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WHEN IS A FARMER A “FAMILY FARMER”? AN ANALYSIS OF CHAPTER 12 INCOME QUALIFICATION

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The United States Bankruptcy Code's (Code)¹ allowance of a small farmer to benefit from utilizing Chapter 12 bankruptcy reorganization is structurally flawed in that it restricts the participation of the very farmers the Chapter was designed to protect. One should consider what the law is, the various approaches that can be taken as to its application, and finally, what modifications may structurally be made to the Code so as to make its application more consistent with the stated purpose of this Code provision.

For a farmer to become eligible for Chapter 12 bankruptcy relief, the debtor must demonstrate that she is not merely a “farmer,” but rather, that she is a “family farmer.”² In order to qualify as a “family farmer” under 11 U.S.C. §§ 109(f), 101 (18–21) and 1201, *et seq.*, a debtor must satisfy very specific conditions. Section 101(18)(A) reads in its entirety:

“[F]amily farmer” means—individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed \$1,500,000 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or

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1. 11 U.S.C. § 101 (2004).
2. 11 U.S.C. § 109(f) (2004).

operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed.³

The simple part of this analysis is determining whether the aggregate debts exceed \$1.5 million and whether not less than eighty percent of that debt arises out of a farming operation. The difficulty generally comes when determining whether *more than* fifty percent of the debtor's gross income for the taxable year preceding the taxable year in which the case is filed qualifies as farming income. If a debtor were to file her bankruptcy petition on December 23, 2002, the applicable tax year for this calculation would be that of 2001. It is often confusing when matching the petition's schedules that are based on the then current tax year with the qualification period of section 101(18)(A) that relies on the immediately prior tax year.

I. WHAT IS FARMING INCOME?

There are two primary paths of analysis that are widely adopted by courts today in determining the fifty percent income satisfaction required by section 101(18) of today's Code.⁴ Many courts have followed the "Totality of the Circumstances" approach, in which it is determined whether the income of a debtor appears to have been legitimately generated from active, at-risk agricultural production.⁵ Factors such as whether a debtor's rental income is guaranteed, whether the debtor lives on and works the farm herself, and the apparent post-bankruptcy intentions of the debtor are all factors that have been used to determine whether the income generated by a debtor qualifies as farm income.⁶ The court will look at both the debtor's history of activity on the farm or ranch and her future prospects of planned agricultural activity.⁷ Is the debtor acting like a farmer or rancher? Is the debtor winding down his agricultural business? Is the debtor himself working the land? Is the

3. 11 U.S.C. § 101(18)(A) (2004).

4. 11 U.S.C. § 101(18)(A) (2004).

5. *In re Cobb*, 76 B.R. 557 (Bankr. N.D. Miss. 1987); *In re Welch*, 74 B.R. 401 (Bankr. S.D. Ohio 1987); and *In re Indreland*, 77 B.R. 268 (Bankr. D. Mont. 1987).

6. *In re Glenn*, 181 B.R. 105 (Bankr. E.D. Okla. 1995).

7. *In re Haschke*, 77 B.R. 223 (Bankr. D. Neb. 1987).

debtor herself subject to the cyclical nature of agriculture, being it from weather or market factors?

What commonly frustrates the qualifying farmer is the need to gain supplemental income in the year prior to bankruptcy. Seldom is a bankrupt party in a position whereby they can turn down opportunities to earn cash income. It is not infrequent for a prospective debtor to work to earn money from selling real estate, teaching, or caring for elderly neighbors or family members. These are typically desperate times for an agricultural producer, otherwise, the debtor would likely not be meeting with a bankruptcy attorney.

A second approach applies the more mechanical test of the Internal Revenue Code (I.R.C.) of gross income,⁸ an approach that has been adopted by some Oklahoma courts.⁹ First the amount of gross income must be determined. On a federal tax return, the gross income is not the Adjusted Gross Income. Gross Income is the total of all income for that taxpayer during that tax year.¹⁰ To determine this the attorney must evaluate each individual schedule of a taxpayer's return, ignoring for purposes of this analysis any expenses associated with those individual schedules.¹¹ Once the non-farming income is identified (typically W-2 payroll income, non-farm investment income, pension or retirement income and so on), the attorney must determine the amount of farming-generated gross income.¹² Remember that if an income item does not fall into the farm side, it automatically is placed on the non-farming side. The absence of a benefit to the calculus is a certain penalty to the debtor. The I.R.C. defines gross income as:

[A]ll income from whatever source derived, including (but not limited to) the following items:

- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;

8. 26 U.S.C. § 61 (2004); 26 C.F.R. § 1.61-1.

