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I. INTRODUCTION

"Taxes," as Justice Holmes informed us long ago, "are what we pay for civilized society."[1] It might surprise many that this price is extracted even from individuals in bankruptcy. Although the right to discharge in bankruptcy ensures an honest but unfortunate debtor a fresh start to begin a new economic life, that right is tempered by the federal government's legitimate interest in protecting the fisc by collecting taxes. The balance struck by the Bankruptcy Code[2] and Internal Revenue Code[3] between the competing interests of an individual debtor and the federal government insulates certain tax claims from the bankruptcy discharge. Under the compromise, only specifically enumerated tax claims will survive a bankruptcy discharge in a Chapter 11 case.[4]

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1. Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

2. 11 U.S.C.A. (West 1993 & Supp. 1995).

3. In this article, the Internal Revenue Code, found in Title 26 of the United States Code, is referred to as "I.R.C." Individual sections of the I.R.C. will be preceded by "I.R.C."

4. 11 U.S.C.A. § 523(a)(1) (West 1993 & Supp. 1995) (identifying those tax claims that are

Recognizing that nondischargeable tax liabilities are inconsistent with the fresh start policy, Congress further attempted to alleviate some harshness through enactment of the Bankruptcy Tax Act of 1980 ("BTA").[5] Among other things, the BTA creates a separate taxable entity when an individual files for relief under either Chapter 7 or 11 of the Bankruptcy Code[6] and enables such a debtor to elect to shorten and end the taxable year, thus shifting at least part of the current year taxes to the estate as a § 507(a)(8) priority claim.[7] Nevertheless, certain tax claims designated as nondischargeable under § 523(a)(1) (such as claims for taxes due within three years of the bankruptcy petition date) survive the discharge and thus significantly affect a debtor's fresh start.

Part II of this Article outlines the concept of the bankruptcy discharge in an individual debtor's Chapter 11 case. I devote more attention than many might believe necessary in order to explain not only the significance of the discharge but also its limitations, particularly in the tax context. Although the discharge is important in bankruptcy, it is not all-encompassing; a number of tax claims do survive the bankruptcy discharge.

Part III analyzes a fundamental concept of bankruptcy: the estate. With particular emphasis on individual debtor Chapter 11 estates, it addresses the issue of whether postpetition earnings and valuable tax attributes are property of the estate.

Finally, Part IV addresses the important issues posed by I.R.C. § 1398. Ignored by most bankruptcy scholars, § 1398 directly affects the scope of the Chapter 11 discharge and the contours of the Chapter 11 individual debtor's estate.

II. INDIVIDUAL DEBTOR'S CHAPTER 11 DISCHARGE

An individual's most important bankruptcy objective is a discharge from debt.[8] The discharge is at the heart of the fresh start policy promoted by the Bankruptcy Code and the BTA. The Chapter 7 discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in prohibited conduct, usually constituting some type of fraud or bankruptcy crime.[9] The statute providing for discharge is liberally construed

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nondischargeable by an individual debtor).

5. Pub. L. No. 96-589, 94 Stat. 3389 (codified in scattered sections of 26 U.S.C.).

6. *See* I.R.C. § 1398 (1988). No separate entity for tax purposes is created when a partnership or corporation files for bankruptcy relief. I.R.C. § 1399 (1988).

7. *See* I.R.C. § 1398(d)(2) (1988).

8. *See generally* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 27-44 (1992) (discussing the fresh start policy); DAVID G. EPSTEIN ET AL., 2 BANKRUPTCY § 7-16 (1992) (discussing the discharge's importance to a debtor).

9. *See* 11 U.S.C. § 727(a) (1988).

in favor of an individual debtor.[10] Thus, the objecting party has the burden of establishing a ground for the denial of a discharge.[11]

Under Chapter 11, § 1141(d) governs the scope and limits of discharge. Pursuant to § 1141(d), the confirmation of a reorganization plan discharges a debtor from any debt that arose before the confirmation of the plan. Unlike § 727(a), a partnership, corporation, or an individual may receive a § 1141(d) discharge.[12] The § 1141(d) discharge is broader than the § 727(a) discharge in that the latter section discharges any debts that arose[13] before the *order for*

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10. *See, e.g.*, First Beverly Bank v. Adeeb (*In re* Adeeb), 787 F.2d 1339, 1342 (9th Cir. 1986); Soft Sheen Prods., Inc. v. Johnson (*In re* Johnson), 98 B.R. 359, 364 (Bankr. N.D. Ill. 1988) (mem.); Bologna v. Cutignola (*In re* Cutignola), 87 B.R. 702, 706 (Bankr. M.D. Fla. 1988) (mem.); Ashton v. Burke (*In re* Burke), 83 B.R. 716, 720 (Bankr. D.N.D. 1988) (mem.); Peoples State Bank v. Drenckhahn (*In re* Drenckhahn), 77 B.R. 697, 701 (Bankr. D. Minn. 1987) (mem.); Morrison v. Howard (*In re* Howard), 55 B.R. 580, 583 (Bankr. E.D.N.C. 1985) (mem.).

11. If a debtor has been denied a discharge, so that all debts remain outstanding, the debtor may not include the same obligations in a subsequent case to obtain a discharge. The denial of the discharge is res judicata as to the obligations existing at that time which become forever nondischargeable. Although understood as part of the warp and woof of bankruptcy law, the right to discharge was not part of the early bankruptcy acts in the United States. The Supreme Court noted that the discharge and fresh-start policies are comparatively new in bankruptcy in United States v. Kras, 409 U.S. 434, 446-47 (1973). There is no constitutional right to a discharge; discharge is a statutory privilege provided to the honest but unfortunate debtor who has not abused the bankruptcy process. *See* Lanker v. Wheeler (*In re* Wheeler), 101 B.R. 39, 47 (Bankr. N.D. Ind. 1989) (mem.). A bankruptcy discharge voids any judgment to the extent that it determines the debtor's personal liability for a prepetition debt. 11 U.S.C. § 524(a)(1) (1988). The discharge also enjoins the commencement or continuation of any action; the employment of process; and any act, including telephone calls, letters, and personal contacts to collect, recover, or offset any discharged debt. 11 U.S.C. § 524(a)(2) (1988). In effect, the discharge is a total prohibition on debt collection efforts against a debtor. However, it does not discharge those liable on the debt with the debtor, including guarantors, co-makers, or partners. *See* 11 U.S.C.A. § 524(e) (1988). Furthermore, under § 524 any attempt to reaffirm a discharged debt is void unless the provisions of the Bankruptcy Code are specifically followed. *See* 11 U.S.C.A. § 524(c) (West 1993 & Supp. 1995). To ensure the effectiveness of the discharge, § 525(a) prohibits a governmental unit from (1) denying, suspending, or refusing to renew a license or permit or (2) denying employment solely because the person involved was discharged, was insolvent before the bankruptcy case, or has not paid a dischargeable debt. *See* 11 U.S.C.A. § 525(a) (West 1993 & Supp. 1995). Additionally, under § 525(b) no private employer may terminate the employment of, or discriminate with respect to employment against, (1) an individual who is or has been a debtor under the Code or (2) an individual associated with a debtor under the Code, solely because the debtor is or has been a debtor under the Code, was insolvent before the commencement of a case under the Code, or has not paid a debt that is dischargeable under the Code. 11 U.S.C.A. § 525(b) (West 1993 & Supp. 1995); *see also* EPSTEIN ET AL., ET. AL., *supra* note 8, § 7-40.

12. In Toibb v. Radloff, 501 U.S. 157, 166 (1991), the Supreme Court held that an individual may properly seek relief under Chapter 11 of the Bankruptcy Code.

