

Part III - Administrative, Procedural, and Miscellaneous

Individual Chapter 11 Debtors

Notice [XXXX-XX]

This notice provides guidance for individuals who file bankruptcy cases under Chapter 11 of the Bankruptcy Code (11 U.S.C. § 1101 et seq.) on or after October 17, 2005. This notice also provides guidance for (1) employers of these individuals, (2) persons filing Forms W-2, 1099-INT, 1099-DIV, 1099-MISC, and other information returns (including Schedule K-1) that report payments to these individuals, and (3) Chapter 11 trustees in bankruptcy cases filed by these individuals. Upon consideration of the comments received concerning this notice, as requested in section 8, additional guidance may be published.

Section 1 PURPOSE

The bankruptcy estate of a Chapter 11 debtor who is an individual is a separate taxable entity under section 1398 of the Internal Revenue Code. The estate, rather

than the debtor, must include in its gross income all of the debtor's income to which the estate is entitled under the Bankruptcy Code, except for amounts received or accrued by the debtor before the commencement of the case. Section 1115 of the Bankruptcy Code was enacted by section 321(a)(1) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Pub. L. No. 109-8, 119 Stat. 23 (2005). Section 1115 is effective for cases filed on or after October 17, 2005. Section 1115 expands the scope of the bankruptcy estate. As a result of the enactment of section 1115, the bankruptcy estate, rather than the debtor, must include in its gross income both (1) the debtor's gross earnings from his or her performance of services after the commencement of the case ("post-petition services") and (2) the gross income from property acquired by the debtor after the commencement of the case ("post-petition property"). The gross earnings from post-petition services include wages and other compensation earned by a debtor who is an employee and self-employment income earned by a debtor who is a self-employed individual.

Sec. 2 BACKGROUND AND GENERAL LEGAL PRINCIPLES

.01 The commencement of a bankruptcy case creates an estate, which generally includes all legal or equitable interests of the debtor in property as of the commencement of the case. 11 U.S.C. § 541(a)(1). Specific exclusions apply, however. See 11 U.S.C. § 541(b) (excluded property). See also 11 U.S.C. § 522 (exempt property); 11 U.S.C. § 554 (abandoned property). Exempt property and abandoned property are initially part of the bankruptcy estate, but are subsequently

removed from the estate. By contrast, property excluded from the estate is never included in the estate.

.02 Confirmation of a Chapter 11 plan of reorganization vests all the property of the estate in the debtor, except as otherwise provided in the plan or in the court order confirming the plan. 11 U.S.C. § 1141(b). If no plan is confirmed and a bankruptcy case is dismissed, the property of the estate generally reverts in the debtor, unless the court orders otherwise. 11 U.S.C. § 349(b)(3).

.03 When a trustee is appointed pursuant to section 1104 of the Bankruptcy Code, the debtor generally must turn over to the trustee control over the assets of the bankruptcy estate. In most Chapter 11 cases, a trustee is not appointed and the debtor (referred to as the debtor in possession) remains in control of the property of the bankruptcy estate. Under section 1107(a) of the Bankruptcy Code, the debtor in possession must perform all the functions and duties of a trustee, except for the duties specified in Bankruptcy Code section 1106(a)(2), (3) and (4).

.04 Section 1398(a) of the Internal Revenue Code provides that when an individual debtor files a bankruptcy case under Chapter 7 or Chapter 11, the bankruptcy estate is a separate taxable entity. Because the bankruptcy estate is a separate taxable entity, the trustee or debtor in possession must obtain an employer identification number (EIN) for the estate. I.R.C. § 6109. The trustee or debtor in possession uses the EIN on any tax returns filed for the estate.

.05 Section 1398(e)(1) of the Code provides that the gross income of the estate

includes the gross income of the debtor to which the estate is entitled under the Bankruptcy Code. Section 1398(e)(2) provides that the gross income of the debtor does not include any item to the extent the item is included in the gross income of the bankruptcy estate.