9. *In re King*, 272 B.R. 281, 293 (Bankr. N.D. Okla. 2002).

10. 26 U.S.C. § 61 (2004); 26 C.F.R. § 1.61-1.

11. 26 U.S.C. § 61 (2004); 26 C.F.R. § 1.61-1.

12. *In re Cobb*, 76 B.R. 557 (Bankr. N.D. Miss. 1987); *In re Maschhoff*, 89 B.R. 768 (Bankr. S.D. 1988).

- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts;
- (11) Pensions;
- (12) Income from discharge of indebtedness;
- (13) Distributive share of partnership gross income;
- (14) Income in respect of a decedent; and
- (15) Income from an interest in an estate or trust.¹³

Obviously, compensation does not have to be in cash for it to be recognized as gross income under the I.R.C. Frequently in the farming business, farm income is generated from non-cash sources. Bartering or trading of services is gross income for I.R.C. purposes.¹⁴ This is absolute, even when there may not be a net taxable effect upon the taxpayer or debtor. One example might be a situation where a farmer hires a fence builder to build fencing to hold in cattle, but rather than paying for the fencing provides grazing rights to that fence builder that might have otherwise been valued at \$1,000. In this instance, the farmer generated \$1,000 worth of income from the "sale" of the grazing rights, offset by the same \$1,000 of expenses. While this event may have no net tax effect on the farmer, it certainly produces \$1,000 of gross income, all of which is recognized as farm income.

13. 26 U.S.C. § 61 (2004).

14. *Id.*

It is essential that the debtor's federal income tax return be correctly reported. Any two tax preparers are likely to find at least that number of different reporting methods or justifications. It is important to be as clear as possible in the reporting. The farm income should be disclosed on the Schedule F (Farm Income) of the taxpayers return. Some preparers report much of farm income on the Schedule 4835, a schedule on which farm-lease income is listed.¹⁵ Perhaps this provides for an opportunity to avoid incurring self-employment taxes. However, such temptation should be avoided because it creates a presumption of non-farm income that will later have to be rebutted. So important is this initial impression that a Kansas court has said that it "ha[d] neither the power nor the inclination to delve beyond the face of debtors' income tax returns."¹⁶

It is often asked, "How much more than fifty percent is required" to demonstrate farming qualification for a Chapter 12 debtor? The answer is simple, \$1.00 more of farm income versus non-farm income is more than fifty percent.¹⁷ The same is true if the difference is but a penny. Remember, that slim difference can cut the other way as well.

II. IS LEASING FARM LAND TO A FARM TENANT FARMING INCOME?

The answer is not so clear. It has been held by some appellate courts that leased farmland may be excluded from income related to farming operations primarily because the farmer receiving the rent at the commencement of the rental term is "insulated from traditional risks associated with farming."¹⁸ However, in that same year a district court in North Dakota held that because the debtors' income was likely tied to the success of their son's farm production, in other words, that it was conditioned upon survival of a risk, that income was allowed to be characterized as being farm income.¹⁹ While some parts of that court's decisions were later overturned,²⁰ the thread of risk associated with "interest" in the success of the farming activity appears to run throughout the court decisions that have held rental income to be included with farming income. It is as though risk is an indicia of ownership, and certainly an inherent characteristic of farming income. A farmer, in

15. Dept. of Treasury Internal Revenue Service Form 4835 (2004).

16. *In re Nelson*, 73 B.R. 363, 365 (Bankr. D. Kan. 1987).

17. 11 U.S.C. § 101(18)(A) (2004).

18. *In re Armstrong*, 812 F.2d 1024, 1028 (7th Cir. 1987), *cert. denied*, 484 U.S. 925 (1987); 100 B.R. 535 (Bankr. D. Or. 1987).

19. *In re Rott*, 73 B.R. 366, 372-73 (Bankr. D. N.D. 1987).