13. The issue of when a debt *arises* has itself become a bone of contention. EPSTEIN ET AL., *supra* note 8, § 7-16.

relief,[14] while the former section discharges any debts that arose before the *confirmation of the plan*.[15]

There are limits, however, to the § 1141(d) discharge. First, debts excepted from discharge under § 523 are not discharged under § 1141(d) when the debtor is an individual. These types of nondischargeable debts include several tax claims.[16] Second, if the plan provides for the liquidation of all or substantially all of the property of the estate, the debtor does not continue in business, and the debtor would be denied a discharge under § 727(a),[17] then confirmation of the plan does not discharge the debtor.[18] These limitations are necessary so that an individual debtor may not employ a Chapter 11 liquidating plan to evade the exceptions or objections to discharge embodied in §§ 523(a) and 727(a).[19]

Section 523 of the Bankruptcy Code specifies which debts of an *individual debtor* are not discharged in a Chapter 11 bankruptcy case under § 1141(d).[20] These debts include certain tax claims, which may be divided into three categories for convenience of analysis.

The first category of nondischargeable tax claims is set forth in § 523(a)-(1).[21] Under this section, a tax specified in § 507(a)(2) as an involuntary gap

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14. The order for relief is entered automatically when a debtor files a voluntary petition in bankruptcy. *See* 11 U.S.C. § 301 (1988). In an involuntary case, the order for relief comes after the court is persuaded that the grounds for involuntary relief are met. *See* 11 U.S.C. § 303(h) (1988).

15. For the requirements for Chapter 11 plan confirmation, see 11 U.S.C.A. § 1129 (West 1993 & Supp. 1995).

16. *See* 11 U.S.C.A. §§ 523(a)(1) (West 1993 & Supp. 1995); *see also* 11 U.S.C. § 507(a)(8) (West 1993 & Supp. 1995); 11 U.S.C. § 523 (a)(7) (West 1993 & Supp. 1995).

17. 11 U.S.C. § 727(a) (1988). Under § 727(a), the bankruptcy court must grant an individual debtor a discharge of prepetition debts unless one of ten conditions is met. Section 727(a)(1) only applies to individuals, a partnership, or a corporation although legitimate debtors under Chapter 7 may not receive a discharge under Chapter 7. Additionally, § 727(a) applies only in liquidation cases under Chapter 7. *See* 11 U.S.C. § 103(b) (1988). Not all individual debtors are entitled to a discharge under § 727(a). The right to discharge is a right reserved for the honest but unfortunate debtor. Over-extension, unforeseen contingencies, the inability to pay debt, and lack of business acumen are not reasons to deny a debtor's discharge. However, fraud, criminal activity, and misconduct are. If a creditor or the trustee is successful in attacking the debtor's discharge under § 727(a), then *all claims* survive the bankruptcy case and may be enforced.

18. *See* 11 U.S.C. §§ 1141(d)(3) (1988).

19. Chapter 11 recognizes liquidation as an acceptable form of reorganization. *See* 11 U.S.C. § 1129(a)(11) (1988).

20. However, these taxes may be discharged in a Chapter 13 under § 1328(a), i.e., the Chapter 13 "super-discharge." See 11 U.S.C.A. § 1328(a) (West 1993 & Supp. 1995).

21. 11 U.S.C.A. § 523(a)(1) reads:

(a) A discharge under section 727, 1141, [sic] 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

claim[22] or in § 507(a)(8)[23] as a priority claim is nondischargeable whether or not a claim for such tax was allowed by the court or filed in the case.[24] These priority and nondischargeable tax claims include the following:

1. Involuntary gap tax claims under § 507(a)(2),[25]

2. Income or gross receipts taxes incurred before the petition and within three years from the filing of the bankruptcy petition,[26]

3. Income or gross receipts taxes assessed within 240 days from the filing of the bankruptcy petition,[27]

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required—

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

11 U.S.C.A. § 523(a)(1) (West 1993 & Supp. 1995).

22. 11 U.S.C. § 507(a)(2) (1988).

23. 11 U.S.C. § 507(a)(8) (West 1993 & Supp. 1995).

24. *See In re* Olsen, 123 B.R. 312, 314 (Bankr. N.D. Ill. 1991) (holding that a nondischargeable tax claim survives bankruptcy regardless of whether such claim was filed or allowed in the bankruptcy case).

25. The second priority as set forth in § 507(a)(2) of the Bankruptcy Code is "unsecured claims allowed under § 502(f) of this title." 11 U.S.C. § 507(a)(2) (1988). Under § 502(f), an involuntary gap claim is one which arises in the ordinary course of a debtor's business after the filing of an involuntary petition against the debtor but before either the appointment of a trustee or the entry of an order for relief. An involuntary gap claim is allowed "the same as if such claim had arisen before the date of the filing of the petition." 11 U.S.C. § 502(f) (1988). The involuntary gap claim is the creature of the involuntary bankruptcy case. This priority speaks directly to the time delay made possible by segregating the order for relief from the filing of the involuntary petition.

26. *See* 11 U.S.C.A. § 507(a)(8)(A)(i) (West 1993 & Supp. 1995). As indicated in that section, the due date of the return and not the date when the taxes are assessed, determines the priority. *See* Smith v. United States, 114 B.R. 473, 475 (W.D. Ky. 1989) (mem.) (holding that the debtor's income tax liability for tax years in which a tax return was due less than three years before the bankruptcy filing was nondischargeable in the bankruptcy case, regardless whether such return was timely filed, filed late, or not filed at all).

27. *See* 11 U.S.C. § 507(a)(8)(A)(ii) (West 1993 & Supp. 1995). The 240-day period is extended for the period of time an offer in compromise is considered by the IRS after submission by the taxpayer plus 30 days after such offer is rejected. Under this rule, the date on which the IRS assesses the tax, rather than the date of the return, determines the priority. Moreover, in Blank v. United States (*In re* Blank), 137 B.R. 671, 673 (Bankr. N.D. Ohio 1992), the bankruptcy court held that the date the debtor was sent a notice of tax deficiency based upon a

4. Income or gross receipts taxes still assessable under applicable law at the time the bankruptcy petition is filed,[28]

5. Recent property taxes assessed prepetition and last due without penalty within one year of the filing,[29]

6. Trust fund taxes incurred at any time,[30]

7. The employer's share of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition to the extent that the return for such taxes was last due (including any extensions of time) within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed,[31]

8. Excise taxes related to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the

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second assessment for the debtor's 1985 income taxes, rather than the date of the first assessment for the debtor's 1985 taxes, controlled for purposes of determining whether the debtor's obligation under the second assessment was entitled to priority and was nondischargeable.

28. *See* 11 U.S.C.A. § 507(a)(8)(A)(iii) (West 1993 & Supp. 1995). This section grants priority to income and gross receipts taxes not assessed before the filing of a bankruptcy petition but which are still permitted to be assessed under applicable tax laws. Accordingly, a tax claim will still receive an eighth priority under this section if the statute of limitations still allows an assessment of the tax liability after the bankruptcy petition is filed even though such assessment was not made within the 240-day period (plus any extension) prior to the bankruptcy filing. *See* Crawford v. United States (*In re* Crawford), 144 B.R. 346, 348 (Bankr. W.D. Tex. 1992) (mem.), (holding that the debtors' federal income tax liability was still assessable after commencement of the bankruptcy case and was therefore entitled to priority (and thus nondischargeable) status); *In re* Lemke, 145 B.R. 1005, 1007 (Bankr. D. Idaho 1991) (summary order) (holding that the debtor's state income taxes were assessable after commencement of the bankruptcy case with the result that the tax claims in question were entitled to priority and thus nondischargeable status).

29. 11 U.S.C.A. § 507(a)(8)(B) (West 1993 & Supp. 1995). Such claims are beyond the scope of this article.