.06 In general, the determination of whether or not any amount paid or incurred by the estate is allowable as a deduction or credit to the estate shall be made as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades and businesses, and in the activities, the debtor was engaged in before the commencement of the case. I.R.C. § 1398(e)(3)(A). The estate is, however, specifically allowed a deduction for administrative expenses allowed under section 503 of the Bankruptcy Code and for any fee or charge assessed against the estate under chapter 123 of title 28 of the United States Code. I.R.C. § 1398(h)(1).

.07 The individual debtor must continue to file his or her own individual tax returns during the bankruptcy proceedings. I.R.C. § 6012(a)(1). In general, the taxable year of the debtor is unaffected by the filing of the bankruptcy case. I.R.C. § 1398(d)(1). The debtor may, however, elect to terminate the taxable year in which the bankruptcy case commences. I.R.C. § 1398(d)(2). If the individual debtor's case is later dismissed by the bankruptcy court, the estate is not treated as a separate entity. I.R.C. § 1398(b)(1).

.08 For bankruptcy cases filed before October 17, 2005, the property of the estate does not generally include any post-petition property acquired by an individual

Chapter 11 debtor. Nor in those cases does the property of the estate include the individual Chapter 11 debtor's earnings from post-petition services, because section 541(a)(6) of the Bankruptcy Code specifically excluded those earnings from the estate. See, e.g., In re Fitzsimmons, 725 F.2d 1208 (9th Cir. 1984); In re Larson, 147 B.R. 39 (Bankr. D.N.D. 1992). Therefore, in these cases income from post-petition property and earnings from post-petition services are not generally includible in the estate's gross income. Instead, such income and earnings are generally includible in the debtor's gross income.

.09 Section 321 of BAPCPA made several changes to Chapter 11, effective for bankruptcy cases filed by individuals on or after October 17, 2005. As a result, many of the provisions that now apply to individual debtors filing Chapter 11 cases operate in a manner similar to the provisions applicable to debtors who file their cases under Chapter 13. A plan under Chapter 11 or Chapter 13 must provide for payments to creditors of all or a portion of an individual debtor's earnings from post-petition services or other post-petition income as is necessary for the execution of the plan. 11 U.S.C. §§ 1123(a)(8) and 1322(a)(1). If a holder of an allowed unsecured claim objects to confirmation of an individual's plan under Chapter 11 or Chapter 13, the plan must provide, as a requirement for confirmation, that the value of property to be distributed on account of such claim is not less than the amount of the claim or that the value of property to be distributed under the plan is not less than the debtor's projected disposable income to be received during a specified period. 11 U.S.C. §§ 1129(a)(15)

and 1325(b)(1). Also, an individual debtor generally is not eligible to receive a discharge until all plan payments have been made. 11 U.S.C. §§ 1141(d)(5)(A) and 1328(a). Moreover, property of the estate includes post-petition property and the debtor's gross earnings from post-petition services. 11 U.S.C. §§ 1115 and 1306. For a Chapter 11 case filed on or after October 17, 2005, section 1115 specifically provides as follows:

(a) In a case in which 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.

.10 Although many of the provisions that apply to individual Chapter 11 cases now operate in a manner similar to the provisions that apply in Chapter 13 cases, section 1398 of the Internal Revenue Code has not been amended and continues to apply to individual Chapter 11 cases, but not to Chapter 13 cases. Based on section 1115 of the Bankruptcy Code and section 1398(e)(1) of the Internal Revenue Code, the debtor's gross earnings from post-petition services and gross income from post-petition

property are, in general, includible in the bankruptcy estate's gross income, rather than in the debtor's gross income. This rule is subject to the exceptions noted below in sections 2.11, 2.12, 2.13, and 2.14.

.11 Earnings from post-petition services and income from post-petition property realized by the debtor after the bankruptcy case is closed are taxed to the debtor. Also, if the case is converted to a Chapter 13 case, the Chapter 13 estate is not a separate taxable entity and earnings from post-conversion services and income from property realized after the conversion to Chapter 13 are taxed to the debtor.

.12 If the Chapter 11 case is converted to a Chapter 7 case, earnings from post-conversion services will be taxed to the debtor, rather than the estate. In such a case, the property of the Chapter 11 estate will become property of the Chapter 7 estate. Any income on this property will be taxed to the estate even if the income is realized after the conversion to Chapter 7.

