TAX CONSEQUENCES OF POST-PETITION INCOME AS PROPERTY OF THE ESTATE IN AN INDIVIDUAL DEBTOR CHAPTER 11 CASE AND TAX DISCLOSURE IN CHAPTER 11

JACK F. WILLIAMS[*] AND JACOB L. TODRES[†]

INTRODUCTION

On April 20, 2005, the President signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[1] ("2005 Act" or "BAPCPA"). Although most of the controversy surrounding the 2005 Act centered on many of the consumer provisions, the 2005 Act also included substantial changes to business bankruptcies and the most substantial modifications of bankruptcy tax law since 1980. Generally, most provisions in the 2005 Act are effective for cases commenced on or after October 17, 2005, unless otherwise noted. However, there are at least a half dozen other dates noted, including on or after the date of enactment (April 20, 2005) for cases or proceedings filed after such date. Thus, during this transition period, it is important to consult the 2005 Act to determine whether the case or proceeding of interest is governed by the 2005 Act or the prior Bankruptcy Code.

Major winners in the 2005 Act happen to be the federal, state, and local taxing authorities. In fact, one bankruptcy judge is rumored as lamenting that the Internal Revenue Service ("IRS") was able to convince Congress to repeal virtually every

---

[*] Professor, Georgia State University College of Law; Resident Scholar, Association of Insolvency and Restructuring Advisors; Director, BDO Seidman, LLP, Atlanta, Georgia; Jwilliams@gsu.edu. Professor Williams was the chair of the Tax Advisory Committee of the National Bankruptcy Review Commission.

[†] Professor, St. John's University School of Law

[1] Pub. L. No. 109–8, 119 Stat. 23 (2005).

tax decision in bankruptcy that had gone against the IRS over the years. The good news is that a number of cases deserved rejection, and the 2005 Act did just that. The bad news is that the 2005 Act did not stop with those cases that had little justification; it went further and proceeded to overturn the results of cases that stood on solid bankruptcy and tax policy. This article addresses two of the changes that may have a drastic impact on how we practice bankruptcy tax law. The first change, discussed in Parts I–II of the Article and prepared by Williams, is the modification to the definition of property of the bankruptcy estate in an individual debtor chapter 11 case through new section 1115. The second change, discussed in Part III of the Article and prepared by Todres, focuses on the meaning of the amendment to section 1125 to require a reasonably specific and meaningful discussion of the federal tax consequences of a proposed plan.

I. PROPERTY OF AN INDIVIDUAL DEBTOR'S BANKRUPTCY ESTATE

The profile of the bankruptcy estate is a central component of bankruptcy law and policy for several reasons. First, the property of the estate is the "pot" to which creditors must turn for satisfaction of their claims. Second, property of the estate is that property that is protected by the automatic stay under section 362(a).[2] Third, by negative implication, that property of the debtor that does not constitute property of the estate is left to the debtor to fund his or her fresh start. Interestingly, the definition of property of the estate under the Bankruptcy Code begins with a foundational precept. This foundation is found in section 541.[3] In addition to the foundation, each chapter for substantive relief also constructs its own edifice to the definition. This discussion begins with the general definition, turning to how each of the chapters add to or otherwise modify the general definition. The discussion then concludes with how the 2005 changes to the definition of property of the estate pose serious tax questions that simply cannot be resolved satisfactorily by existing statutory law. Rather, this discussion calls for an amendment to Internal Revenue Code ("IRC") section 1398[4] to exclude chapter 11 cases from the separate entity rules found therein.

A. *The General Definition: Section 541*

The Bankruptcy Code is designed around a central definition of property of the estate, which is applicable to all chapters for relief.[5] Under section 541(a), property of the estate includes all of the debtor's legal or equitable interest in property at the

---

[2] 11 U.S.C. § 362(a) (2000) (defining contours of automatic stay).

[3] *Id*. § 541 (defining property of the estate).

[4] I.R.C. § 1398 (2000) (explaining rules relating to chapter 11 cases).

[5] *See* 11 U.S.C. § 541(a)(1)–(a)(7) (2000) (defining property of the estate); *id*. § 103 ("Chapters 1, 3, and 5 of this title apply in a case under Chapter 7, 11, 12 or 13 of this title.").

time of the filing of the petition[6] wherever located and by whomever held.[7] According to the legislative history, the broad scope of section 541(a)(1) includes all kinds and forms of property, whether tangible or intangible.[8] There is, however, a temporal dimension of property of the estate: The Bankruptcy Code identifies property of the estate in the first instance as of the date the petition in bankruptcy is filed.[9]

One recurring issue centers on the role an individual's post-petition earnings play in defining the contours of the estate. A thorough understanding of this complex issue requires an analysis of at least three sections of the Bankruptcy Code and one section of the Internal Revenue Code: sections 541(a)(1), (a)(6), and (a)(7);[10] and IRC section 1398.[11] Several courts have addressed the interplay among

---

[6] *Id*. § 541(a)(1) ("Such estate is comprised of all the following property . . . all legal or equitable interests of the debtor in property as of the commencement of the case."); *see, e.g.*, Hebermehl v. United States *ex rel*. IRS (*In re* Hebermehl), 132 B.R. 651, 653–54 (Bankr. D. Colo. 1991) (ruling wages were property of debtor's chapter 7 estate, even though such wages were not paid until post-petition, where wages were for services performed by debtor prior to commencement of chapter 7 case); *In re* Lange, 110 B.R. 907, 910 (Bankr. D. Minn. 1990) (holding entire balance on deposit in chapter 7 debtor's checking account from date bankruptcy petition was filed constituted property of estate).

[7] 11 U.S.C. § 541(a)(1) (2000) ("Such estate is comprised of all the following property, wherever located and by whomever held . . . ."). This section overruled *Lockwood v. Exchange Bank*, 190 U.S. 294, 299 (1903) (finding property generally exempted by state laws did not constitute property of bankruptcy estate); *Lines v. Frederick*, 400 U.S. 18, 19 (1970) (holding vacation pay that had accrued, but not yet been paid, was not property of the estate).

[8] *See* H.R. REP. NO. 95-595, at 367–68 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6323–24 (explaining definition of property of estate); S. REP. NO. 95-989, at 82–83 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5868–69 (explaining section 541).

[9] In defining property of the bankruptcy estate, the Bankruptcy Code starts with the basic definition under section 541(a)(1) and (a)(2), but by no means does it end there. Bankruptcy Code sections 541(a)(3) through (a)(7) contain additions to the basic definition of property of the estate. Property subject to being exempt under section 522 is included in the definition of property of the estate until it is, in fact, set aside as provided in section 522. Moreover, all the interest of the debtor and the debtor's spouse in community property that is under the sole, equal, or joint management of the debtor is included in property of the estate. This is of particular importance in community property states like Texas. Furthermore, inheritances and bequests that come to the debtor within 180 days after the filing of the petition, interests in property as a result of a divorce decree or property settlement agreement with the debtor's spouse, proceeds of a life insurance policy or death benefit plan, and proceeds, rents, and profits from property included in the estate are all included in the definition of property of the estate. Finally, recoveries from a voidable preference, fraudulent transfers, and the other types of avoidance powers are property of the estate. *See* 11 U.S.C. § 541(a)(1)–(7) (2000); *id.* § 522.

[10] *Id*. §§ 541(a)(1), (a)(6)–(7). These sections state, in relevant part:

> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held: (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case. . . . (6) Proceeds, product, offspring, rents, and or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case. (7) Any interest in property that the estate acquires after the commencement of the case.

Id. § 541.

the Bankruptcy Code sections in this context, ignoring the IRC.

All the reported cases that predated the 2005 Act failed to analyze the impact of IRC section 1398 on the issue of the character of post-petition earnings, a grievous oversight. Section 541(a)(6) provides that the proceeds, products, offspring, rents, or profits of or from property of the estate constitute property of the estate.[12] But there is a proviso to that dragnet provision that was important in an individual debtor case—"except such as are earnings from services performed by an individual debtor after the commencement of a case."[13] Thus, future earnings that can be linked to services performed by an individual debtor after the commencement of the case were excluded from property of the estate.[14] Under prior law, it was far from clear what section 541(a)(6) meant in the context of a sole proprietorship, consultant, or employee that sought chapter 11 relief as an individual debtor.[15]

B. The Estate in a Chapter 11 Individual Debtor Case

The preceding discussion addressed the issue of the profile of property of the estate primarily in the chapter 7 context. However, Bankruptcy Code section 103, which deals with the general applicability of various chapters, provides that section 541 applies in all cases under title 11.[16] Thus, in a chapter 7, 11, or 13, the Bankruptcy Code's basic definition of property of the estate is derived from section 541(a). Consequently, because the exclusion of post-petition earnings from property of the estate in chapters 7 or 11 under section 541(a)(6) applies only to individual debtors, the post-petition earnings of a debtor *partnership or corporation* in chapters 7 or 11 are property of the estate. Moreover, because of section 1306 which applies only in chapter 13 cases and expands the general definition of estate property under section 541, the post-petition earnings of an *individual* in chapter 13 are property of the estate under section 1306.[17]

---

[11] I.R.C. § 1398 (2000) (announcing rules relating to individual's title 11 cases).

[12] 11 U.S.C. § 541(a)(6) (2000).

[13] *Id*.

[14] Essentially, there are three things that fuel an individual debtor's fresh start in bankruptcy: exemptions under section 522, the discharge under section 727 in a chapter 7 case (section 1141(d) in a chapter 11 case), and the exclusion of future earnings under section 541(a)(6) from what comprises property of the estate. *See id*. § 522; *id*. § 727; *id*. § 1141(d); *id*. § 541(a)(6).

[15] Under the Bankruptcy Code, a sole proprietorship may not seek relief as a separate entity distinct from the individual. *See id*. § 101(41) (defining "person"); *id*. § 109 (defining persons eligible for bankruptcy relief).

[16] *Id*. § 103 (announcing chapter 5 applies in cases under chapter 7, 11, 12, or 13 of title 11).