30. *See* 11 U.S.C. § 507(a)(8)(C) (West 1993 & Supp. 1995); *see also* Malcuit v. Texas, 134 B.R. 185, 188 (N.D. Tex. 1991) (holding that city and state sales taxes owed by the debtors were trust fund taxes, rather than gross receipts or excise taxes, and were nondischargeable); Peiffer v. Alabama Dep't of Revenue (*In re* Peiffer), 126 B.R. 364, 369 (Bankr. N.D. Ala. 1991) (holding that Alabama sales tax obligations, which the debtor was required to collect and remit to the state of Alabama, qualified as "trust fund taxes" that were nondischargeable in bankruptcy).

31. *See* 11 U.S.C. § 507(a)(8)(D) (West 1993 & Supp. 1995). Older tax claims of this nature are payable as nonpriority general claims. *See* Texas v. Pierce (*In re* Pierce), 935 F.2d 709, 714 (5th Cir. 1991) (holding that employment taxes on wages earned less than three years before the date of the filing of the bankruptcy petition are entitled to priority and are nondischargeable).

bankruptcy petition or due after the filing of the bankruptcy petition,[32] and

9. Certain customs duties under § 507(a)(8)(F).[33]

The second category of nondischargeable tax claims is set forth in § 523(a)(1)(B) and (C) and includes the following taxes:

1. Tax liabilities relating to a tax return which was not filed,[34]

2. Tax liabilities reported by a tax return filed late *and* filed within two years prior to the filing of the bankruptcy petition or filed after the bankruptcy petition,[35] or

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32. *See* 11 U.S.C.A. § 507(a)(8)(E) (West 1993 & Supp. 1995). The excise taxes must relate to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition. If a return is due, the three year period is extended if the due date for filing the return was extended. *Id.* If a return is not required, the tax claim must relate to a transaction which itself occurred within three years prior to the filing of the bankruptcy petition. *Id.* For purposes of this priority, excise taxes include sales taxes, estate and gift taxes, gasoline and special fuel taxes, wagering taxes, and truck taxes. *See* United States v. Unsecured Creditors' Committee *(In re* C-T of Va., Inc.), 977 F.2d 137, 140 (4th Cir. 1992), *aff'g* 135 B.R. 501 (W.D. Va. 1991), *cert. denied*, 113 S. Ct. 1644 (1993) (holding that a tax imposed upon an employer equal to 10% of the assets of a qualified pension plan, when such assets reverted to the employer upon the plan's termination constituted an excise tax rather than a punitive penalty and, therefore, the tax claim was entitled to priority treatment in the employer's Chapter 11 case); United States v. The Mansfield Tire & Rubber Co. *(In re* The Mansfield Tire & Rubber Co.), 942 F.2d 1055, 1059-61 (6th Cir. 1991), *cert. denied sub. nom* Krugliak v. United States, 502 U.S. 1092 (1992) (holding that the federal pension excise tax resulting from the debtor's failure to meet minimum funding requirements for a pension plan was an excise tax entitled to priority rather than a nonpriority penalty).

33. Such claims are beyond the scope of this article.

34. *See* United States v. Bergstrom *(In re* Bergstrom), 949 F.2d 341, 342-43 (10th Cir. 1991) (holding that the term "filed return" was not broad enough to include a substitute return prepared by the IRS absent the debtor's signature thereon); Chastang v. United States *(In re* Chastang), 116 B.R. 833, 834 (Bankr. M.D. Fla. 1990) (holding that the debtor's liabilities for federal income taxes for which the debtor failed to file returns were nondischargeable even though the IRS had prepared substitutes for the returns); Crawford v. United States *(In re* Crawford), 115 B.R. 381, 382-83 (Bankr. N.D. Ga. 1990) (mem.), *abrogation recognized on other grounds*, *In re* Swafford, 160 B.R. 246, 249 (Bankr. N.D. Ga. 1993) (holding a tax obligation for which the debtor did not file a tax return nondischargeable even though the IRS filed the return on the debtor's behalf); Pruitt v. United States *ex rel.* IRS *(In re* Pruitt), 107 B.R. 764, 766 (Bankr. D. Wyo. 1989) (holding that substitute tax returns filed by the IRS when the debtor failed to file such returns for several years did not preclude application of the Bankruptcy Code rendering tax debts nondischargeable for any tax debt with respect to which a return was required and not filed).

35. *See* 11 U.S.C.A. § 523(a)(1)(B) (West 1993 & Supp. 1995).

3. Tax liabilities reported by a fraudulent return or resulting from a willful attempt in any manner to evade or defeat such tax.[36]

The third category of nondischargeable taxes is set forth in § 523(a)(7).[37] This section provides that tax penalties that are punitive in nature are nondischargeable only if the penalty is computed by reference to a related tax liability that is also nondischargeable. Every court of appeals addressing the issue to date has concluded that the tax is dischargeable unless the transaction or event giving rise to the penalty occurs during a three-year period ending on the date of the filing of the bankruptcy petition.[38] However, this is not what § 523(a)(7) requires.

That section purports to follow the equal dignity rule: If the underlying tax is nondischargeable, then any penalty related to the underlying tax should also be nondischargeable. For example, tax liabilities resulting from a willful attempt in any manner to evade or defeat a tax are nondischargeable regardless

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36. 11 U.S.C. § 523(a)(1)(C); *see also* Hopkins v. United States (*In re* Hopkins), 133 B.R. 102, 105-06 (Bankr. N.D. Ohio 1991) (holding that the wife's signing of joint returns which she knew were in error constituted the making of a fraudulent return or willfully attempting to evade such tax and thus such tax debts were nondischargeable in the wife's bankruptcy case); Gilder v. United States (*In re* Gilder), 122 B.R. 593, 595-96 (Bankr. M.D. Fla. 1990), *abrogation recognized, In re* Berzon, 145 B.R. 247 (Bankr. N.D. Ill. 1992) (mem.) (holding that where the debtor submitted false withholding statements for the express purpose for eliminating the withholding of federal income taxes from wages, such conduct was a "willful attempt to evade or defeat tax" within the meaning of the exception to discharge); Fernandez v. IRS (*In re* Fernandez), 112 B.R. 888, 892 (Bankr. N.D. Ohio 1990) (mem.) (holding that the debtor's conduct concerning tax obligations was shown to be willful and evasive and thus the tax obligations were deemed nondischargeable).

37. This Section provides:

> (a) A discharge under section 727, 1141, [sic] 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
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> (7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—
>
> (A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or
>
> (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition[.]

11 U.S.C.A. § 523(a)(7) (West 1993 & Supp. 1995).

38. *See* Roberts v. United States (*In re* Roberts), 906 F.2d 1440 (10th Cir. 1990); Burns v. United States *ex rel.* IRS (*In re* Burns), 887 F.2d 1541 (11th Cir. 1989); *see also* McKay v. United States (*In re* McKay), 957 F.2d 689, 693-94 (9th Cir. 1992) (holding that civil fraud penalties imposed on unpaid taxes accruing more than three years before the filing of the debtor's bankruptcy petition were dischargeable, even though the debt for unpaid taxes was nondischargeable because of fraud).

of when the actual tax arose.[39] However, courts of appeals that have addressed the issue would hold that only penalties related to the nondischargeable tax claim that arise within three years of the filing of the bankruptcy petition would also be nondischargeable.[40] According to the courts that have addressed the issue, penalties outside the three-year period constitute a dischargeable claim.

III. PROPERTY OF AN INDIVIDUAL DEBTOR'S BANKRUPTCY ESTATE

The profile of property of the bankruptcy estate is one of the most important elements of a bankruptcy case. Under the Bankruptcy Code, what constitutes property of the estate ultimately turns on the chapter under which the case is filed and the category of the debtor seeking relief.

