



Section of Taxation

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August 23, 2012

The Honorable Max S. Baucus
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Dave Camp
Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Orrin G. Hatch
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Sander Levin
Ranking Member
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

Re: Options for Tax Reform of Individual Chapter 11 Bankruptcy Cases

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform of individual Chapter 11 bankruptcy cases. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

The Section would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

Rudolph R. Ramelli
Chair, Section of Taxation

Charles H. Egerton
Former Chair, Section of Taxation

Enclosure

cc: Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee
Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee
Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Honorable Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service

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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
OPTION FOR REFORM OF THE TAXATION OF
INDIVIDUAL CHAPTER 11 BANKRUPTCY CASES

This Option for tax reform ("Option") is submitted on behalf of the American Bar Association Section of Taxation and has not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, it should not be construed as representing the position of the American Bar Association.

This Option is submitted as part of a series of tax reform options from the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and to administer.

Principal responsibility for preparing this Option was exercised by Kenneth C. Weil, the Chair of the Bankruptcy and Workouts Committee. This Option was reviewed by Julian Y. Kim, Council Director for the Committee, and Wm. Robert Pope, Jr. on behalf of the Section's Committee on Government Submissions.

Although the members of the Section of Taxation who participated in preparing this Option have clients who might be affected by the federal tax principles addressed by this Option, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this Option.

Contact: Kenneth C. Weil
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Date: August 23, 2012

EXECUTIVE SUMMARY

A 2005 Amendment to the Bankruptcy Code broadened the definition of bankruptcy estate property in individual Chapter 11 cases.¹ Estate property now includes all postpetition earnings from services. This has created significant tax accounting difficulties for these debtors because their current income is now taxable income of the bankruptcy estate.

Before the 2005 Amendment the individual debtor reported all of the taxable income for the entire year in which the bankruptcy petition was filed. The 2005 amendment and application of section 1398 created the current problem.² Section 1398 currently assumes, as was the case before the 2005 Amendment, that all of a debtor's postpetition earnings (starting on the day that the bankruptcy petition is filed) belong to and must be reported by the debtor taxpayer.

The Option submitted would make the tax treatment of individuals under Chapter 11 or 13³ the same by removing individual debtors in Chapter 11 from the scope of section 1398. The amendment contained in this Option requires only the deletion of the phrase "Chapter 11" from section 1398. Section 1399, which applies to all bankruptcy cases except as provided in section 1398, requires no amendment. By eliminating any reference to "Chapter 11" from section 1398, section 1399 will automatically apply to individual debtors in Chapter 11. No separate taxable estate would be created upon the filing of a Chapter 11 petition by an individual.

¹ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Pub. L. No. 109-8, 119 Stat. 37, § 321(a)(1) (adding section 1115 to the Bankruptcy Code, 18 U.S.C. § 101 *et seq.*, referenced as the "2005 Amendment").

² References to "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

³ Individuals also can be debtors under Chapter 12, which is the Bankruptcy Code chapter for farmers and fishers. While Chapter 12 has some special tax rules, for the most part, individual Chapter 12 debtors are treated similarly to individual Chapter 13 debtors.

DISCUSSION

This Option, which is submitted for your consideration, will greatly simplify tax reporting for individual Chapter 11 debtors/taxpayers. The Option would eliminate “Chapter 11” from section 1398. After the proposed amendment, section 1398 would apply only to individual debtors under Chapter 7 of the Bankruptcy Code.⁴

I. PRESENT LAW

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) made extensive changes to the bankruptcy law. One major change added a set of rules designed to force above-median income debtors, with an ability to repay debt, out of Chapter 7 and into a repayment plan under Chapter 13 or Chapter 11.⁵ Although debtors would prefer filing under Chapter 13 because it is less complex and, therefore, less expensive, Chapter 13 has strict debt limits. As adjusted for inflation, the current limits are \$1,081,400 for secured debt and \$360,475 for unsecured debt.⁶ This means many individual debtors are forced into Chapter 11.

As part of its extensive revision of the Bankruptcy Code, Congress apparently determined it necessary to address certain issues regarding individuals that might be forced into Chapter 11.⁷ Ostensibly, the intent of Congress in including these rules was to make individual Chapter 11 cases more similar to Chapter 13 cases.⁸ Among other changes, Congress added section 1115(a)(1) to the Bankruptcy Code.⁹ This provision treats the postpetition earnings of an individual as the property of the bankruptcy estate.