.13 Upon dismissal of a Chapter 11 case, the debtor is treated as if the bankruptcy case had never been filed and as if no bankruptcy estate had been created.

.14 For Chapter 11 cases filed by individuals on or after October 17, 2005, the estate's gross income includes gross income from property held by the debtor when the case commenced ("pre-petition property"), as was the case under pre-BAPCPA law. There are certain exceptions to this rule, however. The gross income on pre-petition property is included in the gross income of the debtor, rather than the estate, if the pre-petition property is excluded from the estate and the gross income is subject to

taxation. Also, the gross income on pre-petition property is included in the gross income of the debtor, rather than the estate, after the pre-petition property is removed from the estate by exemption or abandonment.

Sec. 3 GENERAL GUIDANCE CONCERNING FILING OF INCOME TAX RETURNS OF THE DEBTOR AND THE ESTATE; REQUIREMENT THAT PERSONS FILING INFORMATION RETURNS (OTHER THAN FORM W-2) BE NOTIFIED OF THE CHAPTER 11 BANKRUPTCY CASE AND ITS CLOSING, DISMISSAL OR CONVERSION TO A CASE UNDER A DIFFERENT CHAPTER

.01 If a trustee is appointed, the trustee must prepare and file the income tax returns of the bankruptcy estate if required under section 6012(a)(9). I.R.C. § 6012(b)(4). If no trustee is appointed, the debtor in possession must prepare and file the income tax returns of the estate if required under section 6012(a)(9).

.02 In preparing the income tax returns of the debtor and the bankruptcy estate, the debtor and the trustee (if one is appointed) must follow the rules stated in sections 2.10, 2.11, 2.12, 2.13, and 2.14 of this notice, and must attach to the returns the statement discussed in section 7.

.03 An administrative expense allowed by the bankruptcy court under section 503 of the Bankruptcy Code will generally be deductible by the estate as an administrative expense when it is paid or incurred. I.R.C. § 1398(h)(1). If the debtor is

compensated by the estate to manage its operations as a debtor in possession, amounts paid by the estate to the debtor may qualify as a deductible administrative expense. These amounts will generally be includible in the debtor's gross income and should be reported as miscellaneous income on his or her individual income tax return. I.R.C. § 61(a).

.04 Within a reasonable time after the commencement of a Chapter 11 bankruptcy case, the trustee (if one is appointed) or the debtor in possession should, in general, provide notification of the bankruptcy estate's EIN to persons that are required to file information returns with respect to the bankruptcy estate's gross income, gross proceeds, or other types of reportable payments. The trustee or debtor in possession should not, however, provide the EIN to the debtor's employer or other person filing Form W-2 with respect to the debtor's wages or other compensation. As provided in section 6, an employer should continue to report all wage income and accompanying tax withholdings, whether pre- or post-petition, on a Form W-2 issued to the debtor under the debtor's social security number. Regarding non-wage payments, generally the estate, rather than the debtor, must be shown as the payee or recipient if the gross income, gross proceeds, or other reportable payment represents property of the estate and is otherwise required to be reported on an information return. If so, the gross income, gross proceeds, or other reportable payment must be reported on an appropriate information return using the estate's EIN in the time and manner required under the Internal Revenue Code and regulations (see, e.g., sections 6041 through

6049). See sections 6721 through 6724 for applicable penalties for failure to comply with information reporting requirements, including providing taxpayer identification numbers, and provisions for penalty waivers for reasonable cause.

.05 When a Chapter 11 bankruptcy case is closed, dismissed, or converted to a case under Chapter 7, 12, or 13 of the Bankruptcy Code, the trustee (if one is appointed) or the debtor in possession should, within a reasonable time, provide notification of the closing, dismissal, or conversion to the persons that were previously notified of the bankruptcy case under section 3.03. The purpose of this notification is to ensure that gross income, gross proceeds, and other types of reportable payments realized after the closing, dismissal, or conversion are reported to the proper person. Gross income, gross proceeds, and other reportable payments realized after the closing, dismissal, or conversion should, in general, be reported to the debtor, rather than the estate. If, however, the Chapter 11 case is converted to a Chapter 7 case, the bankruptcy estate will continue to exist as a separate taxable entity and gross income, gross proceeds, or other reportable payments should continue to be reported to the estate if the gross income, gross proceeds, or other reportable payment represents property of the Chapter 7 estate. Income from services performed by the debtor after conversion to Chapter 7 is property of the debtor and should not be reported to the estate.