20. *In re Wruck*, 183 B.R. 862, 864 (Bankr. D. N.D. 1995).

order to be entitled to relief under Chapter 12 of the Code, cannot receive her rent regardless of the success of the tenant.²¹ While the bankruptcy code has gone through numerous revisions and overhauls during the past century, even one hundred years ago it was held that a farmer who possessed a guaranteed lease of his farm "for a year" was not to be engaged in farming.²² Again, the word "leased" was tied to circumstances that buffered the landlord farmer from risk. In *Federal Land Bank v. McNeal*, the Eleventh Circuit Court of Appeals refused to recognize the sale of manure for fertilizer as being part of a farming operation because, as a free-standing business, it was not subject to the "cyclical nature of a farmer's business."²³ It should be argued, if appropriate, that a debtor's leases may be on a month-to-month basis. It must be shown that the debtor's success or income opportunity is tied to some of the same risks that are inherent in active farming.²⁴ The farmer must show that she is not merely a corporate lessor insulated from the risk of cyclical farming conditions and income opportunity.²⁵ If a lessee failed to prosper, or fails to succeed in his agricultural production, then so must the debtor/lessor suffer. With a month-to-month lease, there is no guarantee that a lessee will pay for more than the single month that had been paid.

III. TOTALITY OF THE CIRCUMSTANCES

Another thread that finds itself wound about the arguments against recognizing leased farm land as farming income within 11 U.S.C. § 101(18) is a consideration of all facts and circumstances about the entity and its operation as of the time of filing. This includes such factors as the following:

[W]hether there is a physical presence of family members on the farm, whether the debtor owns traditional "farm assets," whether leasing land is a form of scaling down of previous farm

21. *In re Haschke*, 77 B.R. 223, 224-25 (Bankr. D. Neb. 1987).

22. *In re Matson*, 123 F. 743 (D. Pa. 1903).

23. *Federal Land Bank v. McNeal*, 848 F.2d 170, 171 (11th Cir. 1988) (quoting *In re Armstrong*, 812 F.2d at 1027).

24. *In re Maynard*, 295 B.R. 437 (Bankr. S.D.N.Y. 2003); *In re Robin Ranch, Inc.*, 80 B.R. 166 (Bankr. D. Neb. 1987).

25. *Tim Wargo & Sons, Inc. v. Equitable Life Assurance Soc'y*, 86 B.R. 150 (E.D. Ark. 1988), *aff'd.*, 869 F.2d 1128 (8th Cir. 1989); *In re Mary Freese Farms, Inc.*, 73 B.R. 508 (Bankr. N.D. Iowa 1987).

operations, what the form of any lease arrangement is and whether the debtor entity had, as of the date of filing, permanently ceased all of its own investment of assets and labor to produce crops or livestock [Keeping] in mind that the leasing of farm land, for either cash or a crop share, has been an integral part of many family farm operations throughout this country for years.²⁶

Other courts have simply said the question of what constitutes farming operations for purposes of Chapter 12 income depends on the "totality of the circumstances."²⁷ Two years later, that same district court held that the harvesting of merchantable timber was farming income activity, not simply due to the sustaining yield opportunity, but in considering how actively involved the principals were in "work[ing] the soil by clearing brush and weeds" and doing other activities to further encourage the successful use of the property.²⁸ At least one court has framed the question of whether the farming activity and its resulting income belongs to the owner of the property or the operator as being made by considering the character of the business and whether its income is derived from its own farming or production efforts as opposed to the farming or production efforts of others.²⁹ In *In re Mary Freese Farms, Inc.*, the court held that the farmer had to do more than simply collect rent in order to be recognized as a family farmer.³⁰ In *In re Paul*, the court recognized, in weighing the totality of circumstances, that the debtor intended to continue living on the farmstead and continue to engage in agricultural activities.³¹ Courts will look at the specific activities of the debtor-farmer.³² The attorney must be prepared to demonstrate at an evidentiary hearing that the debtor himself is actively engaged in agricultural production. The court will look at whether the debtor-farmer benefits solely from the work and risk of others or whether such potential benefit is devised of the debtor's own ingenuity and labor.³³ In *In re Easton*, the Eighth Circuit held that property rent for crop production was "farm income" if it could be shown that the debtors

26. *In re Mikkelsen Farms, Inc.*, 74 B.R. 280, 285 (Bankr. D. Or. 1987).

