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(Small Business/Self-Employed)

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subject: Payment of Administrative Expenses Under Chapter 12 of the Bankruptcy Code

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ISSUE

May a Chapter 12 plan provide for payment to lower priority creditors before administrative expenses have been paid in full, if the holders of administrative expense claims have not consented to such treatment?

CONCLUSION

An unpaid administrative claim for federal taxes in a Chapter 12 case must be paid before or at the same time as distributions are made to creditors with lower-priority claims. The better interpretation of B.C. § 1226(b)(1) is that payments cannot be made to lower-priority creditors unless any unpaid administrative expense is paid in full, either first or at the same time as other claims are paid. If a Chapter 12 debtor does not pay significant tax liabilities accruing after the filing of the petition, the preferred course of action for the Service is to move for dismissal of the case, rather than to file an administrative expense claim. See I.R.M 25.17.12.9.3 (9-01-2004).

LAW AND ANALYSIS

Chapter 12 of the Bankruptcy Code provides procedures for the adjustment of the debts of a family farmer with regular annual income. B.C. §1225(a)(1) makes confirmation of a Chapter 12 plan conditional on compliance with all the provisions of Chapter 12 and the other applicable provisions of the Bankruptcy Code. Under a Chapter 12 plan the debtor submits all or a part of the debtor's future earnings or other future income to the supervision and control of a trustee. B.C. 1222(a)(1). Only the debtor can file a plan, and the plan must be filed within 90 days of the filing of the petition. B.C. § 1221. The plan may not provide for payments over a period longer than 3 years, unless the court for cause approves a longer period of up to 5 years. B.C. § 1222(c).

Section 1222(a)(2) requires that the plan provide for the full payment, in deferred cash payments, of all claims entitled to priority under B.C. § 507, unless the holder of a particular claim agrees to a different treatment. Section 1222(b)(4) states that a plan may provide for payments on any unsecured claim "to be made concurrently with payments on any secured claim or any other unsecured claim."

Section 507 enumerates nine categories of expenses and claims that have priority in plan distributions. The first category, listed in section 507(a)(1), consists of administrative expenses allowed under B.C. § 503(b) and fees and charges assessed against the estate under chapter 123 of Title 28. Administrative expenses allowable under section 503(b) include, among other items, the actual, necessary costs and expenses of preserving the estate, and any tax incurred by the estate (except a tax specified in section 507(a)(8) or attributable to an excessive allowance of a tentative carryback adjustment that the estate received) and any fine, penalty, or reduction in credit relating to a tax that is an administrative expense.

Section 1226(b)(1) directs how payments of administrative expenses and fees and charges assessed against the estate under chapter 123 of Title 28 are to be made. It provides:

Before or at the time of each payment to creditors under the plan,
there shall be paid –

(1) any unpaid claim of the kind specified in section 507(a)(1).

The legislative history of the Bankruptcy Reform Act of 1978 regarding section 1326(b)(1), which is a Chapter 13 provision identical in wording to section 1226(b)(1), provides:

Subsection (a) [now subsection (b) of section 1326] requires that before or at the time of each payment any outstanding administrative expenses [and] any percentage fee due for a private standing

Chapter 13 trustee be paid in full. (Emphasis added.)

H.Rep. No. 95-595, 95th Cong. 2d Sess. 430 (1978).

Determining the meaning of a provision of the Bankruptcy Code begins “with the language of the statute itself.” United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241 (1989). If the statute is “coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute.” *Id.*, 240-241. The plain meaning of the statute should be conclusive, except in the “rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.” *Id.*, 242, quoting Griffen v. Oceanic Contractors, Inc., 458 U.S. 564 (1982). However, if the text of the statute is ambiguous, it is appropriate to look to a statute’s legislative history. Toibb v. Radloff, 501 US 157, 162 (1991).

Section 503 of the Bankruptcy Code provides for the allowance of administrative expenses and section 507 gives the payment of those expenses priority when assets are distributed from the bankruptcy estate. The priority given administrative expenses is premised in part on the belief that “administration of the bankruptcy estate is for the collective benefit of the creditors and so it is the creditors who should, by virtue of a lower return, bear the cost of that administration.” 4 Collier on Bankruptcy ¶507.02[1][a], at 507-13 (Resnick & Sommer, ed., 15th ed., rev. 2004). The time at which administrative expenses must be paid varies depending on the chapter under which the case is filed and the circumstances of the case. Thus, in a Chapter 7 liquidation, administrative expenses must be paid first, when the assets of the estate are distributed. B.C. § 726(a). In a Chapter 11 reorganization, administrative expenses must be paid in cash on the effective date of the plan, unless the holder of the claim has agreed otherwise. B.C. § 1129(a)(9)(A). In Chapter 12 and Chapter 13 cases, where the debtor’s regular annual income over the term of the plan serves as a source of payments to creditors, it would be impractical in many cases to require that administrative expenses be paid in cash on the effective date of the plan. Accordingly, under Chapters 12 and 13, unpaid administrative expenses must be paid before or at the time of each payment to creditors, unless the holder has agreed otherwise. B.C. §§ 1226(b)(1) and 1326(b)(1). Requiring full payment of outstanding administrative expenses first, as money comes into the estate from the debtor’s earnings, effectuates the priority given administrative expenses by section 507.