[17] *Id*. § 1306. Section 1306 provides:

> (a) Property of the estate includes, in addition to the property specified in section 541 of this title—(1) all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title . . . whichever occurs first; and (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title . . . whichever occurs first. (b) Except as provided in a confirmed plan

Does section 541(a)(6) apply in a chapter 11 *individual* bankruptcy case? Based on section 103, the answer used to be yes. Section 541(a)(6) specifically excluded future earnings by an individual from the definition of property of the estate.[18] But the extent of the exclusion and the characterization of post-petition earnings were not as clear as the language may have suggested. That controversy ended with the 2005 Act.

Before enactment of the 2005 Act, courts had taken three different positions on whether an individual chapter 11 debtor's post-petition earnings should be included in the bankruptcy estate: (1) that all income flowing to an individual debtor in chapter 11 case becomes property of the estate under section 541(a)(7) pending confirmation of a plan, just as such property does in a corporate or partnership chapter 11 case, that is, the section 541(a)(6) carve out does not apply;[19] (2) that all post-petition earnings by an individual chapter 11 debtor are excluded from the estate by section 541(a)(6);[20] and (3) that the debtor's post-petition income should be split under section 541(a)(6) based on how the income was generated, with the portion linked to services actually performed by the debtor carved out of the estate.[21]

> or order confirming a plan, the debtor shall remain in possession of all property of the estate.

Id.

[18] 11 U.S.C. § 541(a)(6) (2000) ("Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.").

[19] *See In re* Harp, 166 B.R. 740, 750, 753 (Bankr. N.D. Ala. 1993) (holding doctor's post-petition earnings are part of the estate); *In re* Herberman, 122 B.R. 273, 279 (Bankr. W.D. Tex. 1990) (holding income flowing to individual proprietors or to corporations, including post-petition earnings, in chapter 11 cases becomes property of estate).

[20] *See* Larson v. Cameron (*In re* Larson) 147 B.R. 39, 43 (Bankr. D. N.D. 1992) (finding stock options acquired by individual chapter 11 after commencement of case fall within exception of section 541(a)(6) and are therefore excluded from estate); *In re* Molina Y Vedia, 150 B.R. 393, 402 (Bankr. S.D. Tex. 1992) (holding earning from surgeries debtor doctor performed post-petition fall under section 541(a)(6) exception and are excluded from the estate); Gautier-Adams v. El-Amin (*In re* El-Amin), 126 B.R. 855, 860 (Bankr. E.D. Va. 1991) (noting section 541(a)(6) expressly excludes individual debtor's post-petition earnings from property of estate and noting spouse may attempt to collect such post-petition income without imposition of automatic stay); *In re* Fernandez, 97 B.R. 262, 262 (Bankr. E.D.N.C. 1989) (holding debtor doctor's post-petition income is not part of chapter 11 estate).

[21] *See* Fitzsimmons v. Walsh (*In re* Fitzsimmons), 725 F.2d 1208, 1211 (9th Cir. 1984) (holding section 541(a)(6) excepts from inclusion in estate only post-petition earnings generated from services personally performed by debtor and therefore debtor lawyer is only entitled to money he generated for law firm by performing personal services, while law practice's earning not attributable to debtor are part of estate); Altchek v. Altcheck (*In re* Altchek), 124 B.R. 944, 955–56 (Bankr. S.D.N.Y. 1991) ("11 U.S.C. § 541(a)(6) in the context of chapter 11 . . . serves to divide the debtor into two entities . . . an individual who receives earnings for services he or she performs . . . [and] as a sole proprietor who continues the sole proprietorship and receives proceeds . . . ."); *In re* Paolino, No. 85-00759F, 1991 WL 284107, at *3 (Bankr. E.D. Pa. 1991) (holding amount earned from services performed by doctor debtor personally was not part of bankruptcy estate, but amount earned by medical practice was); *In re* Cooley, 87 B.R. 432, 441 (Bankr. S.D. Tex. 1988) (holding creditor has burden of demonstrating which property interests should be excluded from property of estate).

In his *In re Herberman*[22] decision, Judge Leif Clark, in a carefully reasoned opinion based on the interplay of section 541(a) and chapter 11, significantly limited the ambit of section 541(a)(6) at least in the context of a sole proprietorship in a chapter 11 case. Judge Clark sharply narrowed the exception by reading section 541(a)(7) as a limitation to section 541(a)(6) and not as a separate provision speaking to other but related estate property issues.[23] Under section 541(a)(7) "interest in property the estate acquires after the commencement of the case" is property of the estate.[24] Central to Judge Clark's conclusion in *Herberman* that a physician's post-petition billings fell outside section 541(a)(6), was the premise that such billings were not "proceeds, product, offspring, rents, and or profits of or from property of the estate."[25] Consequently, under *Herberman*, although a doctor's post-petition billings may be "earnings from services performed by an individual debtor after the commencement of the case,"[26] they fail to qualify for the earnings exception because they are not earnings from "proceeds, product . . . of or from property of the estate."[27] In other words, to back out income from the estate under section 541(a)(6), the income must first constitute property of the estate.

Furthermore, Judge Clark supported his limitation of section 541(a)(6) by focusing on the fiduciary duty a debtor-in-possession owes to the estate in a chapter 11 case, and his conclusion that there was no "true" conflict with the Thirteenth Amendment.[28] In customary detail, Judge Clark observed that section 1108 imposes on an individual debtor the duties and responsibilities usually shouldered by a bankruptcy trustee: the individual debtor, as the debtor in possession, is a fiduciary of the estate and must act in the best interest of the estate.[29] Permitting a debtor to exclude income earned post-petition from the sole proprietorship is inconsistent with this notion that the debtor acts as a fiduciary of the estate.[30] In rejecting the debtor's Thirteenth Amendment argument that a forced dedication of future income to pay debts constituted involuntary servitude, Judge Clark concluded that peonage and not voluntary labor to repay debt is prohibited by the Amendment.[31]

---

[22] 122 B.R. 273 (Bankr. W.D. Tex. 1990). The text accompanying notes 22–74 *infra* is based, in part, on my article *The Federal Tax Consequences of Individual Debtor Chapter 11 Cases*, 46 S.C. L. REV. 1203 (1994-1995) as updated.

[23] *See Heberman*, 122 B.R. at 278–80.

[24] *Id*. (finding exclusion inapplicable and all earnings of enterprise part of bankruptcy estate under section 541(a)(7)); *see also* 11 U.S.C. § 541(a)(7) (2000).

[25] *Herberman*, 122 B.R. at 278; 11 U.S.C. § 541(a)(6) (2000).

[26] 11 U.S.C. § 541(a)(6) (2000).

[27] *Herberman*, 122 B.R. at 278.

[28] *See id*. at 281–86.

[29] *Id*. at 280 (explaining estate has trustee who owes fiduciary obligation to unsecured creditors and in chapter 11 case, debtor in possession is trustee who owes this fiduciary obligation); *see also* 11 U.S.C. § 1108 (2000).

[30] *See Herberman*, 122 B.R. at 282 (discussing debtor in possession's fiduciary obligation and deciding in order to meet fiduciary duties, debtor who files chapter 11 bankruptcy must refrain from withdrawing anything more than reasonable salary as compensation for services as employee).

[31] *Id*. at 284 (distinguishing between compelled performance, which triggers Thirteenth Amendment, and voluntary performance, which does not trigger Thirteenth Amendment); *see also* U.S. CONST. amend. XIII

The essence of the holding in *Herberman* is captured in the methodology it suggests in addressing these issues. First, the court considered the income generated by the estate.[32] Second, the court asked how much of the income generated by the estate should be used to compensate the debtor for post-petition services.[33] According to Judge Clark, section 541(a)(6) has relevance as to the second inquiry only.[34] Not surprising, *Herberman* failed to discuss IRC section 1398, the separate entity rules, and the legislative history to that section, which strongly suggested a broader reading of section 541(a)(6).

In one of the most exhaustive treatments of this issue, the *In re Molina Y Vedia*[35] court embraced a broad approach to carve outs of future income under section 541(a)(6). The debtor, a surgeon, proposed a chapter 11 plan funded by a portion of post-petition earnings sufficient to pay off forty percent of the unsecured claims.[36] Creditors objected and filed their own competing plan, which included virtually all of the debtor's post-petition income, paying creditors in full.[37]

Rejecting the analysis in *Herberman*, Judge Brown in *Molina Y Vedia* observed that "*Herberman* narrows the earnings exception clause to the point of extinction."[38] Specifically, Judge Brown observed that Congress included the earnings exception clause within the main clause of section 541(a)(6) because post-petition earnings are inherently derived from one of the enumerated categories of estate property in the main clause.[39] According to Judge Brown:

> There can be no other reason for the juxtaposition of these two clauses in the same sentence (one for inclusion, the other for exclusion) apart from Congress' conclusion that but for the exclusion language an individual's service earnings would be 'proceeds, product, offspring, rents and or profits of or from property of the estate.'[40]

The court further disagreed with the portion of the *Herberman* analysis constructed on the premise that "post-petition earnings of the enterprise logically

(stating involuntary servitude shall not exist in the United States).

[32] *Herberman*, 122 B.R. at 287 ("First, we ask 'what monies are generated by the estate?'"); *see also* 11 U.S.C. § 541(a)(7) (2000) (including in property of estate "[a]ny interest in property that the estate acquires after the commencement of the case.").

[33] *Herberman*, 122 B.R. at 287 ("Second, we ask 'what funds should be paid over to the debtor in compensation for his or her services to the estate?'"); *see also* 11 U.S.C. § 541(a)(6) (2000) (excluding earnings from services performed after commencement of case from property of estate).

[34] *See Herberman*, 122 B.R. at 287; *see also* 11 U.S.C. § 541(a)(6) (2000). At this point, Judge Clark suggested that a reasonable salary for the debtor be set by the court pursuant to section 503(b)(1)(A) as an administrative expense. *See Herberman*, 122 B.R. at 287; *see also* 11 U.S.C. § 503(b)(1)(A) (2000).

[35] 150 B.R. 393 (Bankr. S.D. Tex. 1992).

[36] *Id*. at 396.

[37] *Id*.

[38] *Id*. at 397.

[39] *See id*. at 398.

