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How Are Bankruptcy Estate Deductions Claimed?

-by Neil E. Harl

For nearly a decade, there’s been uncertainty as to how bankruptcy deductions, particularly administrative expense deductions, could be claimed.¹ The original position of the Internal Revenue Service that paid administrative expense deductions could not be deducted “above the line” and could only be deducted as miscellaneous itemized deductions to the extent the payments exceed two percent of the adjusted gross income of the bankruptcy estate has now given way to the precisely opposite position.²

The statutory framework

The general rules for the taxation of individuals filing for Chapter 7 or 11 bankruptcy (with a new tax entity created at the time of bankruptcy filing³) in terms of deductions are found in Section 1398(e)(3) of the Internal Revenue Code—

“Except as otherwise provided in this section, the determination of whether or not any amount paid or incurred by the estate . . . is allowable as a deduction . . . shall be made as if the amount were paid 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.”

That general rule thus specifies that a bankruptcy estate is entitled to a deduction if the debtor would have been entitled to claim such a deduction on the debtor’s individual income tax return. That passage does not deal with administrative expenses which would not have arisen but for the filing of a bankruptcy case.

Section 1398(h)(1) of the Internal Revenue Code provides specifically for the deductibility of administrative expenses—

“Any administrative expense allowed under section 503 of title 11 of the United States Code, and any fee or charge assessed against the estate under chapter 123 of title 28 of the United States Code, to the extent not disallowed under any other provisions of this title, shall be allowed as a deduction.”

It is clear that an individual filing under Chapter 7 or 11 bankruptcy, with a new tax entity created, is entitled to a deduction for administrative expenses.⁴ However, there is no hint from those sources whether the deduction is claimed at arriving at adjusted gross income (above the line) or whether the administrative expense deduction is treated as a miscellaneous itemized deduction with the deduction limited to the excess of the amount in excess of two percent of adjusted gross income of the bankruptcy estate.⁵

¹ Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
In Section 67(e) of the Internal Revenue Code, the subsection states –

“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 estate or trust. . . .shall be treated as allowable in arriving at adjusted gross income.”

The question is whether a bankruptcy estate is deemed to be an “estate” for this purpose.

The bankruptcy case of In re Miller

In the bankruptcy case of In re Miller, the Internal Revenue Service took the position that a bankruptcy estate is not an estate. In defense of that position, it is clear that a bankruptcy estate formed as a new entity in a chapter 7 or 11 bankruptcy filing is not taxed as an estate but as an individual. However, the Bankruptcy Court held that “. . .a bankruptcy estate is, in fact, one of the types of “estates” for which 26 U.S.C. § 67(e) was designed and that the bankruptcy estate created at the inception of this bankruptcy case may indeed utilize this provision.”

Somewhat surprisingly, the case was not appealed and the IRS within months issued a Chief Counsel Advice endorsing the holding in In re Miller. In 2006, with questions still apparently being raised, a second Chief Counsel Advice was issued, reiterating that Section 67(e) of the Internal Revenue Code applies to a debtor’s estate in bankruptcy and that “. . .expenses paid or incurred in connection with the administration of an individual’s estate in bankruptcy that would not have been incurred if the property were not held by the bankrupt estate is treated as allowable in arriving at adjusted gross income.” The Chief Counsel Advice also stated “[w]e recommend revising Publication 908 to reflect the conclusion of In re Miller that deductions for expenses that would have been incurred if the property were not held by the bankrupt estate are allowable in arriving at adjusted gross income.” Precisely the same message was sent with a 2006 IRS Advice Memorandum issued in 2007 including the statement about the need for a revision of Pub. 908.

Thus, the position of the Chief Counsel’s Office at least is clear – administrative expense deductions can be claimed “above-the-line” in arriving at adjusted gross income.

FOOTNOTES


3 See I.R.C. § 1398.

4 I.R.C. § 1398(h)(1).


7 I.R.C. § 1398(c)(1).


9 See note 6 supra.


11 Id.


CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr

CONTRACTS

BARTER PROVISION. The plaintiff entered into a contract to purchase a horse from the defendant. The oral sales contract provided for an initial payment of $1500 and for the plaintiff’s son to provide farm labor for the remaining $1500 purchase price. The contract also provided for the horse to remain with the defendant until all payments were made, with the costs of feed and veterinary services to be paid by the plaintiff. The son worked the required hours and submitted a bill for the wages but the defendant refused to pay. The son filed a wage and hour claim with the state and obtained a judgment for the back wages. The defendant allowed delivery of the horse but refused to execute a bill of sale for the horse because $568 in feed and veterinary expenses were not paid. The plaintiff offered $1500 to settle but the defendant refused. The plaintiff sued for the bill of sale. The trial court held that the barter provision of the contract was void as unenforceable under state law, ordered the plaintiff to pay $1500 plus the $568 in boarding costs and ordered the defendant to execute a bill of sale. The plaintiff argued that the barter provision voided the entire contract but the appellate court held that the trial court properly excised the void barter provision and enforced the remaining provisions of the contract. Wolfe v. Newman, 2007 Mont. LEXIS 348 (Mont. 2007).

FEDERAL AGRICULTURAL PROGRAMS

FARM PROGRAM PAYMENTS. The plaintiffs enrolled several tracts of crop land in the Production Flexibility Contract and Direct and Counter-Cyclical Payments programs and included in the enrolled tracts one tract which had been sold several years