



# Ag Decision Maker



## A Business Newsletter for Agriculture

Vol. 9, No. 11                      www.extension.iastate.edu/agdm                      October 2005

### Major developments in Chapter 12 bankruptcy\*

*Neil Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar*  
*Joseph A. Peiffer, Shareholder in Day Rettig Peiffer, P.C., Cedar Rapids, Iowa*  
*Roger A. McEowen, Associate Professor of Agricultural Law, Department of Agricultural Education and Studies, Iowa State University, Ames, Iowa. Member of the Nebraska and Kansas Bars.*

In the most far-reaching revision of bankruptcy law since 1978, Congress has passed and the President is expected to sign legislation making major changes in bankruptcy law. With respect to agriculture, the changes are principally in two areas –

- (1) amendments to the eligibility requirements for Chapter 12 filing and
- (2) modification of the income tax treatment of gains on property liquidated in connection with a Chapter 12 bankruptcy reorganization. A third major area of importance is that the homestead exemption is limited to \$125,000 if the debtor purchased the residence less than three years and four months (defined as 1215 days) before filing. There are exceptions for-
  - (1) the residence of a “family farmer” and

- (2) any amount rolled over from another residence acquired by the debtor before the 1215 day period provided the prior and current residences are located in the same state.

#### Eligibility requirements

Perhaps the most significant features of the new legislation are that it makes Chapter 12 bankruptcy permanent and extends the provisions of Chapter 12 to a “family fisherman” although with different requirements imposed for eligibility. The definition of the term “family farmer” is changed to allow an individual or an individual and spouse engaged in a farming operation to have aggregate debts not to exceed \$3,237,000 (up from \$1,500,000 under prior law) with not less than 50 percent of the aggregate, noncontingent, liquidated debts (excluding the

debt from a principal residence) arising out of a farming operation (down from 80 percent under prior law). Moreover, the requirement that more than 50 percent of gross income must be received from a farming operation the taxable year preceding filing has been relaxed to allow the 50 percent test to be met, in the alternative, during the second and third tax years preceding filing. Thus, a Chapter 12 filer must have more than 50 percent of its gross income from farming in either the tax year prior to filing or in both the second and third tax years prior to filing the Chapter 12 petition.

*continued on page 2*

#### Inside . . .

- Risk management: What does it really mean? ..... Page 3
- New short form cash rent lease available ..... Page 5

Major developments in Chapter 12 bankruptcy, continued from page 1

The dollar requirements are also to be adjusted for inflation at three year intervals.

The requirements imposed on a "family fisherman" remain the same as were imposed on "family farmers" before the 2005 amendments. That is, aggregate debts cannot exceed \$1,500,000, not less than 80 percent of the aggregate noncontingent, liquidated debt must arise out of a commercial fishing operation and the 50 percent gross income test must be met during the taxable year preceding filing.

The 2005 Act does not impose the 50 percent gross income test on otherwise eligible partnerships and corporations for family farmers. That was believed to have been an omission in the 1986 legislation enacting Chapter 12 but it was not changed in the 2005 amendments.

Post-petition taxes

The legislation contains a new provision of immense potential importance to Chapter 12 filers. That provision allows a Chapter 12 debtor to treat claims arising out of "claims owed to a governmental unit" as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" to be treated as an unsecured claim that is not entitled to priority under Section 507(a) of the Bankruptcy Code, provided the debtor receives a discharge. Note that nothing in the legislation specifies when the property can be disposed of to be eligible for unsecured claim status. Of course, the taxing agencies must receive at least as large an amount as they would have received had the claim been a pre-petition unsecured claim. The key point is that, under prior law, taxes were a priority claim and had to be paid in full. Even though the priority tax claims could be paid in full in deferred payments under prior law, in many instances the debtor did not have sufficient funds to allow payment of the priority tax claims in full even in deferred payments.

This amendment addresses a major problem faced by many family farmers filing under Chapter 12 where the sale of assets to make the operation eco-

nomically viable triggered gain which, as a priority claim, had to be paid.

Operationally, if a Chapter 12 bankruptcy filer has liquidated assets used in the farming operation within the tax year of filing or liquidates assets used in the farming operation after Chapter 12 filing as part of the Chapter 12 plan, and gain or depreciation recapture income or both are triggered, the plan should provide that there will be no payments to unsecured creditors until the amount of the tax owed to governmental bodies for the sale of assets used in the farming operation is ascertained. The tax claims are then added to the pre-petition unsecured claims to determine the percentage distribution to be made to the holders of pre-petition unsecured claims as well as the claims of the governmental units that are being treated as unsecured creditors not entitled to priority. With that approach, all claims that are deemed to be unsecured claims would be treated equitably.

Arguably, if a debtor determined post-confirmation that, to insure financial and economic viability, assets used in the farming operation must be liquidated, the Chapter 12 plan could be modified to allow the sale of assets so long as the modified plan made provision to make payments to the taxing bodies in an amount that would equal or exceed what would have been received had it been a pre-petition unsecured claim. Upon entry of the Chapter 12 discharge, the claim of the governmental body for taxes on the sale of assets used in the farming business would also be discharged. If the debtor does not receive a Chapter 12 discharge, the taxing bodies are free to pursue the debtor as if no bankruptcy had been filed, assessing and collecting the tax and all penalties and interest allowed by law.