[40] *In re* Molina Y Vedia, 150 B.R. 393, 398 (Bank. S.D. Tex. 1992).

fall neatly into section 541(a)(7) as 'interest[s] in property acquired by the estate during the pendency of the bankruptcy.'"[41] Judge Brown in *Molina Y Vedia* is correct in her criticism of *Herberman* if the latter case stands for the proposition that "all earnings of every chapter 11 enterprise" are brought into the estate under section 541(a)(7) because this approach "ignores Section 541(a)(6) to such an extent that Section 541(a)(6) becomes wholly superfluous."[42]

Judge Brown persuasively noted that sections 541(a)(6) and 541(a)(7) address overlapping but not congruous categories of estate property, stating:

> Postpetition earnings from any business enterprise, whether corporation, partnership, or sole proprietorship, will employ the assets of the estate and will necessarily generate proceeds, product, offspring, rents, and/or profits. Thus, the sale of goods which the debtor had on hand as of the commencement of the case produce 'proceeds' or 'profits' subject to inclusion under Section 541(a)(6), not Section 541(a)(7). Similarly, a service-oriented enterprise produces profits included in estate property under Section 541(a)(6), rather than after acquired property of the estate under Section 541(a)(7).[43]

Consequently, that portion of the profits represented by earnings from services performed by an individual debtor after the commencement of the case is not property of the estate.[44] However, the portion of the profits represented by earnings from services performed by those in the employ of the debtor after the commencement of the case is property of the estate under section 541(a)(6).[45]

In *Molina Y Vedia*, the court concluded that the *Herberman* court's reliance on the debtor-in-possession's fiduciary obligations to the chapter 11 estate to support its contention that such earnings are property of the estate was a nonstarter.[46] According to the court, "Property of the estate is not determined by the debtor-in-possession's fiduciary obligations to the estate; rather, the scope of the debtor-in-possession's fiduciary obligation is determined by the property constituting the estate."[47] The individual chapter 11 debtor owes no fiduciary obligation to the creditors for property once exempted.[48] It follows, then, that section 1108 should not neutralize other provisions of the Bankruptcy Code, specifically those sections like section 541(a)(6) that further a debtor's fresh start.

---

[41] *Id*. (quoting *In re* Heberman, 122 B.R. 273, 279 (Bankr. W.D. Tex. 1990)).
[42] *Id*.
[43] *Id*.
[44] *Id*.
[45] *In re* Molina Y Vedia, 150 B.R. 393, 398 (Bank. S.D. Tex. 1992).
[46] *See id*. at 400.
[47] *Id*.
[48] *See* 11 U.S.C. § 522(c) (2000) (stating "property exempted under this section is not liable during or after the case for any debt of the debtor that arose . . . before the commencement of the case . . . .").

Judge Brown's reasoning in *Molina Y Vedia* is compelling. Her application of the legal analysis to the facts, however, is problematic. The court quite correctly distinguished between those under a debtor's employ that directly generated income (such as associate surgeons in a medical practice)[49] and those like clerical help who although important did not directly generate income.[50] In *Molina Y Vedia*, those employed by the debtor were his support staff; he did not employ other professionals.[51] Moreover, the court correctly found that the accounts receivable representing pre-petition services were property of the estate.[52] The more difficult issues center on the role fixed assets of the estate (such as the building and medical equipment) and any good will played in producing post-petition income.[53] The court assigned the burden of proof to the creditors to show what value should be attributed to the fixed assets and rejected any estate value for the good will it deemed personal as opposed to business good will.[54]

A court that embraced a middle-of-the-road approach to the exclusion of post-petition earnings was *In re Cooley*.[55] In *Cooley*, the court addressed the issue in the context of a surgeon who filed a voluntary chapter 11 petition and sought to exclude all post-petition earnings derived from the sole proprietorship.[56] The debtor, the world famous heart surgeon, Dr. Denton Cooley, earned substantial revenues from his medical practice, which he operated as a sole proprietorship.[57] Although more than half of the revenues were generated by the debtor, a substantial amount was generated by five associate heart surgeons.[58] The plan proposed by the creditor used a compensation formula and determined that Dr. Cooley's post-petition services constituted 23.4 percent of the income stream.[59] The creditor determined this 23.4 percent, or $2,280,999, belonged to the debtor, while the remaining post-petition income stream was part of the estate.[60]

Of interest is the straightforward analysis Judge Mahoney used in addressing the issues. First, the judge observed that upon the commencement of the case, all property of the debtor passes to the estate either under sections 541(a)(1) or (a)(2)

---

[49] *See In re* Cooley, 87 B.R. 432, 443–45 (Bankr. S.D. Tex. 1988) (distinguishing between employees who generated income and employees who only helped in generating income).

[50] *See Molina Y Vedia*, 150 B.R. at 402 (noting Molina's other employees performed "non-income producing, auxiliary function[s] exclusively.").

[51] *Id*.

[52] *Id*. In fact, the debtor in *In re Molina Y Vedia* conceded the issue. *Id*.

[53] *Id*.

[54] *Id*. (recognizing creditors offered no evidence for court to conclude asset contribution).

[55] 87 B.R. 432 (Bankr. S.D. Tex. 1988).

[56] *Id*. at 441 (noting doctor made prima facie case that his post-petition earning fell within earnings exception).

[57] *Id*. at 434–36.

[58] *Id*. at 435. In 1987, the practice generated $14,705,029 in total net receipts. Of that amount, the debtor was personally responsible for generating $7,073,996. The remaining $7,631,033 was generated by five associate surgeons in the employee of the debtor. *Id*. at 435–36.

[59] *Id*. at 436.

[60] *In re* Cooley, 87 B.R. 432, 436 (Bankr. S.D. Tex. 1988).

or subsequently accrues to the estate under sections 541(a)(3) through (a)(7).[61] Property of the estate that generates post-petition income, such as invested capital in the sole proprietorship, accounts receivable, business good will, and employment contracts, are themselves property of the estate under section 541(a)(6).[62] However, where the (1) debtor is an individual (2) who performs services (3) which generated income (4) post-petition, section 514(a)(6) may carve out that income from what otherwise would be property of the estate under section 541(a)(1).[63]

The *Cooley* court observed that, as a practical matter, under sections 541(a)(1) and (a)(6) separate estates exist where an individual debtor files for chapter 11 relief: (1) the property of the estate and (2) the property of the debtor.[64] Unfortunately, the judge did not push the separate entity analysis further. As a matter of law, the estate and the debtor are separate entities that will recognize separate incomes, compute and pay taxes on their separate incomes, and file their own returns.[65] Additionally, the fact that an individual debtor also happens to be the debtor in possession in a chapter 11 case does not change the separate entity treatment dictated by IRC section 1398.[66] Although forceful in its own right, the judge's analysis in *Cooley* would have been substantially strengthened by an analysis of IRC section 1398.

The court in *Cooley* articulated several justifications for an expansive reading of section 541(a)(6). First, the court observed that Congress chose not to create separate debtor entities for an individual and his or her sole proprietorship;[67] Congress drafted section 541(a)(6) well aware of its impact in such contexts.[68] Second, the court concluded that section 541 applies to all chapters under the Bankruptcy Code.[69] Third, the court focused on Congress' concern in drafting the Bankruptcy Code that the Code's provisions for relief would not violate the Thirteenth Amendment's prohibition against involuntary servitude.[70] Thus, chapter 13 relief, which includes post-petition earnings within the profile of the estate,[71]

---

[61] *Id*. at 440–41; *see also* 11 U.S.C. § 541(a)(1)–(7) (2000).

[62] *See Cooley*, 87 B.R. at 441; *see also* 11 U.S.C. § 541(a)(6) (2000).

[63] *Cooley*, 87 B.R. at 441.

[64] *See id*. at 437 ("In the case of an individual debtor with earnings from services, the interplay between Section 541(a)(1) and (a)(6) creates, in substance if not in legal form, two estates as of the commencement of the case. One consists of property of the estate while the other consists of property of the debtor.").

[65] *See* I.R.C. § 1398 (2000) (distinguishing between estate taxes and individual taxes).

[66] *Id*. (noting section applies to both chapter 7 and chapter 11 cases).

[67] *See Cooley*, 87 B.R. at 439.

[68] *Id*.

[69] *Id*. at 436 ("Section 541 applies invariably to each chapter an individual is eligible under unless the specific chapter invoked dictates a different result."); *see also* 11 U.S.C. § 103(a) (2000) ("Chapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, 12, or 13 of this title.").

[70] *Cooley*, 87 B.R. at 437 ("Congress forcefully expressed its concern with the potential conflict with the Thirteenth Amendment's prohibition against involuntary servitude by mandating that Chapter 13 be strictly voluntary.").

[71] *See* 11 U.S.C. § 1306 (2000) (declaring estate property includes both property acquired after case commencement and earnings acquired after case commencement).

may only be commenced voluntarily by the debtor.[72] Not so with a chapter 11 case. Both creditors (without the debtor's consent) and the debtor may commence a case under chapter 11.[73] Moreover, if creditors commence an involuntary chapter 11 case against a debtor, the debtor may not convert the case to a chapter 7 case without court order.[74]

II. 2005 ACT CHANGE AND SECTION 1398

A. Post-Petition Income Now Part of Chapter 11 Individual Debtor Estate

Section 321(a) of the 2005 Act as codified at section 1115[75] provides that post-petition earnings of an individual debtor in a chapter 11 case are now part of the bankruptcy estate. Section 1115 provides:

> (a) In a case where the debtor is an individual, property of the estate includes, in addition to the property specified in section 541—(1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first; and (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first. (b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.[76]

However, like the *Herberman* case, the new provision fails to consider how the inclusion of post-petition earnings in the bankruptcy estate squares with IRC section 1398. In order to see how this oversight will cause trouble for the IRS administratively and how it fails conceptually, the article now turns to section 1398 and the separate entity rules. An analysis of that section shows that the only clean resolution is the amendment of section 1398 to exclude individual debtor chapter 11 cases from its ambit.

---

[72] *Id*. § 303 (stating involuntary cases may be commenced only under chapters 7 or 11).

[73] *Id*.