27. *In re Burke*, 81 B.R. 971, 976 (Bankr. S. D. Iowa 1987).

28. *In re Sugar Pine Ranch*, 100 B.R. 28, 32 (Bankr. D. Or. 1989).

29. *In re Dakota Lay'd Eggs*, 57 B.R. 648, 656 (Bankr. D. N.D. 1986).

30. *In re Mary Freese Farms, Inc.*, 73 B.R. 508, 510 (Bankr. N.D. Iowa 1987).

31. *In re Paul*, 83 B.R. 709, 713 (Bankr. D. N.D. 1988).

32. *Id.*

33. *In re Easton*, 883 F.2d 630, 636 (8th Cir. 1989).

"had some significant degree of engagement in, played some significant operational role in, or had an ownership interest in the crop production which took place on the acreage they rented."³⁴ Once again, the test is whether the debtor can show "the existence of some indicia of involvement on the part of the debtor in the farming activity which generates the income he seeks to have credited toward satisfaction of the income requirement" for Chapter 12 bankruptcy relief.³⁵

IV. CONGRESSIONAL INTENT

It is clear in reading the statutory history of the original definitions of "farmer," and later as more finely limited to "family farmer," that it was the intent of Congress to not eliminate the small farmers from qualification of bankruptcy rights.³⁶ In fact, although the term "farmer" had previously been defined in the Bankruptcy Act, its present definition, as now found in section 101(21) of the Code, is also a product of the Bankruptcy Reform Act of 1978.³⁷ The term was first defined in the 1938 Revisions to the Bankruptcy Act of 1898 which was then codified as 11 U.S.C. § 1(17) of the former Act.³⁸ The reason for the 1938 definition was not to limit, but rather, to extend the meaning of farmer to "persons engaged chiefly in farming or the tillage of the soil."³⁹ The legislative history pertaining to the passage of section 101(17) of the Code suggests that the definition was derived from the Small Business Act and was meant by its framers to encompass only small farmers rather than agri-business.⁴⁰ Unfortunately, it is often the small farmer who finds herself lost of the opportunity to benefit from the protective rights authorized by Congress simply because of the need of the small farmer to seek alternative short-term, stopgap sources of income.

V. SALE OF SURFACE PRODUCTS

In areas of western Oklahoma it is not uncommon for farmers to sell shale for roadbed materials. Similarly, in southern Oklahoma gravel is frequently sold as a cash product by struggling farmers. There remains a

34. *Id.*

35. *Id.* at 635.

36. See *In re Dakota Lay'd Eggs*, 57 B.R. 648, 652-54 (Bankr. N.D. Iowa 1987).

37. *Id.*

38. *Id.*

39. H.R. REP. NO. 75-1409, at 6 (1937).

40. H.R. REP. NO. 95-595, at 311 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787-6268.

lack of definitive cases directing how this income should be classified by a tax preparer on behalf of a farmer-debtor. However, it can be argued by analogy that not only is this kind of sale directly agricultural income, it would be irresponsible for a farmer not to pursue the sale of this kind of product.

In an appellate decision of a Tax Court ruling, the Second Circuit Court of Appeals upheld the Commissioner's denial of an income tax deduction for losses incurred by a taxpayer in the operation of a farm, relying partly on testimony that she had failed to sell gravel that was available on her farm; gravel on the property could have been sold without spoiling the property's agricultural balance.⁴¹ In another non-bankruptcy case, *Chapman v. Durkin*, the Fifth Circuit considered a matter in which an employer was seeking to exempt from the Fair Labor Standards Act, 29 U.S.C. § 201, certain employees of a fruit company on grounds that the employees were agricultural workers exempt from the Act.⁴² The Act defined "agriculture" as including "farming in all its branches and among other things includes . . . any practices . . . performed by a farmer or on a farm as incident to or in conjunction with such farming operations."⁴³ Later in that same opinion, the court quoted the United States Supreme Court in *Farmers Reservoir & Irrigation Co. v. McComb*, which defined "agriculture" as that which "includes any practices, whether or not themselves farming practices, which are performed either by a farmer or on a farm, incidently to or in conjunction with 'such' farming operations."⁴⁴ The Supreme Court noted that "agriculture, as an occupation, includes more than the elemental process of planting, growing and harvesting crops. There are a host of incidental activities which are necessary to that process."⁴⁵

There are no cases directly on point as to whether the sale of roadbed materials by farmers in the context of creating a better farming environment or in enhancing the agricultural opportunities associated with a particular farm is farm income. However, it appears from the cases that when the activity is directly connected to, and so obviously in furtherance of farming activity, then it should be recognized as farming income for the purposes of a Chapter 12 analysis.