The 2005 Act also specifies that a Chapter 12 plan may provide for less than full payment of all amounts owed for a claim entitled to priority under 11 U.S.C. § 507(a)(1)(B) (a higher priority classification for domestic support obligations

Major developments in Chapter 12 bankruptcy, continued from page 2

assigned to governmental units) only if the plan provides that all of the debtor's projected disposable income for a five-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

The 2005 Act also adds a new provision requiring an individual Chapter 12 debtor to be current on post-petition domestic support obligations as a condition of confirmation of a plan.

Effective dates

Except as otherwise provided, the amendments made by the Act are effective 180 days after enactment, the date of the President's signature. However, the provision making Chapter 12 bankruptcy a permanent part of the Bankruptcy Code was effective July 1, 2005.

The bill also specifies that, except as otherwise provided, the amendments do not apply to cases commenced under Title 11, United States Code

(the bankruptcy provisions) before the effective date of the Act. The amendments made by Sections 308, 322 and 330 apply with respect to cases commenced under Title 11 on or after the date of enactment of the Act.

The Chapter 12 tax provisions (Section 1003 of the Act) are effective upon enactment, as is the homestead exemption provision.

Conclusion

The 2005 amendments make highly important changes to Chapter 12 bankruptcy. The changes involving the possible conversion of taxes on the sale of assets used in the farming operation to the status of pre-petition unsecured claims are particularly notable.

\* Reprinted with permission from the April 22, 2005 issue of Agricultural Law Digest, Agricultural Law Press Publications, Eugene, Oregon. Footnotes not included.



Risk management: What does it really mean?

by Kelvin Leibold, ISU Extension Area Farm Management, kleibold@iastate.edu

A lot of discussion is given to the topic of "Risk Management" but it is usually not well defined. "Risk Management" in agriculture is often thought to encompass five general areas. These areas include Production Risk, Marketing Risk, Financial Risk, Legal Risk, and Human Risk. As we head towards the end of another production cycle and the start of a new, it is prudent that every business review the potential impact of these different risks and what strategies are being used to manage them. Risks are rarely eliminated; the exposure to the risks may just be shifted to another party.

Production risk

The area of risk that most businesses are familiar with is production risk. The government has done a lot to provide tools to manage yield risk through the subsidization of crop insurance. Production risk includes many other areas such as land base and rental rates. A question you may have to answer is: how will you deal with landlords that die or increasingly higher rental rates? Knowing the answer now can help manage the risk later. Maintaining a land base at a reasonable cost is becoming a greater challenge as more land is owned by out of state landlords.

Risk management: What does it really mean?, continued from page 3

Corn hybrid selection is a good example of how production risk management has increased. Do you manage rootworms with insecticides or biotechnology? How does "green snap" impact the crop insurance I buy? How does "dry down" of various hybrids impact my corn drying costs? The decision on which hybrid you plant impacts several other areas.

Another area of production risk that is getting more attention is the area of machinery costs. Producers seem to be more interested in looking at machinery sharing arrangements. This is driven by the high cost of machinery as well as the new technology that is available. Iowa farmers tend to have higher fixed costs with machinery due to the short length of our growing season. Along with fixed machinery costs, there are operating costs such as fuel and repairs. With higher costs for fuel this fall, it will be an expense many are concerned about. To keep operating costs down, expenses may need to be cut in some areas to make up for the higher fuel prices.

Other areas of production risk might include specialty crops, livestock production, and grain drying, handling and storage. Grain storage losses can be significant as we saw at several commercial elevators.

Marketing risk

This leads us into the next area of risk to review and that is marketing risk. Again the government has done a lot to help us manage price risk under the 2002 Farm Bill. We have revenue crop insurance and Loan Deficiency Payments or Marketing Loans to help manage low prices. However, marketing has become more difficult as we now are trying to pick both the high and the low price to maximize revenue. In addition the highly subsidized crop insurance products offer a wide array of choices that can make finding the right one time consuming.

Marketing will continue to be a major factor in the overall profitability of farms. A key starting point is to know what your break-even costs are and

look for opportunities to market above those costs. If your break-evens are so high that you have little opportunity to market at a profit it indicates that you have to reanalyze and find what options there are for you. Decision Tools that are available from the AgDM web site can help you find your break even price for different crop rotations.

Financial risk

Financial risk ties back into marketing risk. The areas of financial risk include strategic planning, business planning, financing, credit analysis, record keeping, retirement planning and estate planning to name a few. To begin managing financial risk, start by looking at the trends in your net worth statement. A Decision Tool is available to help you in analyzing your net worth statement. This spreadsheet is available at: <http://www.extension.iastate.edu/agdm/wholefarm/xls/c3-20net-worth.xls>. Look at several years of operating profits to see what the trend looks like. How is your "working capital" changing over time and in what direction? This will help you get started looking at some of the strategic planning that every firm needs to set aside time to do. What changes are occurring in the industry and how will they impact you? Think about the changes that you may need to make to keep up with technology and similar operations to remain competitive.