[74] *Id*. § 1112 (b)(1) (stating "on request of a party . . . the court may convert a case under this chapter to a case under chapter 7 . . . for cause . . . ."); *see also* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 442, 119 Stat. 23, 115 (2005) (to be codified at 11 U.S.C. § 1112(b)(1)) (stating "on request of a party . . . the court shall convert a case under this chapter to a case under chapter 7 . . . if the movant establishes cause.").

[75] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 321(a), 229 Stat. 23, 94 (2005) (to be codified at 11 U.S.C. § 1115).

[76] *Id*.

B. Separate Entity Rules under Section 1398

One of the most important provisions of the Bankruptcy Tax Act of 1980 ("BTA")[77] is IRC section 1398.[78] Essentially, section 1398 creates a separate entity for purposes of federal income taxes in cases where an individual debtor files for relief under chapter 7 or chapter 11 of the Bankruptcy Code.[79] Section 1398 applies only when an individual debtor files for relief under chapter 7 or chapter 11 of the Bankruptcy Code.[80] Thus, only the bankruptcy estate of an individual debtor in cases under chapter 7 or 11 is treated as a separate taxable entity. A separate taxable entity is not created in chapters 12 or 13 or in any case where the debtor is not an individual.[81]

Section 1398 furthers the fresh start policy embodied in the Bankruptcy Code. The Committee Reports recognize that the purpose of bankruptcy is to provide for a debtor's ability to begin his or her economic life anew.[82] Congress recognized that any expenses incurred by the estate should not burden a debtor's fresh start. Consistent with this purpose is the fact that the income and losses of a separate taxable entity are computed separately from the individual debtor. Moreover, any estate tax liability is generally confined to the estate and its assets. Furthermore, by making the short-year election, a debtor may be able to shift at least part of his or her tax liability to the estate as a section 507(a)(8) priority claim.[83] The committee explained:

> The bill treats the bankruptcy estate of an individual in a liquidation or reorganization case under the new bankruptcy statute as a separate taxable entity for Federal income tax purposes. Also, the

---

[77] Pub. L. No. 96–589, 94 Stat. 3389 (1980).

[78] I.R.C. § 1398 (2000).

[79] *Id*.

[80] *Id*. § 1398(a) (noting "this section shall apply to any case under chapter 7 . . . or chapter 11 . . . .").

[81] *See id*. §§ 1398(a)–(b), 1399.

[82] S. REP. NO. 96-589, at 24 (1980), as *reprinted in* 1980 U.S.C.C.A.N. 7017, 7038 (stating "the individual is given a 'fresh start'—that is, wages earned by the individual after commencement of the case and after-acquired property do not become part of the bankruptcy estate, but belong to the individual, and certain property may be set aside as exempt."). *See generally* Robert W. Van Amburgh, *Tax Considerations for an Individual Debtor Contemplating Bankruptcy*, 1989 ANN. SURV. BANKR. L. 93, 122 ("The treatment of the bankruptcy estate of an individual as a separate taxable entity harmonizes with the 'fresh start' concept of the bankruptcy law."); Jack F. Williams, *A Comment on the Tax Provisions of the National Bankruptcy Review Commission Report: The Good, The Bad, and The Ugly*, 5 AM. BANKR. INST. L. REV. 445, 453 (1997) (stating super-discharge provision reflects fresh start policy); Jack F. Williams, *National Bankruptcy Review Commission Tax Recommendations: Notice, Jurisdiction, and Corporate Debtors*, 14 BANKR. DEV. J. 261, 303 (1998) (noting IRC section 108 incorporates fresh start); Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, 3 AM. BANKR. INST. L. REV. 153, 155 (1995) (explaining IRC adopts fresh start policy); Jack F. Williams, *The Federal Tax Consequences of Individual Debtor Chapter 11 Cases*, 46 S.C. L. REV. 1203, 1204 (1995) (recognizing BTA attempted to incorporate fresh start policy).

[83] *See* I.R.C. § 1398(d) (2000) (allowing debtor flexibility in choosing taxable year); 11 U.S.C. § 507(a)(8) (2000) (giving priority to tax claims). *See generally* 15-TX4 COLLIER ON BANKRUPTCY ¶ TX4.05 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2005).

> bill provides that no separate taxable entity is created by commencement of a bankruptcy case in which the debtor is an individual in a case under chapter 13 of the new bankruptcy law (adjustment of debts of an individual with regular income), a partnership, or a corporation. The Federal income tax rules set forth in the bill with respect to a bankruptcy estate of an individual which is treated as a separate taxable entity include rules for allocation of income and deductions between the debtor and the estate, computation of the estate's taxable income, accounting methods and periods of the estate, the treatment of the estate's administrative costs as deductible expenses, carryover of tax attributes between the debtor and the estate, and requirements for filing and disclosure of returns.[84]

The committee recognized that prior to the addition of section 1398 individuals in bankruptcy had suffered from inconsistent treatment of the debtor's separate estate because of a lack of clarity in the rules:

> At present, there are no rules in the Internal Revenue Code specifying whether the bankruptcy estate constitutes a taxable entity apart from the individual debtor; and, if so, how tax attributes are to be allocated between the estate and the debtor. This has resulted in uncertainty and litigation concerning the Federal income tax liability of the bankruptcy estate and the debtor. The provisions of section 3 of the bill, adding new sections 1398 and 1399 to the Internal Revenue Code, provide the first comprehensive statutory treatment of these issues. In addition, the committee has concluded that an individual debtor in a bankruptcy case generally should be given an election to close his or her taxable year at the date of bankruptcy. If a debtor makes such an election, the debtor's Federal income tax liability for the "short" taxable year ending with commencement of the bankruptcy case becomes collectible out of the bankruptcy estate as a liability incurred before bankruptcy, to the extent the estate has assets with which to pay debts of that priority. Since income items (or benefits of pre-bankruptcy transactions that gave rise to tax liability) may have passed to the bankruptcy trustee, it is appropriate that the tax liability be collectible out of estate assets as a pre-bankruptcy liability. To the extent that assets of the bankruptcy estate are not sufficient to pay any tax due for that year, the bankruptcy statute provides that the remaining liability is not dischargeable in the bankruptcy case and

---

[84] S. REP. NO. 96-589, at 4–5, *as reprinted in* 1980 U.S.C.C.A.N. at 7020.

> hence can be collected from the individual debtor after the case.[85]

Consistent with its separate entity status, an estate computes its own taxable income in the same manner as an individual.[86] The estate is taxed at the same rate as a married individual filing separately.[87] The chapter 7 or 11 trustee is required to file any returns required by law and to pay any taxes due. The trustee must file a return for each taxable year that the estate's gross income exceeds the standard deduction and the exemption amount.[88] Consistent with this requirement, the trustee or debtor-in-possession is responsible for filing Form SS-4 (Application for Employer Identification Number) to obtain an identification number to use in filing tax returns.[89]

The bankruptcy estate's gross income includes the gross income of the debtor to which the estate is entitled under sections 541(a)(1) through (a)(7).[90] Property of the estate includes all of the debtor's legal or equitable interest in property wherever located.[91] Section 1398 does not permit double counting of income or losses by both the estate and the debtor. Thus, section 1398(e)(2) provides that a debtor's gross income for any taxable year does not include any item to the extent it is included in the estate's gross income.[92]

Section 1398(e)(1) provides that gross income of the estate does not include any amount received or accrued by the debtor before the commencement of the case.[93] Thus, section 1398 was intended to override the assignment-of-income principles under tax law. An example may clarify the effect. Assume that a cash-basis

---

[85] *Id*. at 24–25, *as reprinted in* 1980 U.S.C.C.A.N. at 7039.

[86] I.R.C. § 1398 (c)(1) (2000) (explaining "the taxable income of the estate shall be computed in the same manner as for an individual").

[87] *Id*. § 1398 (c)(3) (noting rate is "the same as for a married individual filing a separate return for such year").

[88] *See* Van Amburgh, *supra* note 82, at 122 (explaining trustee needed to file return where gross income exceeded standard deduction and exemption amount).

[89] *See* GRANT W. NEWTON & ROBERT LIQUERMAN, BANKRUPTCY & INSOLVENCY TAXATION § 4.3(a) (3d ed. 2005) (containing sample letter and observing Rev. Proc. 89-37 permits trustee to request bulk federal tax identification numbers).

[90] *See* 11 U.S.C. § 541 (2000).

[91] *See id*.

[92] *See* 15 COLLIER ON BANKRUPTCY App. E-1-(b) (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2005):

> If any item of gross income of the debtor realized after commencement of the bankruptcy case is treated under new Code section 1398(e)(1) as gross income of the bankruptcy estate (because under bankruptcy law such income constitutes property of the estate), that item shall not be included by the debtor as gross income on his or her return or a joint return with the debtor's spouse . . . .

Id.

[93] I.R.C. § 1398(e)(1) (2000) ("The gross income of the estate for each taxable year shall include the gross income of the debtor to which the estate is entitled under title 11 of the United States Code. The preceding sentence shall not apply to any amount received or accrued by the debtor before the commencement date . . . .").

individual who draws a weekly salary nonexempt under applicable state law earns one payment prior to the commencement of his or her chapter 7 case, but it is received by the estate after commencement. In that case, the estate and not the debtor would report the income.[94]

Section 1398(e)(3) provides that the determination as to whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if paid by the debtor and the debtor was still engaged in the trade or business that the debtor was engaged in before the commencement of the case.[95] It would appear that the same accounting method used for income should be used for deductions. Additionally, section 1398(e)(3) permits the estate to characterize some of its expenditures as trade or business expenses which can be used to offset current income of the estate.[96] Furthermore, administrative expenses and any fees under chapter 123, title 28 of the United States Code, are deductible by the estate to the extent not disallowed under another IRC section.[97] If the administrative expenses cannot be used in the current year then they may be carried back three years and carried forward seven years.[98]

Transfers of assets from the debtor to the estate upon commencement of the case and from the estate to the debtor upon termination of the estate are not taxable events.[99] Moreover, the estate succeeds to certain enumerated tax attributes of the debtor upon commencement of the case.[100] Presently, these tax attributes include net-operating loss carryovers as determined under IRC section 172[101]; excess charitable contribution carryovers as determined under IRC section 170(d)(1)[102]; the recovery of tax benefit items under IRC section 111[103]; certain credit carryovers; capital loss carryovers determined under IRC section 1212[104]; the basis, holding

---

94 *See, e.g.*, Van Amburgh, *supra* note 82, at 123 (using example of salary earned by cash-basis debtor prior to commencement of case but received by estate after commencement). Whether the debtor or the estate reports cancellation of indebtedness income will depend on when the taxable event occurs. If the taxable event, e.g., complete or partial discharge, modification of principal amount, etc., occurs before the commencement of the case, generally the debtor should recognize the income under section 61(a) unless it can be excluded under section 108(a). (There is a means by which to shift at least some of the tax consequences from the debtor to the estate through a section 1398 short-year election by the debtor). If the taxable event occurs after commencement of the case, then the estate should recognize the income under section 61(a) unless it can be excluded under section 108(a). *See* I.R.C. §§ 61(a), 108(a), 1398 (2000).

