

**IRS' New Rules for the Treatment
of Individual Chapter 11 Debtors' Income**

Written by:

David N. Crapo, Esq.

Gibbons P.C.

Newark, New Jersey

dcrapo@gibbonslaw.com

Section 321 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat 23 (2005), amended the Bankruptcy Code to add a new § 1115, which governs chapter 11 cases filed by individuals on or after October 17, 2005. Section 1115 expands the scope of individual debtors' chapter 11 bankruptcy estate to include (a) the debtor's earnings from post-petition services and (b) most property acquired by the debtor post-petition, including income-producing property. Bankruptcy Code § 1115(a). The enactment of § 1115 effected a significant change in the law. Previously, as a general rule, post-petition earnings and property acquired post-petition were excluded from the bankruptcy estates of individual chapter 11 debtors. *See, e.g., In re Fitzsimmons*, 725 F.2d 1208 (9th Cir. 1984).

The Internal Revenue Code (IRC) treats the chapter 11 bankruptcy estate as a separate taxable entity from the debtor. I.R.C. § 1398. By expanding the scope of individual debtors' bankruptcy estates at the expense of the debtors themselves, the enactment of § 1115 raised significant tax-related issues. To provide chapter 11 debtors and trustees with guidance on those issues, the Internal Revenue Service (IRS) issued Notice 2006-83 (Notice). *See Internal Revenue Bulletin 2006-50* (Oct. 2, 2006). The Notice sets forth rules governing (a) the tax treatment of individual chapter 11 debtors' earnings derived from either post-petition services or

property acquired post-petition and (b) the preparation of tax returns for such debtors and their bankruptcy estates. Notice, § 3.01. Consistent with § 1115, effective for cases filed on or after October 17, 2005, the bankruptcy *estate* of an individual chapter 11 debtor must include in its gross income both (a) the debtor's gross earnings from post-petition services and (b) the gross income from property acquired by the debtor post-petition. *Id.*, §§ 1, 2.09. The debtor's gross earnings include earnings resulting from either self-employment or employment by a third party. *Id.*, § 1.

The bankruptcy estate may compensate the debtor for continuing to operate post-petition a trade or business he or she operated pre-petition. Such compensation should be reportable *by the debtor* as miscellaneous income on his or her personal tax return. *Id.*, 3.02. Such compensation should also constitute an administrative expense of the bankruptcy estate under Bankruptcy Code § 503 and, therefore, be deductible by the bankruptcy estate on its tax return pursuant to I.R.C. § 1398(h)(1). *Id.* Indeed, as a general rule, any amounts paid or obligations incurred by the bankruptcy estate in connection with a trade, business or activity in which the debtor engaged pre-petition will be deductible by the estate on its tax return to the extent that such payments or obligation would be deductible by the debtor if the debtor were still deemed to be engaged in the trade, business or activity. *Id.*, § 2.06, *citing* IRC§ 1398(e)(3)(A).

Promptly after the filing of a chapter 11 bankruptcy petition, the trustee (if one has been appointed) or the debtor-in-possession must obtain an employer identification number (EIN) for the bankruptcy estate for use on the estate's tax returns. Notice, § 2.04. The debtor or trustee must give notice of the EIN to persons required to file information returns with respect to the estate's gross income, gross proceeds or other reportable payments to the estate. *Id.*, § 3.03.

Once notified, those persons are to report the payments belonging to the estate on information returns using the estate's name and EIN. *Id.*

Notice of the bankruptcy estate's EIN should not be provided, however, to the debtor's employer or any other person filing a Form W-2 with respect to payments to the debtor. *Id.*, § 3.03. The employer should continue to report wage income and the related tax withholding on a Form W-2 issued to the debtor under his or her social security number. *Id.*, §§ 3.03, 5.02. Similarly, although a chapter 11 debtor's post-petition self-employment income is property of the bankruptcy estate, the debtor should continue to report self-employment income on a Schedule SE to his or her personal tax return and to pay the self-employment tax imposed by IRC § 1401. *Id.*, § 4.02.

Section 1115 does not apply to a chapter 11 bankruptcy case once it is closed, dismissed or converted to either chapter 7, 12 or 13, although property acquired post-petition, but pre-conversion, by a chapter 11 debtor will become part of any succeeding chapter 7 bankruptcy estate. Notice, § 2.11. Consequently, the debtor should notify persons who have been notified of the chapter 11 bankruptcy *estate's* EIN of any dismissal or closing or conversion of the case to either chapter 12 or 13, to the extent such notification is necessary to ensure that payments that are, at that time, being reported as income to the *estate* are correctly reported as income to the *debtor*. *Id.* § 3.04. Similarly, once a chapter 11 case has been converted to chapter 7, the debtor should notify each payer of non-employee compensation due the debtor for *post-conversion* services to report such compensation on a Form 1099-MISC, using the debtor's name and social security number. *Id.*, § 3.05.

To facilitate the proper taxation of W-2 income for services provided by a chapter 11 debtor during the year in which the bankruptcy petition is filed, the chapter 11 debtor-in-possession or (if one is appointed) the chapter 11 trustee must allocate such income (and the corresponding withholding) between the debtor and the bankruptcy estate. *Id.*, § 6.01. A similar allocation is required for income that was improperly reported on an informational return as income of the debtor rather than as income of the bankruptcy estate. *Id.*, 6.02. The Notice does not prescribe a specific allocation method. The method utilized must be reasonable, and a simple percentage method may be used, if reasonable. *Id.*, § 6.01, 6.02. The debtor and either the debtor-in-possession or chapter 11 trustee (if one has been appointed) must each attach a statement to their respective tax returns advising IRS of the bankruptcy filing and the method by which the foregoing allocations have been made. *Id.*, § 6.03. A model statement is included in the Notice. *Id.*, § 6.04.

IRS has recognized that further guidance to debtors, chapter 11 debtors-in-possession and chapter 11 trustees is necessary concerning the tax treatment of (a) the debtor's post-confirmation income and (b) that portion of the chapter 11 debtor's post-petition earnings from a third party employer that the debtor is permitted to retain for personal or living expenses. *Id.*, § 7. Section 1115 provides no guidance on those issues. Public comment by December 1, 2006 was invited on those issues. *Id.*, § 7.04. Further notices by the IRS on those issues are, therefore, likely.