41. *Schley v. Comm'r*, 375 F.2d 747, 756 (2nd Cir. 1967).

42. *Chapman v. Durkin*, 214 F.2d 360, 361 (5th Cir. 1954).

43. *Id.*

44. *Id.* at 362 (quoting *Farmers Reservoir & Irrigation Co. v. McComb*, 337 U.S. 755, 763 (1949)).

45. *McComb*, 337 U.S. at 760.

VI. THE ALTERNATIVE "MECHANICAL APPROACH"

While it has proven to be a difficult task for the courts to determine how to interpret family farming activity because of the amending of the Code by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986,⁴⁶ courts have attempted to find objective standards by which to complete this analysis. In 1986, in *Matter of Wagner*,⁴⁷ the court found "hopelessly vague" the earlier tests for engagement in farming activity. In *Wagner*, the court considered whether deferred pension income was to be realized gross income when calculating whether Wagner qualified as a farmer.⁴⁸ Recognizing the great potential for "arbitrariness" in what was then defined in § 101(17) of the Code, the court adopted for the Bankruptcy Code the same meaning of gross income as used in the I.R.C.,⁴⁹ making seemingly simple a previously arbitrary task.⁵⁰ One year later in *Armstrong*,⁵¹ the same court softened that mechanical approach, seemingly retaining the *Wagner* analysis while adding the weight associated with the totality of the circumstances.⁵²

Again, some courts still adopt *Wagner*. In 1987, two months after *Armstrong*, the Bankruptcy Court in *In re Nelson*, held that it "ha[d] neither the power nor the inclination to delve beyond the face of debtors' income tax returns."⁵³ Recently, the Northern District of Oklahoma concluded that "the definition of 'gross income' contained in the Tax Code and adopted in *Wagner* and its progeny is preferable to the more flexible definition used by the courts in *Rott* and similar cases," concluding that such adoption is consistent with the policies behind other bankruptcy provisions and filing requirements.⁵⁴

46. Pub. L. No. 99-554, 100 Stat. 3095, 3097 (1986) (codified at 11 U.S.C. § 101(18)-(20) (2004)).

47. 808 F.2d 542, 544 (7th Cir. 1986).

48. *Id.*

49. 26 U.S.C. § 61 (2004).

50. *Wagner*, 808 F.2d at 547-49.

51. *In re Armstrong*, 812 F.2d 1024, 1026 (7th Cir. 1987).

52. *In re Koenegstein*, 130 B.R. 281, 284-85 (Bankr. S.D. Ill. 1991).

53. *In re Nelson*, 73 B.R. 363, 365 (Bankr. D. Kan. 1987).

54. *In re King*, 272 B.R. 281, 293 (Bankr. N.D. Okla. 2002).

VII. A REPAIR

It has been theorized that a reasonable solution to the quandary of a farmer-debtor facing qualification under a Chapter 12 petition, is that the test should be changed from one that only assesses the last pre-filing tax year's gross income. Perhaps instead, the Code could be made to require that one out of the last three years prior to the filing of the bankruptcy, or the average of the last three years prior to the filing, be sufficient to demonstrate that more than fifty percent of the farmer-debtor's gross income was generated from farming sources.

VIII. SUMMARY

This information and approach will be useful when the larger mortgage creditors of a farmer-debtor object to the qualification of a farmer's Chapter 12 petition, seeking to dismiss for lack of qualification that debtor as a family farmer. Never fail to remind the court in the response that "objections to discharge should be construed liberally in favor of debtors and strictly against objecting creditors."⁵⁵

55. *Id.* at 303 (citing *In re Juzwiak*, 89 F.3d 424, 427 (7th Cir. 1996)).