95 *See id*. § 1398(e)(3).

96 *See id*.

97 *Id*. § 1398(h)(2) (allowing deductions of administrative costs).

98 *Id*. § 1398(h)(2)(B) (allowing carryback).

99 *Id*. § 1398(f) (stating transfer of asset from debtor to estate "shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences" and "the estate shall be treated as the debtor would be treated with respect to such asset.").

100 *See* I.R.C. § 1398(g) (2000) (noting estate succeeds to debtor's net operating loss carryovers, charitable contributions carryover, recovery of tax benefits items, credit carryovers, capital loss carryovers, basis, holding period, character of assets, method of accounting and other attributes).

101 *Id*. § 172.

102 *Id*. § 170(d)(1).

103 *Id*. § 111.

104 *Id*. § 1212.

period, and character of property; the debtor's method of accounting; and other tax attributes of the debtor, to the extent provided in regulations carrying out the purposes of section 1398.[105] The IRS has issued regulations adding passive activity losses and credits to the list.[106] Upon termination of the estate, any unused attributes are transferred back to the debtor.[107]

The essence of section 1398 is that, when originally enacted as part of the Bankruptcy Tax Act of 1980, the bankruptcy estate can earn income and incur expenses as administered by the trustee or the debtor-in-possession,[108] while the individual debtor can also earn income and incur expenses that are not property of the estate.[109]

> The rationale [of section 1398] for generally treating the individual debtor and the bankruptcy estate as separate entities is that the individual may obtain new assets or earn wages after transfer of the pre-bankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred assets of the individual debtor and assets of the bankruptcy estate as in a chapter 7 and exempt property may be used to make payments to creditors, and hence the bankruptcy law does not create the same dichotomy between after-acquired assets of the individual debtor and the assets of the bankruptcy estate as in chapter 7 or chapter 11 cases.[110]

Under section 1398, a separate taxable entity is not created in a chapter 13 case because of the requirement under that chapter that post-petition income is included in the definition of property of the estate.[111] Consequently, there is no separate tax entity in a chapter 13 case because section 1306 specifically includes in the definition of property of the estate all post-petition income of the individual debtor.[112] Thus, because a separate estate is not created in a chapter 13 case and post-petition income is included in estate property, the debtor remains responsible

---

[105] *See generally* C. RICHARD MCQUEEN & JACK F. WILLIAMS, TAX ASPECTS OF BANKRUPTCY LAW AND PRACTICE (3d ed. 2004) (supplying helpful explanation of listed attributes).

[106] *See* Treas. Reg. § 1398-1 (1994).

[107] I.R.C. § 1398(i) (2000).

[108] *Id*. § 6012(b)(4) (requiring fiduciary of estate to make returns of income, specifically in chapter 7 case, fiduciary would be panel trustee, in chapter 11 case, fiduciary would be debtor-in-possession or if appointed, chapter 11 trustee).

[109] The bankruptcy estate files Form 1041 and the individual files Form 1040. *See, e.g.*, U.S. Income Tax Return for Estates and Trusts Form 1041, http://www.irs.gov/pub/irs pdf/f1041.pdf; U.S. Individual Income Tax Return Form 1040, http://www.irs.gov/pub/irs-pdf/f1040.pdf.

[110] Bankruptcy Tax Act of 1980, S. REP. NO. 96-1035, at 25 n.2 (1980).

[111] 11 U.S.C. § 1306 (2000) (including in estate "earnings from services performed by the debtor after commencement of the case.").

[112] *Id*.

for filing federal income tax returns.[113] No chapter 13 estate tax return is filed.

As with any employer, if the bankruptcy estate pays wages, it must withhold income and social security taxes and file the related employment tax returns for wages paid.[114] These wages may be in the form of administrative expenses, priority claims, or unsecured claims.[115] However, little guidance is provided in section 1398, which does not speak to employment taxes.

In its August 1997 Final Report to the National Bankruptcy Review Commission (the "Commission"), the Tax Advisory Committee (the "Committee") recommended a modification to section 1398(e)(3).[116] That modification would have provided that the debtor should be treated as an employee of the bankruptcy estate as to payments by the estate of estate assets to the debtor for services performed.[117] The Commission adopted the recommendation of the Committee. However, the Congress never adopted this provision or otherwise addressed the issue posed by the interplay between IRC section 1398 and Bankruptcy Code section 1115.

C. Tax Issues Posed by Interface Between Section 1398 and Section 1115

Although debate may continue as to whether it is sound bankruptcy policy to include post-petition income of an individual debtor within property of the estate, as we have done with chapter 13 debtors, the conflict now posed by section 1398 and the new provision codified at Bankruptcy Code section 1115 is inescapable. Under section 1398, gross income of the estate includes all income received or accrued by the estate and the gross income of the debtor *to which the estate is entitled under the Bankruptcy Code*. Thus, once the petition in bankruptcy under chapter 11 is filed, the debtor or the debtor's employer must pay over to the estate all post-petition earnings whether in the form of W-2 income (wages, salary, etc.), 1099 income (consulting fees, etc.), some other form of distribution, or a combination thereof. There may be some lure to conclude that any portion paid over from the estate to the employee is income *to which the estate is not entitled under the Bankruptcy Code*. This is unsupportable and ignores the import of new section 1115. That provision, along with others in the Bankruptcy Code, initially makes all of the debtor's property and income property of the estate until it is either exempted in accordance with the law or paid out in accordance with the bankruptcy scheme

---

[113] *See In re* Shank, 240 B.R. 216, 225 (Bankr. D. Md. 1999) (holding debtors have obligation to file returns and pay taxes).

[114] *See* Treas. Reg. § 31.3402(g)–1 (2005) (stating social security taxes are withheld at appropriate current rate and federal tax withholding may be based on IRS Circular E, Employer's Tax Guide, or 20% rate method).

[115] Better practice suggests that one should segregate withholdings in a separate account to avoid IRC § 6672 liability. *See* I.R.C. § 6672 (2000) (setting forth liability for failure to collect tax).

[116] *Id*. § 1398(e)(3).

[117] NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT 44 (October 20, 1997).

embedded in the Bankruptcy Code.

What, however, is the mechanism by which the individual debtor may obtain a portion of the funds paid over to the estate? A look at the precedents discussed above suggests that the estate will pay over to the individual debtor funds in the form of an administrative expense under section 503(b) and section 507(a)(2) in response to an application filed by the debtor. These payments may be in the form of wages, consulting income, or some form of property distribution; the actual treatment is unclear under the Bankruptcy Code and the IRC and, especially so, in light of Private Letter Ruling 8728056 (April 15, 1987).[118]

In Private Letter Ruling 8728056, the IRS analyzed the related question of how a taxpayer should treat the withdrawals of income by the debtor-in-possession, a farmer that operated the farm in chapter 11.[119] In accordance with the Bankruptcy Code, the bankruptcy estate engaged the debtor farmer to manage the farm for the benefit of the estate. The estate treated the farmer as an employee of the estate and characterized amounts paid over by the estate to the farmer as salary. The farmer asked the IRS whether he as the debtor-in-possession should be treated as an employee of the bankruptcy estate and that any funds paid should be considered wages.

The IRS answered no, the amounts paid over do not constitute wages. The IRS concluded:

> [F]or purposes of determining whether the amounts withdrawn by you constitute wages for federal employment tax purposes, section 1398(e)(3)(B) of the Code requires such amounts to be treated as though they had been paid by you and as though you were still engaged in the business of operating your farm. Thus, we conclude that these amounts are not considered as wages paid you as an employee of the bankruptcy estate.[120]

As Newton and Liquerman observe, the fact that the IRS rejected the notion that such payments constituted wages does not lead to the conclusion that such payments constituted 1099 income.[121] The same language in section 1398 that led the IRS to conclude that the payments did not constitute wages also applied to preclude a finding that the payments constituted 1099 income. Thus, according to Newton and Liquerman, the IRS misapplied section 1398(e)(3)(B) in its Private Letter Ruling. Therefore, we have no supportable, yet alone definitive, ruling from the IRS on the issue. Consequently, the amounts paid by the estate may be W-2 wages, 1099 consulting income, distributions of property, or a combination thereof.

The precedents discussed above would, however, conclude that any payment

---

[118] I.R.S. Priv. Ltr. Rul. 87-28-056 (April 15, 1987).
[119] *Id*.
[120] *Id*.
[121] *See* NEWTON & LIQUERMAN, *supra* note 89, at 179–80.

(regardless of tax form) would constitute an administrative expense of the estate. I concur with this approach. Thus, the entire amount of post-petition income paid over to the estate constitutes part of the estate's gross income under section 61(a).[122] The amount that a court has approved to pay over to the individual debtor as a form of compensation for services rendered that benefit the estate under section 503(b)[123] should constitute an adjustment to gross income under either section 1398(h)(1)[124] or, in limited circumstances, section 1398(e)(3)(B).[125] These amounts paid to the individual debtor should constitute "above-the-line" deductions available to the estate in computing adjusted gross income.[126]

At this point, a little further discussion is necessary regarding the actual form of the deduction taken by the bankruptcy estate for the expense discussed above. A basic tenet of federal tax law is that deductions are a matter of legislative grace.[127] As creatures of statute, one must generally find a statutory directive that authorizes any given expense as an allowable deduction. Resorting to general discussions of equity or fairness simply does not cut it; rather, a taxpayer must point to specific statutory authorization to support a deduction.

