

Bankruptcy and the Farm

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 - Treatment of government payments
 - Farm losses and hobby rules
 - Self-employment tax
 - Estate and gift tax
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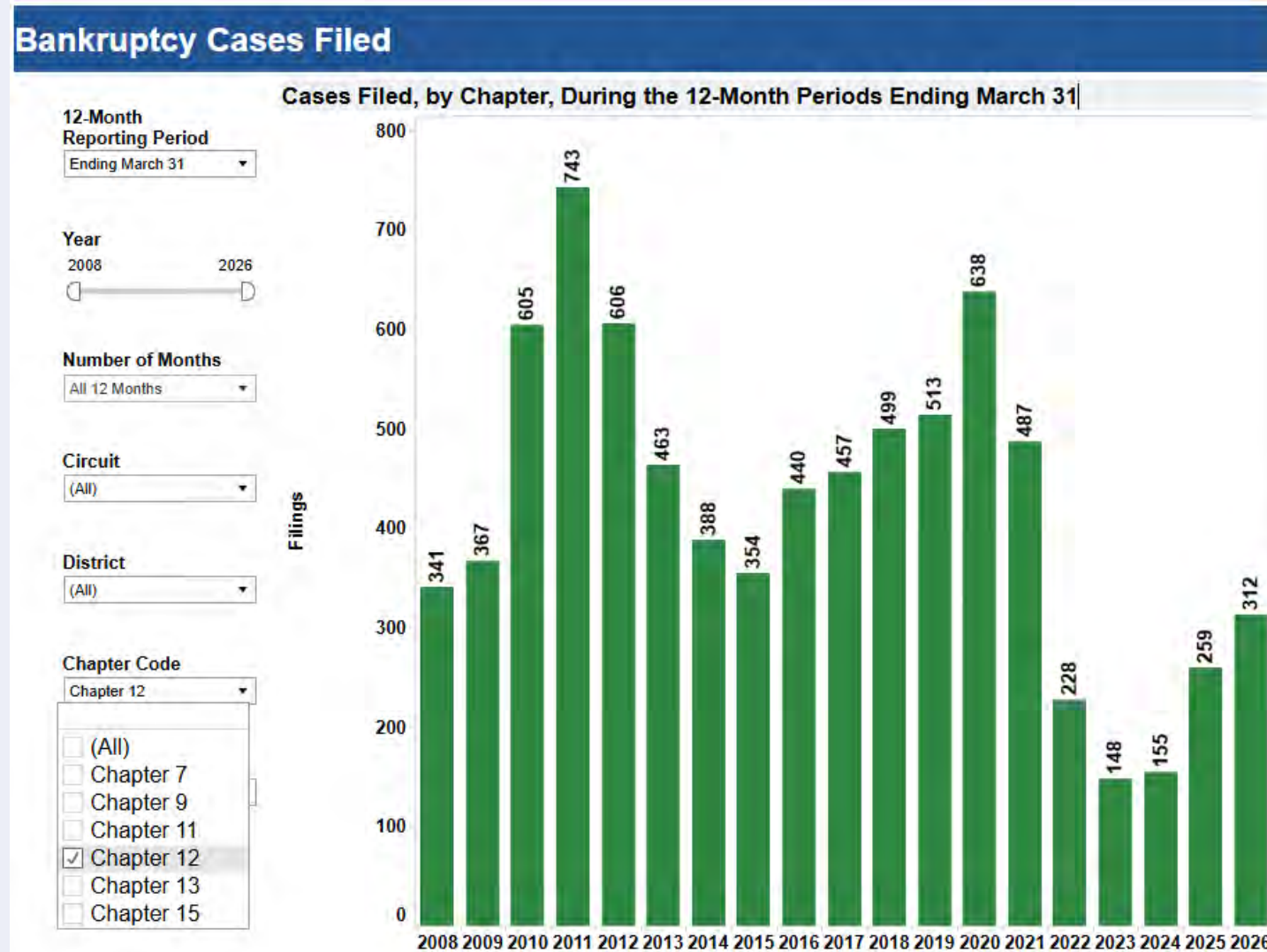
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FARM BANKRUPTCY PERSPECTIVE

- This data is for Chapter 12 only.
- We do not have records of farm bankruptcies filed under Chapter 7 or Chapter 11.