⁴ Section 1398 (d) defines a short-year election for individual debtors under Chapter 7 and Chapter 11. The short-year election allows those debtors to create a priority (and nondischargeable) tax debt for the taxable year ending on the day prior to the filing of the bankruptcy petition. The Option proposed eliminates “Chapter 11” from section 1398. To preserve the short-year election, section 1398(d)(2) must be amended to insert “, including an individual under Chapter 11,” after “debtor” and before “may”.

⁵ See 11 U.S.C. § 707(b)(2). This is known as the means test.

⁶ 11 U.S.C. § 109(e).

⁷ See *In re Shat*, 424 B.R. 854, 862 (Bankr. D. Nev. 2010).

⁸ *Id.* Even if making individual Chapter 11 cases more similar to individual Chapter 13 cases were Congress’s goal, Congress’s failure to amend section 1398 resulted in a significant difference in the tax treatment of individual bankruptcy cases under these two chapters. Compare I.R.C. § 1398 (separate taxable estate for individuals in Chapters 7 and 11) with I.R.C. § 1399 (for all other chapters of the Bankruptcy Code, no separate taxable estate created).

⁹ 11 U.S.C. § 1115.

II. REASONS FOR CHANGE

Because postpetition earnings of an individual are now the property of the Chapter 11 bankruptcy estate and the bankruptcy estate is subject to tax under section 1398, individuals in Chapter 11 cases face significant tax accounting issues in trying to allocate income and expenses between the bankruptcy estate and the individual debtor. For example, the individual debtor earns money and spends it on basic necessities such as food and shelter. Under the Bankruptcy Code and section 1398, however, that money belongs to, and is taxed to, the bankruptcy estate even if it never leaves the debtor's hands. It is unclear how this postpetition income and the debtor's expenses are to be allocated between the bankruptcy estate and the individual debtor.

By way of example, under the current rules an individual's postpetition income is reported on the bankruptcy estate's Form 1041. The procedure is that the applicable box is checked at the top of that form, and, the individual's Form 1040 is then attached to the Form 1041 cover page.¹⁰ It is unclear how the bankruptcy estate's income (*i.e.*, the individual debtor's postpetition income) should be treated on the individual's Form 1040. For example, should it be included on Form 1040, page 1, line 7; Form 1040, page 1, line 21; or on Schedule C? Similar issues arise for money spent by the individual debtor. Are those expenses netted before the income is reported? Is it a business expense; is it a separate entry as a deduction towards adjusted gross income; or, is it a separate entry as a deduction from adjusted gross income?

In Notice 2006-83, the Service provided some guidance to individual Chapter 11 debtors on reporting income.¹¹ On the critical issue of income and expense allocation, the Notice left the decision to the taxpayer but required disclosure of how income and expenses are allocated between the two entities.¹² Notice 2006-83 provides no guidance as to how the expenses of a Chapter 11 estate administration are to be treated. That guidance exists only in a 2006 Chief Counsel Advice, which provides that fees "that would have not been incurred if the property were held by the bankruptcy estate [are] treated as allowable in arriving at adjusted gross income."¹³

III. OPTION FOR TAX REFORM

This Option, which is submitted for your consideration, would remove individual Chapter 11 cases from section 1398. Taxation of the individual Chapter 11 debtor/taxpayer would be governed by section 1399, like individual Chapter 13 cases. Section 1399 expressly provides that no new taxpayer is created except as provided in section 1398. No amendment of section 1399 would be necessary or appropriate to

¹⁰ See IRS Pub. 908, p.6 (March 2009).

¹¹ 2006-2 C.B. 596.

¹² *Id.* at § 6 (allocation must be made in a reasonable manner and disclosed).

¹³ CCA 200630016 (June 30, 2006). The deduction itself is allowed in I.R.C. § 1398(h)(1).

implement this Option. The individual in a Chapter 11 bankruptcy, after the proposed amendment, would be the only taxpayer and would file one return reporting all income. This Option eliminates section 1398's separate taxable estate for the individual Chapter 11 debtor/taxpayer.

In addition, amendments should be considered (or administrative guidance published) to clarify that expenses incurred in administration of the bankruptcy estate in individual Chapter 11 and 13 cases are deductions towards adjusted gross income.¹⁴

¹⁴ Providing for a separate taxable estate when a trustee is appointed in an individual Chapter 11 merits additional consideration but falls outside the Option's objective for simplification.