As previously discussed, there is no doubt that a bankruptcy estate is authorized deductions for administrative expenses under section 1398(h)(1).[128] Moreover, even if the payment of wages, 1099 income, or the like does not constitute ordinary and necessary costs incurred or paid in carrying on a trade or business under sections 162 and 1398(e)(3), such expenses are administrative expenses subject to deduction under sections 67 and 1398(h)(1).

The more difficult question is precisely how to treat any deduction of this sort on the applicable federal income tax return. In *Miller*,[129] the court addressed this issue. In a persuasive opinion, Judge Parker held that the bankruptcy estate deductions under section 1398(h)(1) are to be treated as adjustments to gross income or so-called "above-the-line" deductions not subject to itemization or the 2 percent floor in section 67(a).[130] Thus, the court embraced the argument of the taxpayer in that case, allowing an above-the-line deduction for administrative expenses.

In reaching its conclusion, the court rejected the argument by the IRS that any administrative expense of a bankruptcy estate is subject to the 2 percent floor under

---

[122] I.R.C. § 61(a) (2000).

[123] 11 U.S.C. § 503(b) (2000).

[124] I.R.C. § 1398(h)(1) (2000).

[125] *Id*. § 1398(e)(3)(B).

[126] *See In re Miller*, 252 B.R. 110, 113–14 (Bankr. E.D. Tex. 2000) (asserting section 1398(h)(1) insures deductibility of administrative expenses, even though they were never in trade or business of debtor); Stricka v. United States (*In re* Sturgill), 217 B.R. 291, 296 (Bankr. D. Ore. 1998) (stating administrative expense allowable under section 503 of Bankruptcy Code shall generally be allowed as deduction).

[127] *Dosher v. United States,* 730 F.2d 375, 376 (5th Cir. 1984).

[128] *See* I.R.S. Chief Couns. Adv. 2001-36-004 (May 17, 2001).

[129] *In re Miller*, 252 B.R. 110 (Bankr. E.D. Tex. 2000).

[130] *Id*. at 117.

section 67(a).[131] Section 67(a) houses the general rule imposing a 2 percent floor on miscellaneous itemized deductions. It provides, "In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income."[132]

Section 67(b) then lists some 12 examples of itemized deductions subject to the 2 percent floor.[133] Administrative expenses under section 1398(h)(1) is not one of the listed examples of miscellaneous itemized deductions.[134] Rather, the court found that the more appropriate Internal Revenue Code section is found at section 67(e).[135] Section 67(e) provides:

> (e) Determination of Adjusted Gross Income in Case of Estates and Trusts. For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that— (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and (2) the deductions allowable under sections 642(b), 651, and 661, shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.[136]

Judge Parker found section 67(e) controlling and ruled that a bankruptcy estate's administrative expenses are deductible under section 1398(h)(1) and are an above-the-line deduction under section 67(e) and not subject to the 2 percent floor under section 67(a).[137] Thus, the court treated a bankruptcy estate similar to any other type of estate or trust that would be entitled to an above-the-line deduction for administrative expenses which would not have been incurred if the property were not held in such trust or estate.[138]

Although I find Judge Parker's analysis and conclusion sound, I am cautious about certain weaknesses in the opinion. Section 67(e) is limited to administrative expenses of "estates and trusts." The section also refers to subchapter J descendants' estates and trusts; whereas, a bankruptcy estate is a subchapter V

---

[131] *Id*. at 115–16.
[132] I.R.C. § 67(a) (2000).
[133] *Id*. § 67 (b).
[134] *Id*.
[135] *Miller*, 252 B.R. at 117.
[136] I.R.C. § 67(e) (2000).
[137] *Miller*, 252 B.R. at 117.
[138] It appears that IRS Chief Counsel agrees that administrative expenses of a bankruptcy estate or appropriately deducted "above-the-line." I.R.S. Chief Couns. Adv. 2001-36-004 (May 17, 2001).

estate. Moreover, the bankruptcy estate has certain characteristics and attributes not found in other estates and trusts under federal tax law. For example, a bankruptcy estate under section 1398 is a separate taxable entity taxed at the rate of and in the manner of an individual. A subchapter J estate is generally treated as a pass-through entity and is not treated as an individual for federal tax purposes.

In summary, IRC section 1398(h)(1) provides that any administrative expense allowed under section 503 are deductible expenses of the estate.[139] Such expenses would include wages, salaries, and commissions for services rendered after commencement of the case. Moreover, any tax, or cost associated with those wages, salaries, etc., is also an administrative expense. Thus, the wages, 1099 income, or the like should constitute an administrative expense for which a deduction should be allowed the estate. That deduction should constitute an adjustment to income under section 67(e) and not subject to the 2 percent floor under section 67(a).[140]

The administrative difficulty with this approach, however, is how various reporting forms match up to various tax returns. The estate files Form 1041. The individual files Form 1040. Assume that the individual is a high income earner who is paid a salary and we treat the relationship between the estate and the debtor as an employer/employee relationship. His actual employer will report its employee's income through W-2's. Those W-2's filed with the IRS will reflect the taxpayer identification number (social security number) of the individual debtor. The actual amount (net of social security and withholding taxes), however, is paid over to the estate. A certain portion of that amount will then be paid over to the individual debtor as wages. The estate would then also file a W-2 with the IRS reflecting the individual debtor's social security number and withhold social security and withholding taxes. At the end of the tax year, the various disclosure forms (W-2's, 1099's, etc.) will not clearly disclose the facts nor match with the appropriate Income Tax Forms. This will create an administrative nightmare for the IRS and all taxpayers involved.

To illustrate the potential problems with the present interplay between IRC section 1398 and Bankruptcy Code section 1115, assume the individual debtor is employed and earns wages of $10,000. The employer will withhold social security taxes at the rate of 7.65 percent or $765.[141] All withholdings and gross wages will be reported as being earned by the individual debtor using his taxpayer identification number. The wages, however, belong to the estate. The estate will have to report the gross income of $10,000 even though it only receives $9,235, the gross wages less the social security tax withheld. When the bankruptcy estate pays all or some of the $9,235 to the individual debtor, the estate will be entitled to a

---

[139] I.R.C. § 1398(h)(1) (2000) ("Any administrative expense allowed under section 503 of title 11 of the United States Code . . . shall be allowed as a deduction."); *see also* 11 U.S.C. § 503 (2000).

[140] *Miller*, 252 B.R. at 114–15.

[141] Withholding taxes are ignored in this portion of discussion since any overpayment of withholding taxes may be claimed as a refund on tax return.

deduction for this amount as an administrative expense under Bankruptcy Code section 503 and I.R.C. section 1398(h)(1). Note, however, that the estate has gross income of $10,000 and, at most, a deduction of $9,235, the net amount it received. The estate must pay tax on the amount of social security taxes withheld by the employer—phantom income it never received. In addition, when the estate pays the individual debtor the $9,235 (assuming it pays 100 percent of what it receives) as wages,[142] this will again be subject to social security tax. The estate, of course, will also report all wages and amounts withheld as belonging to the individual debtor. As a result of the foregoing, the estate must report gross income of $765 it never received, the individual debtor is reported to have received wages of $19,235 when only $10,000 was ever earned, and the actual earnings were subjected to duplicate social security tax payments.

A possible solution to the double reporting of income problem discussed above might be for the debtor's employer to simply report the wages as being earned by the bankruptcy estate, rather than by the individual debtor. The same result could be obtained if the individual debtor filed the appropriate form reporting that s/he received the wages belonging to the estate as a mere nominee of the estate.

D. The Fix

By its terms, section 1398 applies to both chapter 7 and chapter 11 individual debtor bankruptcy cases. The reason that section 1398 applied to those cases and not to individual debtor chapter 13 cases is that post-petition income was carved out of the chapter 7 or 11 case but included in the chapter 13 case.[143] With the 2005 Act, that is no longer the case. Now, Bankruptcy Code section 1115 includes post-petition income in a chapter 11 case. The failure to square section 1398 with new section 1115 frustrates the symmetry between the treatment of the estate in certain circumstances as a separate taxable entity and the bifurcation of post-petition earnings between that which belongs to the estate and that which is paid over to the debtor. Moreover, the interplay may cause administrative confusion because of the relationships among the debtor's employer, the estate, and the debtor.

The simplest complete fix is to amend section 1398 to exclude chapter 11 cases. Anything less will result in asymmetrical theory along with twisted, convoluted administrative procedures and perverted case analysis as we struggle with a second-best result.

III. CHAPTER 11 TAX DISCLOSURE

A. Federal Tax Consequences

---

[142] There may very well be an issue of whether amounts paid to individual debtor are wages reportable on form W-2 or other types of income reportable on form 1099.

[143] *See* 11 U.S.C. § 1306 (2000) (including post-petition income in chapter 13 case as part of bankruptcy estate).