A. General Definition: § 541

The Bankruptcy Code is designed around a central definition of property of the estate, applicable to all chapters for relief.[41] Under § 541(a), property of the estate includes all the debtor's legal or equitable interests in property at the time of the filing of the petition,[42] wherever located and by whomever held.[43] According to the legislative history, the broad scope of § 541(a)(1) includes all kinds and forms of property, whether tangible or intangible.[44] 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.[45]

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39. 11 U.S.C.A. § 523(a)(1)(C) (West 1993 & Supp. 1995).

40. *E.g.*, *McKay*, 957 F.2d at 693-94.

41. *See* 11 U.S.C. § 541(a) (1988).

42. *See, e.g.*, Hebermehl v. United States *ex rel.* IRS (*In re* Hebermehl), 132 B.R. 651, 653-54 (Bankr. D. Colo. 1991) (holding that wages were property of a debtor's Chapter 7 estate even though such wages were not paid until postpetition, when the wages were for services performed by the debtor prior to the commencement of the Chapter 7 case); *In re* Lange, 110 B.R. 907, 909-10 (Bankr. D. Minn. 1990) (holding that the entire balance on deposit in a Chapter 7 debtor's checking account from the date the bankruptcy petition was filed constituted property of the estate).

43. 11 U.S.C. § 541(a)(1) (1988). This section overrules Lockwood v. Exchange Bank, 190 U.S. 294 (1903), and Lines v. Frederick, 400 U.S. 18 (1970) (per curiam).

44. H.R. REP. NO. 595, 95th Cong., 2d Sess. 367 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6323; S. REP. No. 989, 95th Cong., 2d Sess. 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868.

45. In defining property of the bankruptcy estate, the Bankruptcy Code starts with the basic definition under § 541(a)(1) and (a)(2), but by no means does it end there. Sections 541(a)(3) through (a)(7) contain additions to the basic definition of property of the estate. Property subject to being exempt under § 522 is included in the definition of property of the estate until it is, in fact, set aside as provided in § 522. Moreover, all the interest of the debtor and the debtor's

Property of the estate is defined more broadly under the Bankruptcy Code than under the Bankruptcy Act.[46] The definition, however, is not without limits. The most significant limit is the temporal dimension to the definition.[47] Only the debtor's property at the commencement of the case and its proceeds are property of the estate.[48] This temporal dimension of property of the estate poses challenging conceptual issues regarding what "assets" are included in the estate. These difficult conceptual issues are not easily escaped by resort to the language of § 541.[49] One commentator has asserted persuasively that one cannot adequately resolve the difficult property of the estate issues under the Bankruptcy Code without resort to a conceptual framework rooted in the 1898 Act and purportedly rejected by the Code.[50]

> That habits of analysis manifested in cases decided under the Bankruptcy Act should resurface when courts must decide to what extent, if any, a debtor's right to future payment becomes property of the estate under section 541 of the Bankruptcy Code is not surprising. Section 541, because it limits the concept of property of the estate temporally but not conceptually, is often insufficient standing alone to strike the balance courts instinctively want to strike when considering whether a debtor's right to future payment should become property of the estate, and, indeed, the balance the courts do strike is that achieved in Segal and the cases under the Bankruptcy Act, even though the vocabulary employed is that of section 541.[51]

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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 states like Texas, which are community property states. Furthermore, inheritances and bequests that come to the debtor within 180 days after the filing of the petition; an interest in property as a result of a divorce decree or property settlement agreement with the debtor's spouse; the proceeds of a life insurance policy or death benefit plan; and the 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) (1988).

46. *Compare* 11 U.S.C. §§ 541 (a)(1)-(a)(7) (1988) *with* 11 U.S.C. § 110 (1976) (repealed). For example, under the Act exempt property did not constitute property of the estate. *See* Lockwood v. Exchange Bank, 190 U.S. 294 (1903).

47. *See also* George R. Pitts, *Rights to Future Payment as Property of the Estate Under Section 541 of the Bankruptcy Code, 64* AM. BANKR. L.J. 61, 62 (1990).

48. *Id.*

49. Aside from future earnings discussed here, difficult issues are posed by the treatment of employment contracts, annuities, retirement plans, commissions, and contingent remainders. *See generally* Pitts, *supra* note 47, at 70-92.

50. *See* Pitts, *supra* note 47, at 87-88, 91-92.

51. *Id.* at 91.

One recurring issue centers on the role an individual's postpetition earnings play in defining the contours of the estate. A thorough understanding of this complex issue requires an analysis of §§ 541(a)(1), (a)(6), and (a)(7) and I.R.C. § 1398.[52] Several courts have addressed the interplay among the Bankruptcy Code sections in this context. Nonetheless, all the reported cases on this issue have failed to analyze the impact of I.R.C. § 1398 on the issue of the character of postpetition 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. This dragnet provision is subject to one caveat, important in an individual debtor case—"except such as are earnings from services performed by an individual debtor after the commencement of a case."[53] Thus, future earnings that can be linked to services performed by an individual debtor after the commencement of the case are excluded from property of the estate.[54] Given the drafters' intent to expand the definition of the estate, courts interpret the postpetition earnings exception narrowly.[55] Presently, it is unclear what § 541(a)(6) means in the context of a sole proprietorship that seeks Chapter 11 relief as an individual debtor.[56] To be sure, the resolution of this complex issue directly involves questions of policy under the Bankruptcy Code.

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52. Sections 541(a)(1), (6), and (7) state:

> (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.

11 U.S.C. §§ 541(a)(1), (a)(6), (a)(7) (1988).

53. 11 U.S.C. § 541(a)(6) (1988).

54. Essentially, three things fuel an individual debtor's fresh start in bankruptcy: exemptions under § 522, the discharge under § 727 in a Chapter 7 case (§ 1141(d) in a Chapter 11 case), and the exclusion of future earnings under § 541(a)(6) from what comprises property of the estate.

55. *See, e.g.*, *In re* Weyland, 63 B.R. 854, 863 (Bankr. E.D. Wis. 1986) (holding that payments to a debtor under a noncompetition agreement were not within the exclusion); *In re* Lee, 35 B.R. 663, 667 (Bankr. N.D. Ohio 1983).

56. Under the Bankruptcy Code, a sole proprietorship may not seek relief as a separate entity distinct from the individual. *See* 11 U.S.C.A. § 101(41) (West 1993 &. Supp. 1995) (defining "person"); 11 U.S.C. § 109 (West 1993 &. Supp. 1995) (defining persons eligible for bankruptcy relief).

B. 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, § 103, which deals with the general applicability of various chapters, provides that § 541 applies in all bankruptcy cases. Thus, in a Chapter 7, 11, or 13 case, the Bankruptcy Code's basic definition of property of the estate is derived from § 541(a). Consequently, the postpetition earnings of a debtor *partnership or corporation* in Chapter 11 are property of the estate under § 541(a)(6).

Does § 541(a)(6) apply in a Chapter 11 *individual* bankruptcy case? Based on § 103, the answer must be yes. Section 541(a)(6) specifically excludes future earnings by an individual from the definition of property of the estate. However, the extent of the exclusion and the characterization of postpetition earnings are not as clear as the language might suggest. In fact, the ultimate resolution of this issue turns less on the language of § 541(a)(6) than it does on the overall bankruptcy scheme and policies embedded therein.

One of the first cases to address the issue was *In re FitzSimmons*.[57] In *FitzSimmons* the Ninth Circuit held that the earnings exception excluded from property of the estate all earnings generated by services "personally" performed by an individual debtor.[58] The debtor, a lawyer operating a sole proprietorship firm, argued that all of the revenues generated postpetition by the law firm should be excluded from the estate under § 541(a)(6). The debtor argued that the court should not distinguish between those revenues actually generated by him personally and those generated by associate lawyers in his employ. In response the Chapter 11 trustee asserted that all earnings from the practice were property of the estate and that the debtor was entitled only to his court-approved salary.[59]

The court identified three factors that led to its conclusion. First, it distinguished between earnings generated by services personally performed by the debtor and earnings generated from other types of assets of a sole proprietorship. The court concluded that to the extent that the earnings of an attorney's law practice were not attributable to his personal services but to the invested capital, accounts receivable, good will, employment contracts with the firm's staff, client relationships, or fee agreements, such earnings constituted property of the estate.[60] It reasoned that creditors should be entitled to enjoy the profits earned by a sole proprietorship just as they must suffer its losses.[61]

57. FitzSimmons v. Walsh (*In re* FitzSimmons), 725 F.2d 1208 (9th Cir. 1984).

58. *Id.* at 1211.