BANKRUPTCY PURPOSE

“Bankruptcy gives to the honest but unfortunate debtor...a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.” *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).



CONSULT WITH AN EXPERT

Bankruptcy is not necessary for all financially distressed farmers. It is also not a do-it-yourself project.

Any farmer that is facing financial difficulty should reach out to a farm financial specialist sooner rather than later.

Some options will disappear if they are not pursued in a timely manner.



BANKRUPTCY OPTIONS

Chapter 7 – Liquidation

Chapter 9 - Municipalities

Chapter 11 – Business Reorganization

- **Subchapter V** – Small business option - \$3,024,725 debt limit.

Chapter 12 – Family Farmer Reorganization

Chapter 13 – Individuals with Regular Income

Chapter 15 – Cross-Border Insolvency

FARMERS AND BANKRUPTCY

- Farmers may use Chapters 7, 11, and 12.
- Today we will compare these chapters, but ultimately focus on Chapter 12, the special reorganization chapter for farmers and fishermen.

INITIATING A CASE (ALL CHAPTERS)

- A voluntary bankruptcy case is commenced by **filing a petition** with the bankruptcy court.
 - Credit counseling must be completed before filing a petition under any chapter.
- The filing of the petition constitutes an “**order of relief.**” 11 U.S.C. § 301.



AUTOMATIC STAY (ALL CHAPTERS)

At the time a bankruptcy petition is filed, the automatic stay **temporarily halts** lawsuits, foreclosures, garnishments, and creditor collection activities.

- The length and application of the stay varies according to the type of bankruptcy.
- Because of the automatic stay, the bankruptcy court generally oversees tax claims, tax determinations, and tax discharges in bankruptcy.



CHAPTER 7 - LIQUIDATION

Chapter 7 is a liquidation bankruptcy.

- This applies to farmers **getting out of business**.
- The debtor initiates this relief by filing a petition, including a schedule of assets and liabilities, a schedule of income and expenses, a statement of financial affairs, and a schedule of contracts and unexpired leases.
- This filing creates an “estate” comprising all of the debtor’s property.
- A trustee collects non-exempt assets and makes distributions.



CHAPTER 7 - LIQUIDATION

Trustee first pays the cost of administration and priority unsecured claims, such as child support and tax debt.

Secured creditors retain security interest in collateral.

Unsecured creditors receive payment only in asset cases.

- Then, unsecured creditors collect on a pro-rata basis.

DISCHARGE

Individuals, partnerships, and corporations (with some exceptions) can file for Chapter 7 bankruptcy protection,

Individual debtors receive a **discharge**, releasing them from personal liability for certain dischargeable debts.

- Some debts, such as child support and some student loans, are not dischargeable in bankruptcy.



EXEMPT PROPERTY

Individual debtors are allowed to keep assets considered “exempt” under either Bankruptcy Code or state law. 11 U.S.C. § 522.

The Bankruptcy Code allows states to replace federal exemptions with their own.

- Illinois and Iowa, for example, require debtors to use **state exemptions**. Wisconsin uses federal exemptions.

SOME FEDERAL EXEMPTIONS

- Automobile (\$5,025 in equity in one vehicle)
- Child Support and Alimony
- Health Aids
- Implements, books, and tools of the trade up to \$3,175.
- Jewelry (up to \$2,125)
- Personal Injury Settlement up to \$31,575
- Animals, crops, clothing, appliances and furnishings, books, household goods, and musical instruments (up to \$800 per item or \$16,850 total)
- Pensions and IRAs up to \$1,711,975
- Homestead (\$31,575 in equity)

MEANS TEST

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 prohibits **consumer debtors** from discharging debt under Chapter 7 if they have the “means” or income to make payments over a period of time to creditors.

- These consumers must instead file for Chapter 13 relief (payment plan).



SECURED CREDITORS

- The secured creditor is generally entitled to retrieve non-exempt collateral, unless the debtor chooses to **redeem or reaffirm the debt**.
- Debtors generally have 30 days from the filing of the petition to make this declaration.
- Secured creditors are not entitled to the value of the collateral in excess of the debt owed.

