1040X, Mr. Hoy first determined that the proportion of other income to gain income was 75/25. Mr. Hoy then reduced the gross income to taxable income and arrived at an income tax of \$40,666.00 (Compare to the \$40,663.00 at line 6 of the Form 1040X). Mr. Hoy then allocated the income tax of \$40,666.00, using the 75/25 proportion of non-gain to gain income. Mr. Hoy determined that \$30,500.00 of the income tax was due to non-gain income and \$10,166.00 of the income tax was due to gain from the sale of farm assets.

There were payments made on Debtors' tax liability. Before Mr. Hoy could allocate those payments between the non-gain taxes and gain taxes, Mr. Hoy had to determine Debtors total 2004 liability and the source of the payments. Mr. Hoy added

Debtors' self employment taxes from farm operation to the income tax to arrive at a total tax liability of \$55,842.00 (compare to the \$55,839.00 at line 10 of the Form 1040X).

Mr. Hoy then determined that the proportion of total taxes on non-gain income to the taxes on the gain on sale of farm assets was 82/18.

Mr. Hoy then reduced the taxes on other income by payments that were 100 percent attributable to non-gain income, arriving at an intermediate net due on of \$55,322.00, of which \$45,156.00 was tax attributable to non-gain income and \$10,166.00 was attributable to gain income.

Debtors had made an undesignated payment of \$8,000.00 on their total tax liability. That payment was not from a source that could be attributed to either non-gain or gain income. Mr. Hoy allocated the payment of \$8,000.00, using the ratio 82/18, as \$6,530.00 to non-gain income and \$1,470.00 to gain income. After the payment, the total remaining 2004 total tax liability is \$47,322.00 of which \$38,626.00 is attributable to non-gain income and \$8,696.00 is attributable to gain income. Note the Debtors made a subtraction error at line 21 of their Form 1040X. Based on the numbers on the Form 1040X, line 21 should be \$47,319.00 (compare to \$47,322.00 on the Mr. Hoy's worksheet).

Based on Mr. Hoy's worksheet, \$8,696.00 is the amount of the 2004 tax liability which is attributable to gain income and is the amount of the priority income tax claim which 11 U.S.C. § 1222(a)(2)(A) allows to be treated as an unsecured claim. In fact, Mr. Hoy prepared the Proof of Claim dated November 10, 2005, showing the \$8,696.00 as part of an unsecured claim.

As discussed above, an allocation of postpetition taxes between gain taxes and non-gain taxes is not required since post-BAPCPA does not apply to postpetition taxes. But, should this Court determine that § 1222(a)(2)(A) does apply to postpetition taxes,

the United States asserts that the methodology used by Mr. Hoy is the correct methodology to allocate the total postpetition tax liability between gains taxes and non-gain taxes.

**4. THE MARKET HOGS WERE NOT ASSETS USED IN DEBTORS' TRADE OR BUSINESS**

11 U.S.C. § 1222(a)(2)(A) applies to "any farm asset used in the debtor's farming operation." The Debtors propose to include the sale of hogs raised for sale to the slaughter market (market hogs) with the hogs used for breeding and raising hogs for the market (breeding stock) in those assets sold as having been "used in" the Debtors' farm operation as stated in 11 U.S.C. § 1222(a)(2)(A). The United States asserts that such hogs are products of the farming operation and are not "used in the farming operation" as intended by the statute.

Debtors filed an original Form 1040 for tax year 2004. (Exhibit 1). Debtors used the cash method of accounting in computing the profit or loss from farming on the Form F for tax year 2004. (Exhibit 1). Debtors filed an amended Form 1040, a Form 1040X, for tax year 2004. (Exhibit 2). Debtors' amended return for 2004, Form 1040X, was filed to revoke Debtors' original election of 26 U.S.C. § 179 treatment of the expenses of remodeling their hog building. (Form 1040X, Exhibit 2).

On the Forms 1040 and 1040X for 2004, Debtors included the sale of market hogs on the Schedule F, Profit or Loss from Farming. (Exhibit 1 and 2). On the Forms 1040 and 1040X for 2004, Debtors included the sale of the breeding stock on line 2 of the Form 4797, Sales of Business Property. Debtors then transferred the sale of the breeding stock to line 11 of the 2004 Schedule D. From Schedule D, Debtors transferred the sale of the breeding stock to line 13 of the 2004 Form 1040. (Exhibit 1).