59. *Id.* at 1210.

60. *Id.* at 1211.

61. *Id.* The Ninth Circuit, consequently, remanded to the bankruptcy court for a determination of the portion of the debtor's postpetition earnings attributable to his personal efforts. *FitzSimmons*, at 1212; *see also* 11 U .S.C. § 541(a)(6) (1988).

The court, however, did not answer the question of how to differentiate between earnings from services performed by the debtor and earnings from services *personally* performed by the debtor.

Second, the court read § 103 literally, finding that § 541(a)(6), including its carving out of certain future income of an individual debtor, applied in a Chapter 11 case.[62] The court observed that when Congress sought to override § 541(a)(6), it explicitly did so as in § 1306(a), which makes postpetition income property of the estate.[63] Third, the court observed that § 1108 does not neutralize an individual Chapter 11 debtor's power to employ § 541(a)(6) to shield postpetition income from services personally performed by the debtor from the estate in a Chapter 13 case.[64]

Although not a basis for the Ninth Circuit decision affirming the Bankruptcy Appellate Panel (BAP), the BAP in *FitzSimmons* noted that if the carving out of future income were not permitted under § 541(a)(6), individual debtor Chapter 11 cases would raise serious questions involving the Thirteenth Amendment's prohibition against involuntary servitude.[65] In particular, the court observed that a Chapter 11 case, unlike a Chapter 13 case, may be commenced against the debtor involuntarily.[66] If so commenced, the debtor does not have the absolute right to convert the Chapter 11 case to a case under Chapter 7.[67] Moreover, a debtor who files under Chapter 7 might be forced into Chapter 11 by creditors under § 706(b).[68] Concerned with the forced impoundment of postpetition earnings, Congress provided in § 706(c) that a court may not convert a case under Chapter 7 to a case under Chapter 13. "It is not likely that it was intended that a debtor's future income would be subject to involuntary conversion in Chapter 11 but not in Chapter 13."[69]

In his dissent in the BAP opinion in *FitzSimmons*, BAP Judge Lasarow argued that the carve out should be disregarded based on the fact that, as a debtor in possession, an individual debtor has a fiduciary duty to the estate.[70] Thus, reducing the value of the estate by carving out future income under § 541(a)(6) is inconsistent with the notion of fiduciary relationships.[71] This

62. *FitzSimmons*, 725 F.2d at 1210.

63. *Id.* at 1210-11.

64. *Id.* at 1211; *see also* 11 U.S.C. §§ 1306(a) (1988).

65. FitzSimmons v. Walsh (*In re* FitzSimmons), 20 B.R. 237, 240 (Bankr. 9th Cir. 1982), *aff'd*, 725 F.2d 1208 (1984).

66. *See id.*; *see also* 11 U.S.C. § 303(a) (1988).

67. *See* 11 U.S.C. § 1112(a)(2) (1988).

68. *See* 11 U.S.C. § 706(b) (1988) (providing that "[o]n request of a party in interest and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 11 of this title at any time").

69. *FitzSimmons*, 20 B.R. at 240.

70. *Id.* at 240-41 (Lasarow, J., dissenting); *see also* 11 U.S.C. §§ 323(a), 1108 (1988).

71. *FitzSimmons*, 20 B.R. at 240-41.

argument, however, proves too much. Any exemption of property[72] where the exempt asset has any equity is also inconsistent with the dissenting judge's notion of fiduciary duty. Judge Lasarow failed to appreciate that a debtor in possession's fiduciary duty is defined in the overall context of the Bankruptcy Code.[73]

In sum, the Ninth Circuit articulated a rule of allocation that allows some postpetition earnings to the creditors and some to the debtor.

> [W]e hold that § 541(a)(6) excepts from the proceeds of the estate only those earnings generated by services personally performed by the individual debtor. FitzSimmons is thus entitled to monies generated by his law practice only to the extent that they are attributable to personal services that he himself performs. To the extent that the law practice's earnings are attributable not to FitzSimmons' personal services but to the business' invested capital, accounts receivable, good will, employment contracts with the firm 'staff, client relationships, fee agreements, or the like, the earnings of the law practice accrue to the estate. On remand, the Bankruptcy Court should ascertain the portion of the law practice's earnings that were attributable to Fitzsimmons' personal efforts and exclude that amount from the bankruptcy estate. The practice's earnings from all other sources belong to the estate . . . .[74]

The two fashionable knocks against the Ninth Circuit's approach in *FitzSimmons* are: (1) that the court unjustifiably inserted the term "personal-

72. Exempt property is property of the estate until it is declared exempt. Any individual may exempt certain property from the estate under § 522. The exemption right applies in all chapters in which an individual may file for relief. *See* 11 U.S.C. § 109 (West 1993 & Supp. 1995).

73. The dissent also rejected the argument that the carve out was necessary to avoid Thirteenth Amendment problems by observing that individual debtors may always give up their livelihood and thus could not be forced to work for their creditors. This justification is uncompelling.

This line of analysis implicitly suggests that every potential debtor has entered into an inherent anticompetitive covenant with himself. As debtors, we will not compete with ourselves. This approach is fundamentally incorrect and does not work. Let us remove ourselves from the rich doctor cases and consider a blue-collar worker who files under chapter 11. Does it make sense to say that such a debtor is not entitled to her postpetition earnings except to the extent they are "approved" by the bankruptcy court as a salary under § 503(b)? Is the estate hiring our worker as some cases suggest happens when the debtor is a doctor? Is it true that to avoid the *Herberman* pitfall she must quit her present employment and seek work in some other line. What drives the resolution of these issues is emotion: Herberman (or any rich professional) should not be permitted to walk away from his debts in the manner he contemplates. The same strong emotion is not present with our blue collar worker.

74. *FitzSimmons*, 725 F.2d at 1211.

ly" into the inquiry under § 541(a)(6)[75] and (2) that by requiring an allocation of assets between the estate and the creditor, the court is demanding a division of the indivisible.[76] The criticisms are related. Concerned with the legitimate expectations of creditors based on a broad reading of §§ 541(a)(1) through (a)(7) and a debtor's substantial right to a fresh start, the *FitzSimmons* court essentially requires an inquiry into the primary genesis of any postpetition earnings. Thus, postpetition earnings from fixed assets, prepetition accounts receivables, invested capital, and good will are property of the estate.[77] However, earnings generated by services personally performed by a debtor as opposed to those earnings generated by services performed by those people employed by a debtor are not property of the estate under § 541(a)(6).[78] In effect, the Ninth Circuit embraces a conceptual approach to the issue, accommodating creditor and debtor interests. The use of the term "personally" by the Ninth Circuit, possibly unfortunate, should be analyzed in context; the court was merely emphasizing the need to look beyond the claims of parties in interest and discern the primary source of the postpetition earnings. To be sure, allocation rules present some of the most troubling issues in the law. Generally, the resolution of allocation issues are fact-intensive and not generally susceptible to clear rules (although, over time, clear rules do begin to emerge to guide discretion). But to dismiss *FitzSimmons* as requiring an impossible effort is disingenuous. To say the allocation rules in *FitzSimmons* are difficult is a correct observation; to say they are unworkable is just not true. Nothing in the Bankruptcy Code requires judges to be seers. A reasonable allocation based on the guiding principles articulated in *FitzSimmons* and cases like it is no less workable than the estimation of future claims under § 502(c) or even the valuation of property under § 506(a). At some level of abstraction, all of these judicial inquiries are folly, but they are not folly without purpose. And purposeful folly can be a good thing.