.06 The debtor is not required to file a new Form W-4 with an employer adjusting the debtor's withholding allowances solely because the debtor has filed a Chapter 11

case and his or her post-petition wages are includible in the gross income of the estate. This is true even though the estate may be taxed at a higher tax rate than the debtor and is entitled to only one personal exemption. A new Form W-4 may be necessary, however, under the applicable regulations when, for instance, the debtor employee is no longer entitled to claim the same number of allowances claimed on the Form W-4 previously provided to the employer. See § 31.3402(f)(2)-1 of the Employment Tax Regulations.

Sec. 4 TAXATION OF INCOME EARNED BY THE DEBTOR AFTER
CONFIRMATION OF THE CHAPTER 11 PLAN

.01 Section 1115 does not address whether, or to what extent, income earned by the debtor from services performed after plan confirmation is property of the estate or property of the debtor. Nor does section 1115 address whether, or to what extent, property of the estate retains its character as such after it vests in the debtor upon plan confirmation under section 1141(b) of the Bankruptcy Code. Courts have addressed the effects of plan confirmation, however, on the scope and extent of the Chapter 13 estate under the analogous provisions of that Chapter.

.02 Because courts have reached varying and conflicting results as to the impact of plan confirmation under Chapter 13, they may also reach varying and conflicting results interpreting the parallel provisions of Chapter 11. See 11 U.S.C. §§ 1115 and 1306 (providing identical definitions of property of the estate under Chapters 11 and

13); 11 U.S.C. §§ 1141(b) and 1327(b) (providing that, in general, property of the estate vests in the debtor upon confirmation of a plan under Chapter 11 or 13). There is a tension in Chapters 11 and 13 between the broad definition of property of the estate and the general rule that property of the estate vests in the debtor upon plan confirmation. The court in Telfair v. First Union Mortgage Corp., 216 F.3d 1333 (11th Cir. 2000), discussed three approaches that courts have taken to resolve this tension:

In resolving this conflict, courts have adopted one of three models: the estate termination approach, the estate preservation approach, and the estate transformation approach. Under the estate termination approach, all property of the estate becomes property of the debtor upon confirmation and ceases to be property of the estate. According to the estate preservation approach, all property of the estate remains property of the estate after confirmation until discharge, dismissal, or conversion. A compromise between these two extremes is struck by the estate transformation approach, which regards only that property necessary for the execution of the plan as remaining property of the estate after confirmation.

216 F.3d at 1340 (citations omitted). A fourth approach to this issue was suggested in Barbosa v. Soloman, 235 F.3d 31, 36, 37 (1st Cir. 2000):

[A] fourth line of cases has held that by virtue of sections 1327(b)-(c), property of the estate at the time of confirmation vests in the debtors free of any claims from the creditors. The estate does not cease to exist however, and it continues to be funded by the Debtors' regular income and post-petition assets as specified in section 1306(a). In re Reynard, 250 B.R. at 247; In re Trumbas, 245 B.R. 764, 766 (Bankr. D. Mass. 2000); In re Holden, 236 B.R. at 162-63; In re Rangel, 233 B.R. at 198.

.03 The absence of a separate taxable entity in Chapter 13 cases means that the approaches noted above have no tax consequences for cases under that Chapter. As a result of the enactment of section 1115, however, the conflicts in the case law may have tax consequences in cases under Chapter 11. Whether, or to what extent, post-

confirmation earnings of the debtor are property of the estate would appear to govern the extent to which the estate or the debtor is taxed on post-confirmation earnings of the debtor. The taxation of post-confirmation income thus may depend upon the jurisdiction in which the Chapter 11 case is filed. The terms of the Chapter 11 plan and the order confirming the plan also may affect the taxation of post-confirmation earnings of the debtor and post-confirmation income on property of the estate.