Before creditors and equity security holders may be solicited to vote on a chapter 11 reorganization plan, the proponent of the plan must file a disclosure statement that provides to holders of claims and interests adequate information to enable them to make an informed judgment about the plan.[144] Since tax consequences of a reorganization plan can have a significant impact on the plan's prospects for success, for example, whether a proposed plan is feasible, section 717 of the 2005 Act amended Bankruptcy Code section 1125(a) "to require that a chapter 11 disclosure statement discuss the plan's potential material Federal tax consequences to the debtor, any successor to the debtor, and to a hypothetical investor that is representative of the claimants and interest holders in the case."[145]

To focus more clearly on the potential issues raised by this amendment, it is helpful to first focus briefly on the structure of Bankruptcy Code section 1125 as well as on the amendatory language. Section 1125(b) is the operative portion of section 1125. It provides that no solicitation of acceptance or rejection of a reorganization plan from a holder of a claim or interest may occur unless, either at the time of, or before, the solicitation, there is transmitted to such holder the plan or summary of the plan and a written disclosure statement containing "adequate information."[146] The written disclosure statement must have been approved, after notice and a hearing, by the bankruptcy court as containing adequate information.[147] "Adequate information" is defined in section 1125(a)(1).[148] A black-lined copy of the relevant portion of section 1125(a) follows in which language added by section 717 of the 2005 Act is underlined and deleted language is shown stricken through:

> § 1125. Post-petition disclosure and solicitation
>
> (a) In this section—
>
> (1) "adequate information" means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records <u>including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case</u>, that would enable ~~a hypothetical reasonable investor typical of holders of claims or interests~~ <u>such a hypothetical investor</u> of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan . . .[149]

---

[144] *See id*. § 1125 (a)–(b).
[145] *See* H.R. REP. NO. 109-31, at 104 (2005), *as reprinted in* 2005 U.S.C.C.A.N. 88, 168.
[146] 11 U.S.C. § 1125(b) (2000).
[147] *Id*.
[148] *Id*. § 1125(a)(1).
[149] UNITED STATES BANKRUPTCY CODE & RULES BOOKLET: MAY 2005 BLACK LINE EDITION (Dahlstrom

Although section 717 of the 2005 Act amended section 1125(a)(1) to explicitly require a discussion of the material federal tax consequences to have "adequate information" in the disclosure statement, a similar requirement already existed before the amendment. In section 1125(a)(1) Congress had always defined "adequate information" in a very broad and general manner. Without particularizing any specifics, it was the type of information necessary to enable holders of claims and interests in the reorganizing debtor to make an informed judgment about the proposed reorganization plan. Congress intentionally drafted section 1125(a)(1) very broadly and generally so as to give the courts maximum flexibility in the development of what constituted adequate information:

> That standard [of what constitutes adequate information] is a substantive standard. Precisely what constitutes adequate information in any particular instance will develop on a case-by-case basis. Courts will take a practical approach as to what is necessary under the circumstances of each case . . . There will be a balancing of interests in each case.[150]
>
> Both the kind and form of information are left essentially to the judicial discretion of the court, guided by the specification in subparagraph (a)(1) that it be of a kind and in sufficient detail that a reasonable and typical investor can make an informed judgment about the plan. The information required will necessarily be governed by the circumstances of the case.[151]

Working with these broad guidelines, the case law developed an extensive list of nineteen types of information that might be included in a typical disclosure statement, all of which included on the list the tax consequences of the plan.[152] Even when a court specified a more modest list of minimum disclosure requirements such as might be appropriate for small and medium sized debtors, it also included a discussion of the tax consequences of the plan among the minimum disclosure

Legal Publishing, Inc. 2005). The remaining portion of 11 U.S.C. § 1125(a)(1), as added by section 431 of the 2005 Act, provides: "<u>and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information</u> . . . ." *Id*.

[150] H.R. REP. NO. 95-595, at 409 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 6365.

[151] S. REP. NO. 95-989, at 121 (1978) *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5907.

[152] *See, e.g.*, *In re* United States Brass Corp., 194 B.R. 420, 424–25 (Bankr. E.D. Tex. 1996); *In re* Cardinal Congregate I, 121 B.R. 760, 765 (Bankr. S.D. Ohio 1990); *In re* Scioto Valley Mortgage Co., 88 B.R. 168, 170–71 (Bankr. S.D. Ohio 1988). *In re Metrocraft Publ'g Servs., Inc*., 39 B.R. 567, 568 (Bankr. N.D. Ga. 1984), traces the evolution of the nineteen factors: items one through eleven to *In re A.C. Williams Co.*, 25 B.R. 173 (Bankr. N.D. Ohio 1982), twelve and thirteen to *In re William F. Gable Co.*, 10 B.R. 248 (Bankr. N.D. W. Va. 1981), and fourteen and fifteen to *In re Adana Mortg. Bankers, Inc*., 14 B.R. 29 (Bankr. N.D. Ga. 1981). The court itself added items sixteen through nineteen. *In re Metrocraft Publ'g Servs.*, 39 B.R. 567 at 568.

requirements.[153] In *Smith v. The Bank of New York*,[154] a plan proponent was held liable for negligent misrepresentation when it failed to analyze the tax consequences of its plan and concomitantly failed to make provision for payment of the tax.[155] The court rather emphatically stated that "[t]he law requires an analysis of the tax consequences and provision for payment."[156]

One commentator in describing the intent of the changes made by section 717 of the 2005 Act codified at section 1125(a)(1) indicated the purpose was simply to reinforce the previous requirement, not to make any changes. "The purpose of the amendment is not to change existing law, but to make plan proponents adhere to the original intent of the law, to effectively disclose the tax ramifications of the plan on the debtor."[157]

The reason why the amendment was necessary according to this commentator was because the old law for disclosure of the tax impacts of a plan did not generate the desired results. Frequently, the interested parties were simply advised to consult with their tax advisor.[158] This, Congress determined, was unacceptable. Implicit in Congress' action is the determination that the bankruptcy courts failed to enforce the disclosure requirements in any meaningful way when it came to taxes.

While changes to the prior law may not have been intended, it seems that certain changes might have occurred, though perhaps inadvertently. This will be one of the first issues that will need to be addressed by the courts.

B. Disclosure of State and Local Tax Consequences

The first issue is whether the amendment of section 1125(a)(1) by section 717 of the 2005 Act, has eliminated the need to disclose state and local tax consequences. Under prior law where section 1125(a)(1) was just a very broad, general and flexible requirement for relevant adequate information, the cases interpreted this to require the disclosure of tax information, which presumably meant all taxes, not just federal.[159] It makes no difference to the viability of a proposed reorganization plan whether some of the proceeds of the sale of assets are utilized to pay federal or other taxes. In either event the proceeds are not available to the reorganized debtor or creditors of the estate and the information is most important. In *Smith v. Bank of New York*[160] the court, in its recitation of the facts, specifically noted the $2.5 million of state taxes involved in addition to the

---

153 *See, e.g.*, *In re* Malek, 35 B.R. 443, 444 (Bankr. E.D. Mich. 1983) (involving reorganization of individual debtor).

154 161 B.R. 302 (Bankr. S.D. Fla. 1993).

155 *Id*. at 307.

156 *Id*.

157 Grant W. Newton, *Tax Provisions in New Bankruptcy Law* 1, 9 (2005), http://www.airacira.org/pdf_files/articles/tax_provisions_new_bankruptcy_law.pdf.

158 *Id*.

159 *See supra* note 152.

160 161 B.R. 302 (Bankr. S.D. Fla. 1993).

unspecified amount of federal taxes,[161] and seemed to be addressing all taxes when it held "[t]he law requires an analysis of the tax consequences and provision for payment."[162]

Under prior law, there was no requirement of any discussion of the tax consequences to the hypothetical reasonable investor typical of holders of claims or interests, but only of the tax consequences to the debtor (and, perhaps, any successor). So while the amendment to section 1125(a)(1) clearly broadened the scope of whose tax consequences need be addressed, if the new provision is interpreted to eliminate the need to discuss state and local tax consequences of the debtor, there has been a narrowing of the type of disclosure necessary vis-à-vis the debtor.

By amending section 1125(a) to specify that adequate information include "a discussion of the potential material *Federal* tax consequences of the plan," (emphasis added) the issue arises whether Congress intended thereby to eliminate the need for disclosure of state and local tax consequences. Did Congress intend to preempt the case law in this area and to require a discussion of *only* the federal tax consequences, or did Congress simply intend to mandate that federal tax consequences always be discussed while not addressing the need to discuss state and local tax consequences—in effect, leaving that decision to the bankruptcy courts as heretofore?

The legislative history of the 2005 Act is silent on this issue.[163] To judge the effect of the amendment, it is necessary to trace its origin. It originated as one of the proposals of the Tax Advisory Committee appointed in February 1997 by the National Bankruptcy Review Commission in connection with its review of the bankruptcy laws.[164] It was one of the consensus items recommended by the Tax Advisory Committee in its Preliminary Report and adopted by the National Bankruptcy Review Commission on May 14, 1997.[165] The Tax Advisory Committee's recommendation was as follows:

> **701 Amend 11 U.S.C. § 1125(b) to establish standards for tax disclosures in a Chapter 11 disclosure statement.**
>
> The Advisory Committee recommends that 11 U.S.C. § 1125(b) be amended to require a discussion of the potential material federal and state tax consequences of the plan to the debtor and any entity created pursuant to the plan, and a discussion of the

---

[161] *Id*. at 306.

[162] *Id*. at 307.

[163] *See* H.R. REP. NO. 109-31, at 104 (2005), *as reprinted in* 2005 U.S.C.C.A.N. 88, 168. The entire legislative history of section 717 is only one paragraph long and is silent on this issue. *Id*.

[164] The National Bankruptcy Review Commission was established pursuant to the Bankruptcy Reform Act of 1994 as an independent commission to investigate and evaluate issues relating to bankruptcy law.

[165] The report is reprinted in 11 REAMS & MANZ, FEDERAL BANKRUPTCY LAW: A LEGISLATIVE HISTORY OF THE BANKRUPTCY REFORM ACT OF 1994 PUB. L. NO. 103-394: INCLUDING BANKRUPTCY CODE AMENDMENTS (1987–1993), at doc. no. 109.

> potential material federal tax consequences of the plan to a hypothetical investor typical of the holders of claims or interests. A failure to discuss the potential tax consequences of a plan of reorganization in the disclosure statement can result in seriously misleading creditor constituencies and other parties in interest about the plan's economic effects. *See Smith v. Bank of New York*, 161 B.R. 302 (Bankr. S.D. Fla. 1993). There is no justification for allowing a plan proponent to ignore a plan's tax consequences in the disclosure statement. A plan's tax consequences represent an important aspect of the plan and should be fully discussed to the extent they are material. A chapter 11 debtor or other plan proponent who possesses the financial resources to propose a plan of reorganization and draft a disclosure statement is likely to possess the necessary resources to analyze the plan's tax effects. A debtor or other plan proponent cannot be expected to provide each creditor with individually tailored tax information; it would be impractical and unreasonably expensive. On the other hand, addressing the material federal tax matters affecting a hypothetical creditor or equity security holder in each class created under the plan is not burdensome, and a plan proponent fairly can be required to supply such information in its disclosure statement.[166]

The intent of the Committee seems twofold: First, to specifically identify the need for disclosure of material federal and state[167] issues concerning the debtor and any successor; and second, to cover the material federal (but not state) tax issues of the typical holder of a claim or interest. With respect to the first prong, concerning the debtor and any successor, presumably the proposal would just codify existing requirements, without intending any change.[168] With respect to the extension of requirements to address the taxes of the typical holder of a claim or interest, the proposal was limited to only federal taxes, not state taxes. Presumably this limitation was due to recognition that it would be very burdensome to have to deal with the tax consequences of all states in which any creditor or security holder resides.[169]

The early versions of legislation to codify the Committee's proposal passed by the House and/or Senate all required the disclosure to include "a full discussion of the potential material Federal, State and local tax consequences of the plan . . . ."[170]

---

[166] *Id*.