CHAPTER 7 SUMMARY

The advantage of a Chapter 7 liquidation bankruptcy is that it is relatively inexpensive and efficient.

- It generally requires only 90 days from filing to discharge.
- Farmers who are getting out of farming are candidates for Chapter 7.

The disadvantage of Chapter 7 is you are getting out of farming. Your assets will be gone.

CHAPTER 11 REORGANIZATION

- Allows business debtors to reorganize their debt *and* **continue operating their business.**
- A Chapter 11 petition may be filed by individuals, partnerships, and corporations, with certain exceptions.
- Chapter 11 is usually complicated and expensive.
- Chapter 11 has no debt limit.

CHAPTER 11 REORGANIZATION

- A *creditors' committee* ensures fair representation to the unsecured creditors.
- Debtor has 120 days to file a reorganization plan, and 180 days to have the plan “accepted” by the creditors.
- Creditors can reject a plan.

CHAPTER 11 REQUIREMENTS

- Must be **feasible**
- Must be in good faith
- Must be in the best interest of creditors
- Must provide **adequate protection** to secured creditors
 - Collateral will not lose value during plan.
- Must follow **absolute priority** rule
 - Debtor cannot generally retain property **unless the plan provides for the payment of all debt** (unless creditors agree otherwise)
 - This is a problem for farmers who need property to farm.

CHAPTER 11 FEATURES

- Can provide **longer payment schedules**, including 15 to 30 years for real estate and three to seven years for machinery.
- **Interest rates are generally two percent greater** than the yield on U.S. Treasury notes or bonds.
- After filing, debtor must seek approval of court to obtain additional secured debt.
 - Use of cash collateral is not allowed absent approval of creditors or the court.
 - The court requires monthly reports, and the trustee fees are paid by the debtor.
 - Chapter 11 provides no specific time period for making repayments under the confirmed plan.

CHAPTER 11 FEATURES

- Chapter 11 is available for large debtors that want to restructure and reorganize.
- Chapter 11 is difficult for most farmers because:
 - Because it was designed for the largest businesses in the country, complexity and cost are big hurdles for family farms
 - Tax problems can prevent rightsizing and creating a feasible plan
 - Creditors can prevent farmers from retaining assets
 - Creditors can veto plans

CHAPTER 12

Originally enacted in 1986 to provide temporary relief for “family farmers,” Congress made Chapter 12 permanent in 2005.

Chapter 12 was created during the farm crisis of the 1980s because Chapter 11 was unworkable for these debtors.



CHAPTER 12 ADVANTAGES

- ✓ Debtor may downsize or right-size without tax liability preventing those options.
- ✓ Debtor may retain assets, even though the unsecured creditors do not receive full payment for their claims.
 - **No absolute priority rule.**
- ✓ Debtor may **reduce balance** of secured claims to FMV value of the collateral, including claim against debtor's house.

CHAPTER 12 ADVANTAGES

- ✓ Payment terms on secured debt can be **stretched out, re-amortized, and the interest rate adjusted.**
 - ✓ This was especially helpful in the 1980s when some had 20 percent notes.
- ✓ Payments may be made on a monthly, yearly, or other basis, depending upon the income stream of the farm.
- ✓ A farm debtor operates as a "debtor in possession," maintaining the right to operate the farm while restructuring their liabilities .
- ✓ The process is efficient and economical.

LIMITATIONS OF CHAPTER 12

For most debtors, the most challenging Chapter 12 requirement is **feasibility**.

- Farmers must show that business will cash flow once plan is in place.
- Debtors who have been unable to continue their operation because of financial impairment may be hard pressed to show that they will be able to make the required plan payments.
- In recent history **fewer than 50 percent of Chapter 12 plans** have been successfully completed through discharge.

CHAPTER 12 ELIGIBILITY

- A Chapter 12 case may be filed by a “family farmer or family fisherman with **regular annual income.**” 11 U.S.C. § 109(f).
- Chapter 12 is a reorganization chapter. Debtor must show income is sufficient to support a feasible plan.