Sec. 5 APPLICATION OF THE SELF-EMPLOYMENT TAX

Section 1401 of the Internal Revenue Code imposes a tax upon the self-employment income of every individual. The term "self-employment income" means the net earnings from self-employment derived by an individual. I.R.C. § 1402(b). The term "net earnings from self-employment" means, in relevant part, the gross income derived by an individual from any trade or business carried on by such individual less deductions allowed attributable to such trade or business. I.R.C. § 1402(a). Under section 1115 of the Bankruptcy Code, the earnings from a Chapter 11 debtor's post-petition services, including the debtor's self-employment income, constitute property of the estate under section 1115. As property of the estate, the income from post-petition services is includible in the gross income of the bankruptcy estate, rather than the gross income of the debtor. I.R.C. § 1398(e)(1). However, neither section 1115 of the Bankruptcy Code nor section 1398 of the Internal Revenue Code addresses the application of the self-employment tax to the earnings from the individual debtor's continuing services. Because the debtor continues to derive gross income from the

performance of services as a self-employed individual after the commencement of the bankruptcy case, the debtor must continue to report on Schedule SE of the debtor's individual income tax return the self-employment income earned post-petition and must pay the resulting self-employment tax imposed by section 1401.

Sec. 6 APPLICATION OF EMPLOYMENT TAXES AND OBLIGATION TO
FILE FORM W-2

.01 As a result of the enactment of section 1115, post-petition wages earned by a debtor are generally treated for income tax purposes as gross income of the estate, rather than the debtor, as noted above. Section 1115 has no effect, however, on the determination of wages under the Federal Insurance Contribution Act (FICA), including application of the contribution and benefit base (as determined under section 230 of the Social Security Act). I.R.C. § 3121(a). Thus, for example, a Chapter 11 debtor who would be entitled to a credit under sections 6413(c) and 31(b) because he or she had more than one employer and received wages from multiple employers exceeding the contribution and benefit base will be entitled to exactly the same credit. Similarly, the enactment of section 1115 does not have any effect on the determination of wages for Federal Unemployment Tax Act (FUTA) tax or Federal Income Tax Withholding purposes. See I.R.C. §§ 3306(b) and 3401(a).

.02 Since section 1115 does not affect the application of FICA tax, FUTA tax, or Federal Income Tax Withholding, with respect to the wages of a Chapter 11 debtor in a case commenced on or after October 17, 2005, an employer should continue to reflect such wages and accompanying tax withholdings on a Form W-2 issued to the debtor

under the debtor's name and social security number.

Sec. 7 ALLOCATION OF INCOME AND CREDITS ON INFORMATION RETURNS AND REQUIRED STATEMENT FOR RETURNS

.01 When an employer issues a Form W-2 to a Chapter 11 debtor reporting all of the debtor's wages, salary, or other compensation to the debtor for a calendar year, and a portion of the wages, salary, or other compensation represents earnings from post-petition services that is includible in the estate's gross income under section 1398(e)(1), an allocation of the amounts reported on the Form W-2 must be made. The debtor in possession (or the trustee, if one is appointed) must allocate in a reasonable manner wages, salary, or other compensation reported in box 1 of Form W-2 between the debtor and the estate. The debtor in possession (or the trustee, if one is appointed) must also allocate the withheld income tax reported in box 2 of the Form W-2 in a manner corresponding to the allocation of the wages, salary, or other compensation. The allocations must be in accordance with all the rules stated in sections 2.10, 2.11, 2.12, 2.13, and 2.14 of this notice. If reasonable, the debtor and trustee may use a simple percentage method for allocating income and withheld income tax between the debtor and the estate. The same method used to allocate income must be used to allocate withheld income tax. For example, if one-sixth of the wages reported on Form W-2 for the calendar year ending December 31, 2005, was earned after the commencement of the case and must therefore be included in the estate's gross income, one-sixth of the withheld income tax reported on Form W-2 must be claimed as a credit on the estate's income tax return and five-sixths of the withheld income tax

must be claimed as a credit on the debtor's income tax return. See I.R.C. § 31(a).