[167] The Committee never explicitly referred to local taxes, though they might possibly be comprehended within "state" taxes. Obviously, it is just as important to know how much money will be utilized to pay tax to a locality as to a state.

[168] *See* Newton, *supra* note 157, at 9 (explaining purpose of amendment was not to change law).

[169] *See supra* text accompanying note 166 (last two sentences).

[170] *See, e.g.*, Bankruptcy Reform Act of 1998, H.R. 3150, 105th Cong. § 518 (1998); Bankruptcy Reform

On November 9, 1999 Senators Roth and Moynihan introduced an amendment on the floor of the Senate that dropped the reference to "State and local" and simply required a discussion "of the potential material Federal tax consequences . . . ."[171] All subsequent versions of this proposal, including the enacted version of section 717 of the 2005 Act, seem to have followed the Roth-Moynihan language, requiring a discussion of the material Federal tax consequences,[172] and omitting any reference to state and local.

Does this omission imply that discussion of state and local taxes is no longer necessary? Arguably yes, as why else was the initially proposed language changed? It now is the same as the requirement vis-à-vis the typical holder of a claim or interest where the initial reference to only federal tax was intentional. On the other hand, there is no indication anywhere in the legislative history that Congress (or the Committee) ever intended for this amendment to narrow the disclosure requirements. However, by dropping the reference to state and local taxes in earlier versions of the legislation, it might appear to be a fair inference that Congress did this intentionally.

C. Scope of Tax Disclosure

Consistent with Congress' approach in section 1125(a)(1), the amendment made by section 717 of the 2005 Act, is very broad and general and does not specify any details. It simply provides that adequate information must include "a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case."[173] Apart from issues concerning materiality, which presumably the accountants and lawyers already have much experience dealing with, the precise scope of exactly what tax consequences must be discussed is left open, presumably for the courts to decide on a case-by-case basis. Some of the income tax issues that need be addressed might include:

<u>Concerning the Debtor</u>

1. Any gain or loss recognized on the sale/disposition/abandonment of property?
    a. Any relevant allocations, such as between interest or principal
2. Availability of IRC sections 108 and 1017 vis-à-vis discharge of indebtedness income
    a. Elections available under IRC section 108

Act of 1999, H.R. 833, 106th Cong. § 817 (1999); Bankruptcy Reform Act of 1999, S. 625, 106th Cong. § 717 (1999). The 1998 bill passed by the Senate on September 23, 1998 did not contain any similar provision. *See* S. 1301, 105th Cong. (1998).

[171] 145 CONG. REC. S14385 (daily ed. Nov. 9, 1999).

[172] *See, e.g*., Bankruptcy Reform Act of 2000, H.R. 833, 106th Cong. § 717 (2000).

[173] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 717, 119 Stat. 23, 131 (2005) (to be codified at 11 U.S.C. § 1125(a)(1)).

b. Effect of basis reduction vis-à-vis otherwise available depreciation deductions

3. Is a tax-free reorganization occurring under IRC section 368? If yes, discuss issues.

4. What are the debtor's available net operating losses and/or other tax attributes and whether any will be lost or restricted under the plan? (IRC sections 381–84)

5. Any opportunity to defer income or accelerate deductions?

6. Timing issues re attribute reduction under IRC section 108.

Concerning Successors to the Debtor

1. Any gain or loss recognized on the transaction(s) by which it becomes the successor?

2. Starting basis in properties and obligations acquired from the debtor.

3. Availability of the debtor's tax attributes.

4. Tax relationship to fresh start accounting under SOP 90-7.

Concerning Holders of Claims or Interests

1. Availability of any deduction (and, if yes, its nature as ordinary or capital) on any payments or exchanges received under the plan. (IRC sections 165, 166, 354-56)

2. Basis in stock/securities/property received.

While the above list focuses on income tax issues, it should be noted that the amended version of section 1125(a)(1) is not so limited. It requires discussion of "potential material Federal tax consequences." It seems to encompass all types of federal taxes, not just income taxes. As an example, assuming materiality, if a change in the business of, or ownership in, debtor would, or could, trigger negative consequences under a special valuation election under federal estate tax,[174] a discussion of the estate tax consequences would seem to be required. Similarly, discussions concerning some other federal taxes, such as excise,[175] or employment trust-fund[176] taxes also might be required.

D. Miscellaneous

Several issues are mentioned here rather cursorily without extended discussion. The first issue is whether the tax discussion now explicitly required in the disclosure statement will result in subjecting it to the requirements of recently strengthened Treasury Department Circular 230.[177] If yes, one of three possibilities seems likely: (1) the tax analysis will be much more extensive, and costly, than

---

[174] *See, e.g.*, I.R.C. §§ 2032A, 2057 (2000).
[175] *See, e.g.*, *id*. § 4001 *et seq.*
[176] *See, e.g.*, *id*. § 3101 *et seq.*
[177] *See* 31 C.F.R. §§ 10.0–10.93 (2005).

under previous practice; (2) the tax advisor now may not be able to give a positive opinion about all or some of the tax issues; or (3) the tax opinion may contain a prominent cautionary banner advising that the tax opinion "was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that my be imposed on the taxpayer."[178]

The recent changes to Circular 230 were in response to the spate of abusive tax shelters that were marketed in recent years[179] and would seem to have no logical connection to the tax discussion in a chapter 11 reorganization disclosure statement. The problem, however, is that the scope of Circular 230 is potentially so broad that it impacts all written tax advice, not just that pertaining to tax shelter transactions.[180] The potential penalties for violating Circular 230 are so severe that a careful tax practitioner will assume Circular 230 is applicable if there is any uncertainty at all.[181] Even a cursory reading of Circular 230 suggests that the tax advice in a disclosure statement might very well fit within its ambit as a reliance or marketed opinion, if not in another category.[182]

The second issue is what are the effects of an error in the discussion of a tax issue in the disclosure statement? This may become quite problematic since certain relevant issues may be intrinsically difficult to resolve. And the difficulty might be exacerbated by the absence of good records, which often occurs in a reorganization context.

The final issue is whether it is somehow possible to prevent the IRS from being able to challenge the tax treatment contained in a disclosure statement for a reorganization plan approved by the bankruptcy court. While such an eventuality might seem extreme, if the IRS is given appropriate notice of the hearing before the bankruptcy court concerning approval of the disclosure statement, it would seem to give the IRS ample opportunity to object to the tax discussion if it perceives any error. Under section 1125(d) the IRS would have standing to participate in the hearing, though it could not appeal from, or seek review of, an order approving a disclosure statement.[183]

CONCLUSION

The 2005 Act has dramatically changed how bankruptcy law is to be practiced

---

[178] *Id*. § 10.35(b)(4)(ii).

[179] Preamble to December 20, 2004 Amendment to Circular 230, T.D. 9165, 69 Fed. Reg. 75839 (Dec. 20, 2004).

[180] *See* N.Y. State Bar Assoc. Tax Section, *Recommendations For Improving the Circular 230 Regulations*, 107 TAX NOTES 91, 107 (Apr. 4, 2005).

[181] *Id*; *see also* Jonathan G. Blattmachr et al., *The Application of Circular 230 in Estate Planning (This Article May Not Be Relied on for Penalty Protection)*, 107 TAX NOTES 61, 63 (April 4, 2005); Jonathan G. Blattmachr et al.., *Circular 230 Redux: Questions of Validity and Compliance Strategies*, 107 TAX NOTES 1533, 1543 (June 20, 2005).

[182] *See*, *e.g*., 31 C.F.R. §§ 10.35(b)(2)(C), (4), (5) (2005).

[183] 11 U.S.C § 1125(d) (2000).

in the future. Among a host of changes are modifications to how tax issues are treated in the bankruptcy context. Although many of these tax issues will pose difficult challenges in the years ahead, one challenge need not occupy much more of our time. The need to amend section 1398 to exclude chapter 11 cases is obvious. What is not so obvious is how long we will demand the IRS and the private bar to struggle with this fact before Congress acts to fix the problem it created with the 2005 Act.

The changes to 1125 were designed to emphasize that a meaningful discussion of the federal tax consequences of a proposed plan must be reflected in the disclosure statement. Boilerplate, and mindless recitations of blackletter tax law simply do not cut it; rather, reasonable detail and a wedding of facts to tax law are now necessary to discharge the duty under new section 1125. With the importance of the tax consequences of reorganization plans increasing, we should demand no less than a careful and deliberate discussion of the tax issues.

While a very plausible argument could be made that discussion of relevant state and local tax consequences of a proposed plan is no longer required, the policy reason for such a change is illusive. Certainly the use of money to pay state and local taxes is as important as its use to pay federal taxes. There is no indication anywhere in the legislative history of the amendment to section 1125 that there was any intent to restrict the scope of the disclosure previously required. If anything, the intent seems to have been to the contrary, to assure that the previously mandated disclosure requirements not be able to be avoided. Hopefully, the courts will interpret the amendment to section 1125(a) only as requiring a discussion of the material federal tax consequences; and not as eliminating the need for any discussion of state and local tax consequences. Knowledge of the state and local taxes to be incurred under a proposed plan of reorganization still seems to fit within the section 1125(a) definition of adequate information that must be disclosed, *i.e.*, "information of a kind . . . that would enable . . . [an investor] to make an informed judgment about the plan."[184]

---

[184] *Id*. § 1125(a).