ELIGIBILITY - INDIVIDUALS

Must be **engaged in farming operations** at the time of filing.

- Does not generally include former farmers or those who are engaged in farm-related businesses or lease-only activities, but off-farm income can be used to make payments. *In re Williams* (Bankr. W.D. Ky. 2016).

ELIGIBILITY - INDIVIDUALS

Farmer's debts cannot exceed **\$11,097,350** (adjusted every three years).

- The original debt limit was \$3,237,000. By 2019, inflation had increased the limit to a \$4,411,400, but this amount kept some otherwise “family farmers” from qualifying for Chapter 12 protection. On August 23, 2019, the Family Farmer Relief Act of 2019, went into effect.
- This has allowed farmers with more debt to qualify for Chapter 12.

ELIGIBILITY - INDIVIDUALS

Fifty percent of index-adjusted debt must arise from the farming operation.

- The home mortgage is included only if it secures the farm debt.



ELIGIBILITY - INDIVIDUALS

Must have earned **more than half of gross income** from farming in year prior (or in each of the 2nd and 3rd years prior to the filing).

- Gross income (not gross receipts) is used. Tax return is prima facie evidence.

ELIGIBILITY - ENTITIES

Corporations or partnerships, including LLCs, are eligible to file for Chapter 12 bankruptcy protection if:

- More than 50 percent of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family (relative is interpreted broadly).
- The family or such relatives must **conduct the farming operation**.
- At least 80 percent of the value of its assets consists of assets related to the farming operation.
- The total indebtedness cannot exceed **\$11,097,350** (less for a commercial fishing operation).

ELIGIBILITY - ENTITIES

- At least 50 percent of its aggregate non-contingent, liquidated debts on the date the case is filed, arise out of the farming operation owned or operated by such corporation or such partnership; and
 - Residential debt exclusion can count if a shareholder or partner lives in the house, even if they are not involved in the farming operation.
- No stock is publicly traded.



COMMENCING A CHAPTER 12

- To initiate a Chapter 12, the debtor files a petition including:
 - a schedule of assets and liabilities,
 - a schedule of current income and expenses,
 - a schedule of executory contracts and unexpired leases, and
 - a statement of financial affairs.
- Husbands and wives may file joint or individual petitions.
- **Automatic Stay begins at filing.**
- Trustee oversees the process.
- Debtor remains in possession of property unless removed for cause.

PROPOSED PLAN

Debtor files **within 90 days of petition.**

Plan period is **generally three years**, but it can be extended to five “for cause.”

- Chapter 12 requires that unsecured creditors **receive as much as they would in a Chapter 7 liquidation.**
 - **This means farmer can retain some assets.**

PLAN REQUIREMENTS

- **All net disposable income** must be distributed to unsecured creditors until discharge.
- Must provide for **full payment**, in deferred cash payments, of all priority claims, unless agreement otherwise.
- Must provide the same treatment for each class of claim or interest within a particular class unless agreement otherwise.

OPTIONAL PROVISIONS

- May modify mortgages and other contracts, re-amortizing them over longer periods and lowering interest.
 - 15-30 years for real estate or 3 to 7 for machinery
- May assume or reject contracts or leases.

CONTINUING THE FARMING OPERATION

- The **debtor** will continue to operate the farm as provided in 11 U.S.C. § 1203.
- As a *fiduciary* of the bankruptcy estate, the debtor must pay all taxes owed to the IRS and state taxing authorities.

PERMITTED ACTIVITIES

- Use proceeds from sales of grain and livestock and milk not pledged as security for living and farm expenses.
- Obtain unsecured credit in the ordinary course of business and debt will be allowable as an administrative expense.
- May “right size” the farming operation by selling assets.

ACTIVITIES THAT REQUIRE APPROVAL

Using, selling or leasing property in the non-ordinary course of business.

- This includes the sale or purchase of machinery or dairy or breeding livestock or real property.

Using cash collateral.

- If court allows the use, adequate protection must be provided.

Acquiring secured or priority debt.

PLAN CONFIRMATION

Within **45 days of the debtor filing the plan**, the court will hold a confirmation hearing to ensure that the requirements of the Code are met.