Since *FitzSimmons*, courts have taken three positions on whether an individual Chapter 11 debtor's postpetition earnings should be excluded from the bankruptcy estate: (1) all the income flowing to an individual debtor in a Chapter 11 case becomes property of the estate under § 541(a)(7) pending confirmation of a plan, just as such property does in a corporate or partnership Chapter 11 case (*i.e.*, the carve out does not apply to postpetition earnings);[79] (2) all postpetition earnings by an individual Chapter 11 debtor are excluded

75. *See In re* Cooley, 87 B.R. 432, 441 (Bankr. N.D. Tex. 1990).

76. "[T]he *Fitzsimmons* rule may well be impossible to apply in practice: what postpetition earnings of a sole proprietorship are not attributable in some measure to the efforts of the sole proprietorship?" Pitts, *supra* note 47, at 72 (footnote omitted).

77. *FitzSimmons*, 725 F.2d at 1211.

78. *Id.* at 1211.

79. *See, e.g., In re* Harp, 166 B.R. 740, 748-55 (Bankr. N.D. Ala. 1993) (mem.); *In re* Herberman, 122 B.R. 273, 278-81 (Bankr. W.D. Tex. 1990).

from the estate by § 541(a)(6);[80] and (3) the debtor's postpetition income should be allocated under § 541(a)(6) based on how the income was generated, with the portion linked to services performed by the debtor carved out of the estate.[81]

In *In re Herberman*,[82] Judge Clark significantly limited the ambit of § 541(a)(6), at least in the context of a sole proprietorship in a Chapter 11 case. He sharply narrowed the exception by reading § 541(a)(7) as a limitation to § 541(a)(6) and not as a separate provision speaking to other but related estate property issues.[83] Under § 541(a)(7) "[a]ny interest in property that the estate acquires after the commencement of the case" is property of the estate.[84] Central to Judge Clark's conclusion in *Herberman* that a physician's postpetition billings fell outside § 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."[85] Consequently, under *Herberman*, although a doctor's postpetition billings might be "earnings from services performed by an individual debtor after the commencement of the case,"[86] they failed to qualify for the earnings exception because they were not earnings from "'proceeds, product, . . . of or from property of the estate.'"[87] In other words, to carve out income from the estate under § 541(a)(6), the income must first constitute property of the estate.

According to Judge Clark, it did not.

> The role of Subsection (a)(6) is restricted to a discussion of proceeds, etc. "of or from property of the estate." The exception clause is contained within this provision and commences "except such as are earnings from services performed . . . ." The word "such" can only refer to the "proceeds, [etc.] of or from property of the estate" referenced in the first part of the subsection. Earnings from services which are not proceeds, etc. of or from

80. *See, e.g.*, Larson v. Cameron (*In re* Larson) 147 B.R. 39 (Bankr. D.N.D. 1992) (mem.); *In re* Molina Y Vedia, 150 B.R. 393 (Bankr. S.D. Tex. 1992) (mem.); Gautier-Adams v. El-Amin (*In re* El-Amin), 126 B.R. 855, 860 (Bankr. E.D. Va. 1991) (mem.); *In re* Fernandez, 97 B.R. 262 (Bankr. E.D.N.C. 1989).

81. *See, e.g.*, FitzSimmons v. Walsh (*In re* FitzSimmons), 725 F.2d 1208, 1211 (9th Cir. 1984); Altchek v. Altchek (*In re* Altchek), 124 B.R. 944, 954-56 (Bankr. S.D.N.Y. 1991); *In re* Paolino, No. 85-00759F, 1991 WL 284107 (Bankr. E.D. Pa. Jan. 11, 1991); *In re* Cooley, 87 B.R. 432, 439-41 (Bankr. S.D. Tex. 1988).

82. 122 B.R. 273 (Bankr. W.D. Tex. 1990).

83. *See id.* at 278-80.

84. 11 U.S.C. § 541(a)(7) (1988).

85. *See Herberman*, 122 B.R. at 278; *see also* 11 U.S.C. § 541(a)(6) (1988).

86. 11 U.S.C. § 541(a)(6) (1988).

87. *Heberman*, 122 B.R. at 278 (quoting 11 U.S.C. § 541(a)(6) (1988)).

property of the estate in the first place are not governed by the exception clause in subsection (a)(6).[88]

Furthermore, Judge Clark supported his limitation of § 541(a)(6) by focusing on the fiduciary duty that a debtor in possession owes to the estate in a Chapter 11 case; he also noted that there was no conflict with the Thirteenth Amendment.[89] These justifications for neutralizing the carving out of future earnings were also asserted by the dissenting Bankruptcy Appellate Panel judge in *FitzSimmons*.[90] In customary detail, Judge Clark observed that § 1108 imposes on an individual debtor the duties and responsibilities usually shouldered by a bankruptcy trustee. In particular, the individual debtor, as the debtor in possession, is a fiduciary of the estate and must act in the best interest of the estate.[91] Permitting a debtor to exclude postpetition income from the sole proprietorship is inconsistent with the notion that the debtor acts as a fiduciary of the estate.[92] In rejecting the debtor's Thirteenth Amendment argument, Judge Clark noted that peonage, and not voluntary labor to repay debt, is prohibited by the Amendment.[93]

Herberman suggests a methodology for addressing these issues. The court first considers the type and extent of income generated by the estate.[94] Next, the court asks how much of the income generated by the estate should be used to compensate the debtor for postpetition services.[95] According to Judge Clark, § 541(a)(6) relates to the second inquiry only.[96] Thus, § 541(a)(6) shields from creditors a postpetition salary for the debtor approved by the court under § 503(b) and nothing more.

Although not asserted by the debtor, Judge Clark addressed the argument that Chapter 13's specific inclusion of postpetition earnings as property of the estate implicitly excluded postpetition earnings from the Chapter 11 estate.[97] His opinion becomes strained at this point. The assertion that Chapter 13 is confined to "wage earners"[98] misses the change in the Bankruptcy Code to

88. Herberman, 122 B.R. at 278.

89. *See id.* at 281-86.

90. *See* FitzSimmons v. Walsh (*In re* FitzSimmons), 20 B.R. 237, 240-41 (Bankr. 9th Cir. 1982) (Lasarow, J., dissenting).

91. *Herberman*, 122 B.R. at 279-82.

92. *Id.* at 280-82.

93. *Id.* at 283.

94. *Id.* at 287; *see also* 11 U.S.C. § 541(a)(7) (1988).

95. *Herberman*, 122 B.R. at 287; *see also* 11 U.S.C. § 541(a)(6) (1988).

96. *Herberman*, 122 B.R. at 288. At this point, Judge Clark suggests that a reasonable salary for the debtor be set by the court pursuant to § 503(b)(1)(A) as an administrative expense. *Id.* at 281.

97. *Id.* at 286-87.

98. *Id.* at 286.

expand Chapter 13 relief to individuals with regular income, that is, "income earners."[99] Furthermore, a debtor as a sole proprietorship may file a Chapter 13 petition; continue to conduct the business' affairs; and, theoretically, draw a court-approved salary from the estate under § 503(b).[100]

Additionally, in its analysis of a debtor's fiduciary duties, *Herberman* failed to consider the role that exemptions play in Chapter 11. Under § 541(a), exempt property is property of the estate until declared exempt. The declaration of exempt property by the debtor is inconsistent with traditional notions of fiduciary duties. Does § 1108 neutralize the right to exempt property under § 522, much like it would to exclude earnings under § 541(a)-(6) in *Herberman*?[101]

Finally, the analysis has two conceptual flaws. First, *Herberman* fails to discuss I.R.C. § 1398, the separate entity rules, and the legislative history to that section, which strongly suggest a broader reading of § 541(a)(6) than employed by Judge Clark. Second, the analysis is fundamentally inconsistent with Chapter 11's plan confirmation process.