.02 In some cases, persons filing information returns may report to the debtor gross income, gross proceeds, or other reportable payments that should have been reported to the bankruptcy estate using Forms 1099-INT, 1099-DIV, 1099-MISC, Schedule K-1 or other information returns. This may occur, for instance, if the debtor in possession fails to notify the payor of the bankruptcy as required by section 3.03. In these cases, the debtor in possession (or the trustee, if one is appointed) must allocate the improperly reported income in a reasonable manner between the debtor and the estate. In general, the allocation must ensure that any income (and any income tax withheld) attributable to the post-petition period is reported on the estate's return, and any income (and income tax withheld) attributable to the pre-petition period is reported on the debtor's return. The allocations, however, must be in accordance with all the rules stated in sections 2.10, 2.11, 2.12, 2.13, and 2.14 of this notice.

.03 The debtor must attach a statement to his or her income tax return stating that he or she filed a Chapter 11 bankruptcy case. The statement must reflect the foregoing allocations of income and withheld income tax and must describe the method used to allocate income and withheld tax between the debtor and the estate. The statement should list the filing date of the bankruptcy case, the bankruptcy court in which the case is pending, the bankruptcy court case number, and the bankruptcy estate's EIN. The debtor in possession or trustee must attach a similar statement to the income tax return of the estate.

.04 The following model statement may be used by debtors, debtors in possession and trustees in complying with the requirements of section 7 of this notice:

Notice XXXX-XX Statement_

Pending Bankruptcy Case

The taxpayer, _____, filed a bankruptcy petition under Chapter 11 of the Bankruptcy Code on _____ in the Bankruptcy Court for the _____ District of _____. The bankruptcy court case number is _____. Gross income, and withheld federal income tax, reported on Form W-2, Forms 1099, K-1, Schedule K-1, and other information returns received under the taxpayer's name and social security number (or other taxpayer identification number) are allocated between the taxpayer and the bankruptcy estate (EIN__-____) as follows, using [describe allocation method]:

	<u>Year</u>	<u>Taxpayer</u>	<u>Estate</u>
1. Form W-2 from _____ Co.		\$ ____	\$ ____
Withheld income tax shown on Form W-2		\$ ____	\$ ____
2. Form 1099-INT from _____ Bank		\$ ____	\$ ____
Withheld income tax (if any) shown on Form 1099-INT		\$ ____	\$ ____
3. Form 1099-DIV from _____ Co.		\$ ____	\$ ____

Withheld income tax (if any) shown on Form 1099-DIV	\$ ____	\$ ____
4. Form 1099-MISC from ____ Co.	\$ ____	\$ ____
Withheld income tax (if any) shown on Form 1099-MISC	\$ ____	\$ ____

Sec. 8 REQUEST FOR COMMENTS

.01 The IRS and the Treasury Department are aware that further guidance is needed in this area and request comments on certain issues. In particular, comments are requested on the effects of plan confirmation, as discussed in section 4 of the notice, and the impact of the conflicting court decisions noted in section 4 on the taxation and reporting of post-confirmation earnings from services and post-confirmation income from property. Comments are also requested as to whether the taxation and reporting of post-confirmation earnings from services and post-confirmation income from property will be affected by the terms of the Chapter 11 plan and the order confirming the plan.

.02 Comments should be submitted on these and other relevant issues in writing on or before _____ to the Internal Revenue Service, P.O. Box ____, Washington, D.C. 200__, Attn: CC:PA:CBS (Notice 2006-__). Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111 Constitution Avenue, N.W., Washington, DC 20224, Attn:

CC:PA:CBS (Notice 2006-___), Room _____. Submissions may also be sent electronically via the internet to the following email address:

Notice.comments@irscounsel.treas.gov. Include the notice number (Notice 2006-___) in the subject line. All comments will be available for public inspection and copying.

Sec. 9 DRAFTING INFORMATION

The principal author of this notice is William F. Conroy of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this notice contact William F. Conroy at (202) 622-3620 (not a toll-free call).