To be confirmed, the debtor bears the burden to show that the plan must meet the requirements set forth in 11 U.S.C. § 1225.

REQUIREMENTS FOR CONFIRMATION

- The plan was proposed in **good faith**.
- All fees and costs are paid.
- The plan meets the “best interest of the creditors test.”
 - The property to be distributed to pay unsecured claims is **equal to or greater than the amount that would be paid on each claim in a Chapter 7 case**.



REQUIREMENTS FOR CONFIRMATION

The plan must provide for the secured creditor in one of three ways:

- through a **consensual agreement** with the debtor,
- by **surrendering the collateral** to the creditor, or
- by allowing the secured creditor to **retain the lien and receive the *present value of the secured portion of its claim.***
 - Adequate protection must be provided to secured creditors to protect the value of their interest in the collateral retained by the debtor. 11 U.S.C. § 1205(b)(1)–(3).

REQUIREMENTS FOR CONFIRMATION

- The plan must be “**feasible**,” meaning that the debtor will be able to make all required payments.
- The debtor must be current on post-petition domestic support obligations.

REQUIREMENTS FOR CONFIRMATION

If an unsecured claim holder or the trustee objects, the plan will be confirmed if:

- The plan devotes **all disposable income** to making payments under the plan,
- The value of property to be distributed is not less than the debtor's disposable income, **or**
- The property to be distributed has a value, as of the effective date of the plan, not less than the amount of the claim.

IMPACT OF CONFIRMATION

With rare exception, confirmation of the Chapter 12 plan vests all property of the estate in the debtor. 11 U.S.C. § 1227(b).

- This property will be free and clear of any claim or interest of any creditor provided for in the plan. 11 U.S.C. § 1227(c).

DISCHARGE

The debtor receives a discharge only **after all plan payments are made.**

- Debt such as alimony or child support is not dischargeable.
- Rarely, the debtor may receive a “hardship” discharge for extraordinary circumstances.

Discharge covers all debts provided for by the plan, with the exception of secured debts to be paid beyond the plan term and any excepted debts.



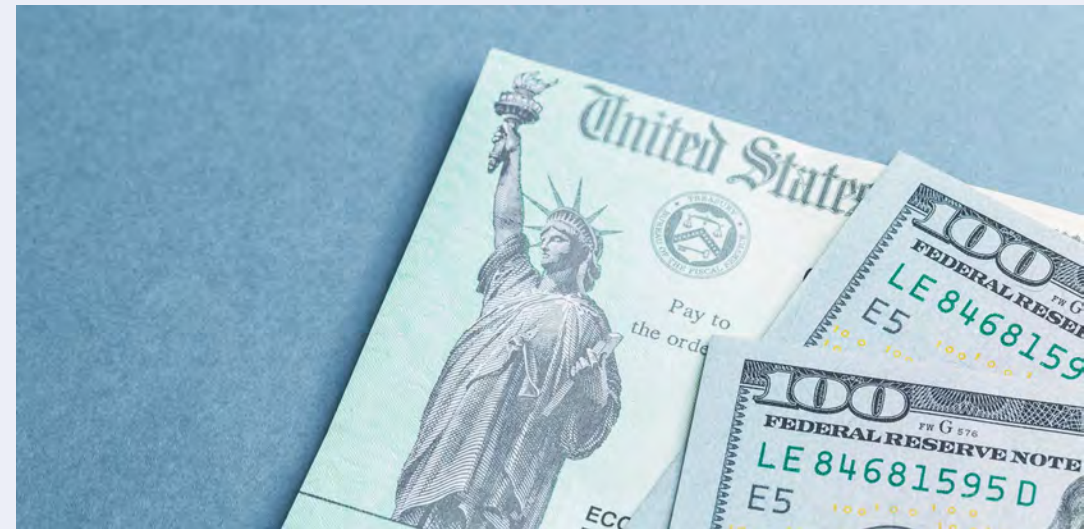
TAXATION IN BANKRUPTCY

Chapters 7 and 11 create a **separate taxable estate**

- Trustee files form 1041.
- Debtor assumes tax attributes at conclusion of the proceedings.