Like all reported cases addressing the scope of § 541(a)(6) in the sole proprietorship context, *Herberman* fails to consider the impact that I.R.C. § 1398 has on the issue. Section 1398 provides that a separate taxable entity is created when an individual files for relief under chapter 7 or 11 of the Bankruptcy Code.[102] Thus, both the individual debtor and the debtor's estate are treated as separate taxable entities for federal tax purposes.[103] Consequently, the bankruptcy estate as represented by the trustee or the debtor in possession will realize, recognize, compute, and report its own income and pay its own taxes separate from the debtor. This is not the case for partnership or corporate debtors or for cases commenced by individuals under chapter 12 or 13.[104]

There are two justifications for separate entity status for the estate in chapter 7 or 11 cases. First, drafters of the BTA concluded that it was unfair to impose upon a debtor the tax consequences associated with the *estate's*

99. *See* 11 U.S.C. §§ 101(30) (West 1988 & Supp. 1993); 11 U.S.C.A. § 109(c) (West 1993 & Supp. 1995).

100. *See* 11 U.S.C. §§ 103, 1304 (1988). Sections 503(b) and 507(a)(1) apply in Chapter 13 cases. The debtor must meet the debt ceiling limitations in § 109(e).

101. Judge Clark cannot save the analysis here by arguing that creditors would not have access to exempt property in any case. First, bankruptcy law includes exempt property in the estate available for creditors and thus primes state law. Second, the debtor in *Herberman* was a Texas resident able to choose either the Texas exemptions or the federal exemptions under § 522. Although most Texas debtors choose the state exemptions because of its liberal homestead exemption, some choose the federal exemptions.

102. I.R.C. § 1398(a).

103. Similar treatment is provided for state and local tax purposes. *See* 11 U.S.C.A. § 346 (West 1993 & Supp. 1995).

104. I.R.C. § 1399.

economic activity. The drafters believed that the taxes resulting from estate transactions should be imposed solely on the estate, thus preserving a debtor's fresh start.[105] Second, the drafters of § 1398 concluded that separate entity treatment for estates was justified in chapter 7 and 11 cases because only in those cases was an individual debtor entitled to postpetition income.

> The rationale 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 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 assets of the bankruptcy estate as in chapter 7 or chapter 11 cases.[106]

Herberman is inconsistent with the purpose of § 1398. The quoted language suggests that § 541(a)(6) requires a clear division between that which is of the estate and that which is of the debtor. An approach that views § 541(a)(6) as excluding only a salary approved by the court under § 503(b) is no longer true to the dichotomy between estate and debtor embodied in § 1398. In fact, one of two tax consequences might result from a *Herberman* analysis. First, the I.R.C. might follow the spirit and language of § 541(a)(6) and I.R.C. § 1398 and assess a tax deficiency against the debtor for taxes arising from all earnings generated by the debtor's postpetition services notwithstanding a § 503(b) order allowing a debtor a smaller portion as salary. In essence, the IRS might characterize the *Herberman* approach as an assignment of income inconsistent with § 1398 and the I.R.C. The IRS might have an incentive to make this argument if the estate cannot pay the tax on postpetition earnings of the debtor or if the individual debtor is in a higher tax bracket than the estate. Second, under *Herberman*, the estate must take into income all earnings resulting from a debtor's postpetition activity and deduct any salary to the debtor under § 503(b). Generally, chapter 11 trustees and debtors in possession are not doing so in violation of the I.R.C.

The more basic flaw in the *Herberman* analysis is its failure to perceive its inconsistency with the chapter 11 plan confirmation process. According to *Herberman*, a sole proprietor's postpetition earnings are property of the estate. Section 541(a)(6) excludes from the estate only those earnings approved by the court as benefitting the estate under § 503(b). Cases like *Herberman* make an emotional argument:

105. H.R. REP. NO. 833, 96th Cong., 2d Sess. 9 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess. 9-10 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7024-25.
106. *Id.*

> Were the debtor a corporation wholly owned by an individual who also served as the corporation's principal employee, we would not question a creditor's challenging the wages which that person was drawing out of the debtor corporation. That the enterprise which files bankruptcy happens to be a sole proprietorship rather than a corporation should not make a difference.[107]

A group of commentators has echoed the plea:

> Creditors of a corporate or a partnership debtor share in the earnings and losses of the debtor. Creditors of a sole proprietorship debtor share in the losses of the debtor. Creditors of a sole proprietorship debtor should also share in the earnings of the debtor.[108]

The problem with this argument is that it fails to perceive where it must ultimately lead in the chapter 11 process: a fundamental frustration of the bankruptcy discharge and the fresh start policy. To their credit, the commentators quoted above recognize the concern, but they dismiss it quickly.

> The bankruptcy concept of discharge and the bankruptcy policy of fresh start are not reasons for distinguishing between corporations and sole proprietorships on this question. Remember, the question is whether the debtor is able to retain all postpetition earnings that are attributable both to prepetition property of the estate and to services performed by the individual debtor in the gap between the filing of a Chapter 11 petition and the confirmation of a Chapter 11 plan. (Confirmation vests the property back in the debtor, section 1141). In Chapter 11, both debtors that are corporations and debtors that are individuals operating sole proprietorship can receive a discharge. And, in Chapter 11, a debtor can not receive a discharge until the plan has been confirmed.[109]

The commentators miss the mark. Property of the estate revests in the debtor upon confirmation of the plan. However, the stumbling block is *confirmation*. If postpetition earnings of an individual debtor are property of the estate, then an individual debtor cannot obtain confirmation of a chapter 11 plan (and concomitant revestment[110] and discharge[111]) and retain an

107. *Herberman*, 122 B.R. at 282.
108. 1 EPSTEIN ET AL., *supra* note 8, § 2-8, at 48.
109. 1 *id.* § 2-8 at 48 n.37.
110. 11 U.S.C. § 1141(b).
111. 11 U.S.C. § 1141(d)(1).

interest in the postpetition earnings absent creditor consent.[112] Proposed retention by a debtor of an interest in estate property after confirmation violates the absolute priority rule embodied in § 1129(b)(2)(B)(ii). The proposed plan will not be confirmed. This leaves our sole proprietor with several unpalatable choices. She may not receive her chapter 11 discharge and retain postpetition earnings unless she pays her creditors in full or convinces them to accept less. She may convert the case to a case under chapter 7, frustrating the reorganizational goals of the Bankruptcy Code. Or, of course, she, a world-renowned surgeon, may quit the practice of medicine and head for law school.

In one of the most exhaustive treatments of the issue, the court in *In re Molina Y Vedia*[113] embraced a broad approach to carve outs of future income under § 541(a)(6). The debtor, a surgeon, proposed a Chapter 11 plan funded by a portion of postpetition earnings sufficient to pay off forty percent of the unsecured claims.[114] Creditors objected and filed their own competing plan. The competing plan included virtually all of the debtor's postpetition income, paying the creditors in full.[115]

Rejecting the analysis in *Herberman*, Judge Brown observed that "*Herberman* narrows the earnings exception clause to the point of extinction."[116] Specifically, she noted that Congress included the earnings exception clause within the main clause of § 541(a)(6) because postpetition earnings are "inherently derived from one of the enumerated categories [of estate property] in the main clause."[117]

> 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."[118]

The court further disagreed with that portion of the *Herberman* analysis constructed on the premise that "'postpetition earnings of the enterprise logically fall neatly into Section 541(a)(7) as "interest[s] in property acquired by the estate during the pendency of the bankruptcy."'[119] This criticism is correct if *Herberman* stands for the proposition that "all earnings of every

112. 11 U.S.C. § 1129(b)(2)(B)(ii).