Debtors received any benefits from reduced taxes on the sale of the breeding

stock by using the Schedule D Tax Worksheet at page D-9 of 2004 Instruction for Form 1040. Debtors did not include the sale of market hogs as assets used in a trade or business on their pro forma "2004 Section 1222(a)(2)(A) Return, Schedule 5 to the proposed Plan. (Exhibit 7). Debtors did not include the sale of market hogs as assets used in a trade or business in their "§ 1222(a)(2)(A) Liquidation Analysis", Schedule 1B to the proposed Plan.

Debtors have now asked this Court to determine that the sale of the market hogs should also be included as assets used a trade or business as part of Debtors' farm operation and to determine that any income from the sale of market hogs is income to which post-BAPCPA 1222(a)(2)(A) applies. At trial, the United States objected to Debtors' request to include the market hogs as an asset used in the trade or business.

The Internal Revenue Service Code and Regulations shed some light of the propriety of such a claim. A farmer is entitled to report its income under the cash method or accrual method. Treas. Reg. § 1.61-4. If a farmer elects to use the cash method, all taxable income is included in income in the year it is actually received or constructively received. Farm business expenses are deductible only in the taxable year in which they are paid. A farmer using the cash method does not normally use inventories to compute income. Treas. Reg. §§ 1.461-1(a) and 1.471-6(a). A farmer using the cash receipts and disbursement method of accounting must include the following in gross income:

- (1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,
- (2) The profits from the sale of any livestock or other items which were purchased,
- (3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources.

The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable. Treas. Reg. § 1.61-4(a).

Debtors complied with their income reporting requirements and reported the market hogs in gross income on the Schedule F. (Form 1040, Exhibit 1). Debtors also took advantage of the provisions of 26 U.S.C. § 1231 and reported the sale of the breeding stock on Form 4797. The breeding stock were assets used in a trade or business and the net gains from the sale of assets used in a trade of business may be long-term capital gains for taxation if the assets meet the eligibility requirements. 26 U.S.C. § 1231(b).

However, to be eligible for § 1231 treatment, hogs must be used for draft, breeding, dairy, or sporting purposes. Debtors' breeding stock apparently meets that requirement. Debtors' market hogs would not meet that requirement. 26 U.S.C. § 1231(b)(3)(B). In addition, to be eligible for § 1231 treatment, hogs must be held for a period of 12 months or more from the date of acquisition. Debtors' breeding stock apparently meets that requirement. Debtors' market hogs do not meet that requirement. 26 U.S.C. § 1231(b)(3)(B). Property that is held by the taxpayer primarily for the sale to customers in the ordinary course of the taxpayer's business are not assets "used in a trade or business" and are not eligible for § 1231 treatment. 26 U.S.C. § 1231(b)(1)(B).

Debtors took advantage of 26 U.S.C. § 1231 in their 2004 income tax returns by reporting the sale of the breeding stock on the 2004 Form 4797 and carrying that sale through to the Form 1040. (Form 1040, Exhibit 1).

Post-BAPCPA § 1222(a)(2)(A) requires that the assets which qualify for treatment as an unsecured claim be assets used in Debtors' farming operation. Market hogs are not "used" in a farming operation but, instead, are "produced" by the assets "used" in the farming operation. Debtors' market hogs are not eligible for treatment as an unsecured claim under the authority of post-BAPCPA. 1222(a)(2)(A).

### **III. CONCLUSION**

The United States respectfully requests that confirmation be denied and for such further relief as the Court deems appropriate.

DATED this 18th day of August, 2006.

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**CERTIFICATE OF SERVICE**

I, the undersigned, do hereby certify that I electronically filed a true and correct copy of the above **POST- HEARING BRIEF MEMORANDUM OF LAW IN SUPPORT OF THE UNITED STATES' OBJECTION TO CONFIRMATION OF THE CHAPTER 12 PLAN** with the Clerk of the Court using the CM/ECF system which sent notification of such filing to the following:

Eric Nystrom  
4200 IDS Center  
80 South Eighth Street  
Minneapolis, MN 55402

Joseph A. Peiffer  
PO Box 2877  
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Roger L. Sutton  
119 North Jackson Street  
Charles City, IA 50616

John E Waters  
Iowa Department of Revenue  
Attn Bankruptcy Unit  
Hoover State Office Bldg  
1305 East Walnut Street

and also hereby certify that a copy of the same was served by regular mail, postage prepaid, to the following non-CM/ECF participant(s), all on the date indicated: NONE

DATE: August 18, 2006

UNITED STATES ATTORNEY

BY: s/ Martin J. McLaughlin