Legal risk

Another area of risk to review is legal risk. This ties in with some of the other areas. Many contracts are signed without the individual obtaining any legal review of the document. In grain marketing, grain is often sold over the phone without even a signature. Misunderstandings can be avoided down the road by having a written lease contract that has been reviewed by a legal expert. All the various insurance policies such as life, disability, long term care, medical, liability, and property, should also be reviewed. Taking a little extra time now could save you time and money in the future. In the near future, legal issues regarding the environment will be coming to the forefront; especially for livestock producers.

Risk management: What does it really mean?, continued from page 4

Human risk

The area of human risk is often overlooked in agriculture. How would the operation be impacted if you were injured or disabled? How would the labor and management of the operation be handled? Is the rest of the family knowledgeable about the operation? Do you use hired help? Do you provide training and help in learning new skills? Are you complying with all of the legal requirements? Planning ahead can make dealing with an illness or injury much easier on the individuals and the business that is affected.

I have touched on just a few of the many issues related to risk management. Many of these are tied together. Hopefully you will spend some time thinking about how these risks impact your business. If you would like more in-depth information visit the following web sites. The Ag Risk Library <http://www.agrisk.umn.edu/Library/Topics.asp?CMD=Count&LIB=Main> at the University of Minnesota has hundreds of articles on these topics. The Agricultural Marketing Resource Center <http://www.agmrc.org/> also has a lot of information on business risk management.



New short form cash rent lease available

by James Jensen, Iowa State University Extension Farm & Business Management Specialist, [jensenjh@iastate.edu](mailto:jensenjh@iastate.edu)

Recent Iowa State University data reveals what we know we have been seeing for years...leasing relationships are changing. Leasing agreements are moving from crop-share arrangements between the tenant and landowner to cash rent agreements. There are many reasons for the change which include both advantages and disadvantages for the tenant and the landowner. The move to cash rents has been gradual over the years but at an increased rate recently. To help accommodate this change, Iowa State University Extension has created a new "short form" cash rent lease form that it hopes will encourage leasing participants to have a written lease. Iowa State University Survey data suggests that only 56% of leases in Iowa are committed to writing and less than that are reviewed every year. Leasing property is a legal relationship that often involves large sums of money changing hands. Written leases that are updated yearly are a good way to make sure that the agreements are business-like and up to date. The agreements should be stored and labeled in such a manner that relatives or business partners can find them if the need develops. The new form is ISU Publication Number FM 1874 and can be obtained at any ISU Extension Office

or an interactive form is available on the AgDM web site at <http://www.extension.iastate.edu/agdm/wholefarm/pdf/c2-16.pdf>.

The following discussion touches on some of the advantages and disadvantages to landowners and tenants when using a cash rent rather than a crop share lease.

Tenant advantages to cash rent leases:

- The tenant does not need to keep production from each landlord separate and can commingle the grain from various landowners into one storage bin.
- The tenant does not need to check with every landowner when making production related decisions including FSA programs. This reduces the time it takes to make decisions and act.

Tenant disadvantages to cash rent leases:

- The tenant has more risk exposure than with a crop share lease situation.
- Operating cash needs are increased.

New short form cash rent lease available, continued from page 5

Landowner advantages to cash rent leases:

- Less risk exposure to weather conditions and prices.
- The guaranteed payment rate allows land owners to budget income for the year.
- There is less of a management requirement for the owner so it is easier to handle the leasing transaction from a distance.
- There is less of a need for the landowner to keep up to date on changes occurring in agriculture. The trend is for landowners to know less and less about farming.

Landowner disadvantages to cash rent leases:

- The tenant might not pay the rent and collecting it may be problematic.
- The land may not be treated the way the land owner would like and they may not even know this is happening.

Updates, continued from page 1

Handbook updates

For those of you subscribing to the handbook, the following updates are included.

Estimated Costs for Livestock Fencing – B1-75 (4 pages)

Cattle Price Changes by Two-Week Periods – B2-20 (1 page)

Please add these files to your handbook and remove the out-of-date material.

Internet updates

The following update has been added to [www.extension.iastate.edu/agdm](http://www.extension.iastate.edu/agdm).

Weather-Related Sales of Livestock–C4-28 (3 pages)

... and justice for all

The U.S. Department of Agriculture (USDA) prohibits discrimination in all its programs and activities on the basis of race, color, national origin, gender, religion, age, disability, political beliefs, sexual orientation, and marital or family status. (Not all prohibited bases apply to all programs.) Many materials can be made available in alternative formats for ADA clients. To file a complaint of discrimination, write

USDA, Office of Civil Rights, Room 326-W, Whitten Building, 14th and Independence Avenue, SW, Washington, DC 20250-9410 or call 202-720-5964. Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Stanley R. Johnson, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.

Permission to copy

Permission is given to reprint ISU Extension materials contained in this publication via copy machine or other copy technology, so long as the source (Ag Decision Maker Iowa State University Extension ) is clearly identifiable and the appropriate author is properly credited.