Chapters 12 and 13 also require that the plan provide that priority claims be paid in full in deferred cash payments and permit payments on a unsecured claim to be made concurrently with payments on any other unsecured or secured claim. B.C. § 1222(a)(2) and (b)(4); B.C. § 1322(a)(2) and (b)(4). Some bankruptcy courts have relied on those provisions to conclude that a Chapter 12 or Chapter 13 plan can provide for the payment of administrative claims in installments at the same time that payments of lower priority claims are made over the life of the plan.

Three reported bankruptcy cases have confirmed Chapter 12 plans that provided for payment of administrative expenses over the life of the plan, concurrently with payments to secured and unsecured creditors. In re Ryan, 228 B.R. 746, 748 (Bankr. Ore. 1999) (Chapter 12 debtors allowed “to propose a plan which provides for payment of administrative expenses, over the life of the plan, concurrently with payments to secured or unsecured creditors”); In re Palombo, 144 B.R. 516, 518 (Bankr. D. Colo. 1992) (section 1226(b)(1) “clearly and unambiguously” allows administrative expense payments to be drawn out over the full term of the plan); In re Teigen, 142 B.R. 397, 403 (Bankr. D. Mont. 1992) (construing section 1226 to mean that administrative claim payments can be drawn out over the term of the plan).

Holdings in Chapter 13 cases have been regarded by the courts as instructive in Chapter 12 cases because the legislative history of Chapter 12, although sparse, indicates that Congress modeled Chapter 12 on the provisions of Chapter 13. See, e.g., BDT Farms Inc., 21 F.3d 1019, 1021 n.3 (10th Cir. 1994). The bankruptcy courts in In re Ryan and In re Palombo, in reaching their conclusions, relied in part on a case interpreting B.C. § 1326(b)(1), a Chapter 13 provision identical to section 1226(b)(1). See In re Parker, 15 B.R. 397 (Bank. E.D. Tenn. 1981), aff’d, 21 B.R. 692 (E.D. Tenn. 1982). In re Parker determined that concurrent payments of administrative expenses and general unsecured claims are allowed under section 1326(b)(1), because section 1322(b)(4) specifically permits payment of priority claims concurrently with payments on general unsecured claims.

While In re Parker concluded that the trustee in a Chapter 13 proceeding is not required to pay administrative expenses in full before the trustee can make any payment to creditors, the bankruptcy court in In re Harris, 304 B.R. 751 (Bankr. E.D. Mich. 2004), concluded otherwise. In re Harris read section 1326(b)(1) as requiring that at any given time after confirmation of the plan, if there is any unpaid, allowed administrative expense, no payment may be made to any other creditor under the plan unless the unpaid administrative expense is paid in full, either first or at the same time. A partial payment would not satisfy section 1326(b)(1) because there still would be an unpaid administrative claim. The court interpreted the “before or at the time of each payment” phrase in section 1326(b)(1) as addressing situations where at any given time there are funds available for distribution to other creditors after full payment of the administrative claims. “[B]efore or at the time of each payment” permits the remaining funds to be paid immediately to creditors in other classes without having to wait for the next monthly distribution. As the court, at 304 B.R. 757, stated:

Thus, for example, when the Chapter 13 Trustee makes her first monthly disbursement after confirmation, she may not disburse any payment to secured or unsecured creditors unless at the same time, the Trustee pays, *in full*, the unpaid, allowed attorney fees of Debtors’ counsel.

The court's holding in In re Harris is supported by the legislative history of the Bankruptcy Reform Act of 1978, which enacted section 1326. That legislative history makes it clear that Congress intended to delay payment to pre-petition creditors in Chapter 13 cases until administrative expenses are paid in full. See H.Rep. No. 95-595, 95th Cong. 2d Sess. 430 (1978), stating that any outstanding administrative expenses must be paid in full before or at the time of payments to other creditors.

The bankruptcy court's reading of section 1326(b)(1) in In re Harris supports the position that, pursuant to the identical provision of section 1226(b)(1), a Chapter 12 plan must provide for payment of administrative expenses in full before payments may be made to lower priority creditors. Administrative expenses have priority over other unsecured claims under the Bankruptcy Code, and it would be inconsistent with the purpose of providing priority if other unsecured creditors receive distributions under a Chapter 12 plan while administrative expenses are outstanding.

Given the language of section 1226(b)(1), the purpose of providing priority to administrative expenses under the Bankruptcy Code, and the holding of In re Harris and the legislative history of the Chapter 13 analog to section 1226(b)(1), the Service has strong support for continuing to contend that its administrative expense claim in a Chapter 12 case must be paid in full before other creditors with lower priority begin receiving payments. However, before filing an administrative claim for post-petition taxes in a Chapter 12 case, the Service should consider whether other action is more appropriate. In cases where a Chapter 12 debtor has not paid significant tax liabilities accruing post-petition, the Internal Revenue Manual provides that the Service should consider moving for dismissal of the case. I.R.M 25.17.12.9.3 (9-01-2004).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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