Chapter 12 **does not create** a separate taxable estate

- Sole proprietors **continue to file Form 1040**.
- Report all income and deduct all expenses.
- Cancelled debt is not included in income.



TAX CLAIMS AGAINST THE ESTATE

- **Perfect**ed tax liens are secured claims.
- Federal tax liens arise at the time the tax is assessed, and attach to all the taxpayer's property, as well as the taxpayer's after-acquired property.
- The tax lien is perfected when the IRS files a Notice of Federal Tax Lien in the appropriate public filing office under applicable state law.
 - Because the IRS may enforce its lien even if the tax debt is discharged, ***bankruptcy should be filed before the IRS perfects its lien.***

GENERAL RULE

- Creditors (including the IRS) must file a proof of claim with the bankruptcy court.
- A claim for taxes can be either a claim secured by a perfected tax lien or an unsecured claim.
- Perfected liens generally pass through bankruptcy proceedings unaffected, even if the debtor's personal liability for the debt is discharged.
- Outside of Chapter 12, most tax claims are **priority unsecured claims**. Unsecured claims without priority are satisfied last.

SPECIAL TAX RULE IN CHAPTER 12

- A key change implemented by the BAPCPA was the addition of 11 U.S.C. § 1222(a)(2)(A) (2005).
 - This provision stated that claims owed to a governmental unit that arose as a result of the “**sale, transfer, exchange, or other disposition of a farm asset used in the debtor’s farming operation**” were treated as **general unsecured claims subject to discharge**.
- **Priority stripping** allows Chapter 12 confirmations that otherwise would be denied because of large capital gain or depreciation recapture arising from the sale of farm assets.
 - Before this rule, if a farmer sold assets in an effort to raise cash to allow the farming operation to continue, the tax bill generated by the sale robbed the debtor of the cash needed to make payments under a plan (**NOT FEASIBLE**)

SPECIAL TAX RULE IN CHAPTER 12

- After split in the circuits, Supreme Court ruled that the **special rule applied only to pre-petition sales**. *Hall v. U.S.*, 132 S. Ct. 1882 (2012).
 - This prevented debtors from right-sizing once the bankruptcy petition was filed.
 - Selling before filing was often impractical.

SPECIAL TAX RULE IN CHAPTER 12

- On October 26, 2017, The Family Farmer Bankruptcy Clarification Act of 2017 fixed this problem by creating new 11 U.S.C. § 1232.



SPECIAL TAX RULE IN CHAPTER 12

An unsecured tax claim that arise **before** the filing, **after** the filing, or **before** discharge as a result of the **sale, transfer, exchange, or other disposition of any property used in the debtor's farming operation**:

- shall be treated as an **unsecured claim** arising before the date on which the petition is filed;
- **shall not be entitled to priority** under section 507;
- shall be provided for under a plan; and
- **shall be discharged** in accordance with section 1228.

WHICH PROPERTY QUALIFIES?

The claim arose (1) as a result of (2) the sale, transfer, exchange, or other disposition (3) of any property (4) used in (5) the debtor's farming operation.

- Land (§ 1231)
- Machinery (§ 1245)
- Grain (ordinary income)
- Livestock (ordinary income)
- Crop Insurance Proceeds (ordinary income - disputed)

REQUIRED ANALYSIS BEFORE FILING

- ✓ **Feasibility** is determined through cash flow projections
- ✓ The **liquidation value** of the assets must show that the unsecured creditors would receive as much under the plan as in liquidation.
- ✓ Must consider the **timing of the filing** with respect to the sale of assets, tax attributes such as NOLs, and other considerations.

DISCHARGE OF DEBT INCOME

I.R.C. § 108(a)(1) provides that gross income generally does not include **CODI** if any of the following apply:

- Cancelled in **bankruptcy**
- Cancelled when debtor was **insolvent**
- Canceled debt is a “**qualified farm debt**”
- Canceled debt is **qualified real property business debt** (except for C corporation)
- Canceled debt is **qualified principal residence indebtedness**, discharged before 2018



SEEK HELP IMMEDIATELY

- Consult with a qualified attorney (someone who works with farm financial distress) as soon as issues arise.
- Non-bankruptcy reorganization through negotiations with business and personal creditors may be possible.



