“IRS spells out new rules for Chapter 11 bankruptcy”

Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, and with that legislation came some changes in the way bankruptcy debtors are taxed.

New Internal Revenue Service guidelines have been issued to help explain provisions of the act that affect individual taxpayers filing Chapter 11 bankruptcies. The guidelines are issued in IRS Notice 2006-83 and relate to all Chapter 11 bankruptcies filed on or after Oct. 17, 2005.

A Chapter 11 bankruptcy provides the debtor with the opportunity to reorganize and continue to conduct business, while keeping creditors at bay. Previously more popular with corporate taxpayers, Chapter 11 now has wider appeal for individuals, due to the tightening of rules surrounding the more common Chapter 13 bankruptcy.

One of the complexities surrounding the Chapter 11 bankruptcy is that a separate bankruptcy estate is created; that estate must obtain a federal tax identification number and file its own income tax return (Form 1041). For the individual filing a Chapter 11, this means that all personal income earned after the date of the bankruptcy becomes income of the estate and gets reported on the estate’s tax return.

From a tax point of view, that’s not a problem in a Chapter 13, because the estate’s not a separate taxpayer, and so the debtor has to pull all that income on his income tax return anyway. But now they have put the same rule in for Chapter 11 in the bankruptcy code.

They’re basically setting up a separate entity for the Chapter 11. This is necessitated by some of the things that Congress did when they changed the bankruptcy laws. What they did is they made Chapter 11 a much more viable option for an individual.

The popularity of Chapter 11 bankruptcies is going to increase greatly going forward. A couple of years back, individuals rarely filed, Chapter 11.

Divided against themselves

Typically, the bankruptcy debtor maintains control over the bankruptcy estate and prepared the necessary tax forms; however, in some cases a trustee might be appointed to manage the bankruptcy estate. In either case, in the year that the bankruptcy is filed, the individual filing a Chapter 11 is responsible for dividing earnings for the year into two parts, amounts earned prior to the bankruptcy filing and amounts earned after the filing. The IRS guidelines recommend that the debtor should make the allocation between personal and bankruptcy income in “a reasonable manner.”

Employers don’t have to worry about extra paperwork or allocating income and tax withholding between two entities. The IRS instructed employers to go ahead and put all the debtor’s wages on the W-2 and send it to the debtor, then the debtor has to figure out how much of that belongs on his own return and how much on the estate’s return.

In addition, the IRS guidelines call for a statement to be attached to both tax returns describing the amount allocated, the method used to allocate income and tax withholdings, the filing date and court case number of the bankruptcy case, the name of the court, and the federal identification numbers of the estate and the debtor.

After the first year of Chapter 11, the taxpayers/debtor continues to file a personal income tax return, even if all income is being reported on the bankruptcy estate’s return.

During each year of the bankruptcy, the individual is to attach a Form 1041 as a cover sheet on the Form 1040. The 1041 should include the estate's identification information at the top of the return, and the amount of tax and taxes paid by the estate. The taxpayer is to write the phrase, "Attachment to Form 1041. Do Not Detach" across the top of the Form 1040, and attach that form to the 1041 for filing.