113. *In re* Molina Y Vedia, 150 B.R. 393 (Bankr. S.D. Tex. 1992) (mem.).

114. *Id.* at 395-96.

115. *Id.* at 396.

116. *Id.* at 397.

117. *Id.* at 398.

118. *Molinda Y Vedia*, 150 B.R. at 398.

119. *Id.* (quoting *In re* Herberman, 122 B.R. 273, 279 (Bankr. W.D. Tex. 1990)).

Chapter 11 enterprise" are brought into the estate under § 541(a)(7), because this approach "ignores Section 541(a)(6) to such an extent that Section 541(a)(6) becomes wholly superfluous."[120]

Judge Brown persuasively noted that §§ 541(a)(6) and 541(a)(7) address overlapping but not congruous categories of estate property.

> 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).[121]

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.[122] 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 § 541(a)(6).[123]

According to Judge Brown, the Bankruptcy Code "reflects various policy considerations towards an individual debtor" that support the court's construction of § 541(a)(6).[124] In *Molina Y Vedia* she observed that in defining property of the estate, § 541 applies to all chapters, whether the case is commenced voluntarily or involuntarily.[125] She was also concerned with the construction of § 541(a)(6), which she believed was espoused in *Herberman*, that was inconsistent with the policies embodied in the Thirteenth Amendment's prohibition against involuntary servitude.[126]

The legislative history to Chapter 13 depicts a Congress concerned with the Thirteenth Amendment. Under Chapter 13, § 1306 expands the profile of the estate to include "earnings from services performed by the debtor after the commencement of the case."[127]

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120. *Molinda Y Vedia*, 150 B.R. at 279.

121. *Id.*

122. *Id.*

123. *Id.* at 398.

124. *Id.*

125. *Molinda Y Vedia*, 150 B.R. at 398; *see also* 11 U.S.C. §§ 103(a), 301-02 (1988); 11 U.S.C.A. § 303 (West 1993 & Supp. 1995).

126. *Molinda Y Vedia*, 150 B.R. at 399.

127. 11 U.S.C. § 1306(a)(2) (1988); *see also* 11 U.S.C. § 1207(a)(2) (1988). The inclusion

> Congress manifested a clear intent that Chapter 13 and Chapter 12 would be strictly voluntary, and no creditor can initiate an involuntary proceeding against a debtor eligible under those chapters. Similar Congressional concern for the Thirteenth Amendment is evidenced by the fact that debtors under Chapter 12 and Chapter 13 have an absolute right to convert or dismiss their cases.[128]

Judge Brown asserted that *Herberman* missed the mark with its analysis of the Thirteenth Amendment concern. Recall that Judge Clark in *Herberman* dismissed the Thirteenth Amendment argument, concluding that the Amendment was not violated where a debtor commences a voluntary Chapter 11 case.[129]

> The question is not, as stated in *Herberman*, whether the Thirteenth Amendment is implicated, but whether Congress in drafting Section 541 of the Code sought to avoid any potential conflict with the Thirteenth Amendment. Congress expressed its concern with the Thirteenth Amendment in the following passage:
>
> As under current law, Chapter 13 is completely voluntary. This committee firmly rejected the idea of mandatory or involuntary Chapter XIII in the 90th Congress. The Thirteenth Amendment prohibits involuntary servitude. *Though it has never been tested in the wage earner plan context*, it has been suggested that a mandatory Chapter 13 by forcing an individual to work for creditors would violate this prohibition.[130]

The point here is not whether the inclusion of an individual's postpetition earnings in the profile of the estate in a chapter 11 case would violate the Thirteenth Amendment, but whether Congress recognized many of the possible concerns embodied in the Thirteenth Amendment in crafting section 541(a)(6) of the Code. Congress might have overblown the true significance of the Thirteenth Amendment to this debate; nonetheless, if a motivating factor in drafting section 541(a)(6) was the Thirteenth Amendment, even if misunderstood by Congress, *Molina Y Vedia* comes much closer to the mark than *Herberman*.[131]

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language of §§ 1306 and 1207 is virtually identical to the exclusion language of § 541(a)(6). *See Molina Y Vedia*, 150 B.R. at 399.

128. *Molinda Y Vedia*, 150 B.R. at 399 (citing 11 U.S.C. §§ 303(a), 1307, 1208 (1988) (citations omitted)).

129. *Herberman*, 122 B.R. at 286.

130. *In re* Molina Y Vedia, 150 B.R. at 399 (quoting H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 322, at 120 (1977); S. REP. NO. 95-989, 95th Cong., 2d Sess. 94, at 32 (1978), *reprinted in* 1978 U.S.C.C.A.N. at 6080).

131. *See* John D. Ayer, *How to Think About Bankruptcy Ethics*, 60 AM. BANKR. L.J. 355, 398 n.75 (1986).

In *Molina Y Vedia*, the court concluded that "[t]he *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. 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."[132] The individual Chapter 11 debtor owes no fiduciary obligation to the creditors for property once exempted.[133] 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.

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 people in a debtor's employ that directly generate income (such as associate surgeons in a medical practice)[134] and those like clerical help who, although important, do not directly generate income.[135] In *Molina Y Vedia*, those employed by the debtor were his support staff; he did not employ other professionals.[136] Moreover, the court correctly found that the accounts receivable representing prepetition services were property of the estate.[137]

The more difficult issue is the role fixed assets of the estate, such as the building and medical equipment and any good-will, play in producing postpetition income.[138] 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.[139] The issue of how to treat good-will and fixed assets as well as the issue regarding the assignment of the burden of proof are analyzed in detail in the discussion of *Cooley* below.

A court embracing a reasonable approach to the exclusion of postpetition earnings is *Cooley*.[140] In *Cooley*, the court addressed the issue in the context of a surgeon who filed a voluntary Chapter 11 petition and sought to exclude

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132. *Molina Y Vedia*, 150 B.R. at 400.

133. *See* 11 U.S.C. § 522(c) (Supp. V 1993).

134. *See In re* Cooley, 87 B.R. 432, 443-45 (Bankr. S.D. Tex. 1988) (distinguishing between primary employees who generated income and secondary employees who help in generating income).

135. *In re* Molina Y Vedia, 150 B.R. 393, 402 (Bankr. S.D. Tex. 1992).

136. *Id.*

137. *Id.* In fact, the debtor conceded the issue. *Id.*

138. *See id.*

139. *Molina Y Vedia*, 150 B.R. at 402.

140. *In re* Cooley, 87 B.R. 432 (Bankr. S.D. Tex. 1988).

all postpetition earnings derived from the sole proprietorship.[141] The debtor, the famous heart surgeon Dr. Denton Cooley, earned substantial revenues from his medical practice, which he operated as a sole proprietorship.[142] Although more than half of the revenues were generated by the debtor, a substantial amount were generated by five associate heart surgeons.[143] The debtor proposed a plan funded by a portion of his postpetition earnings in an amount sufficient to pay forty percent of the unsecured claims. The creditors objected, asserting that all postpetition earnings were property of the estate and should be included in the distributional scheme under the proposed plan.[144]

The court in *Cooley* made many of the same points that the court in *Molina Y Vedia*[145] would later make. Of interest is the straightforward analysis Judge Mahoney used in addressing the issues. The judge observed that upon the commencement of the case all property of the debtor passes to the estate under section 541(a)(1) or (a)(2) or subsequently accrues to the estate under sections 541(a)(3) - (7) of the Code.[146] Property of the estate that generates postpetition 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). However, when the debtor is an individual who performs services that generate income postpetition, the debtor may carve out that income from what otherwise would be property of the estate under section 541(a)(6).[147]

The *Cooley* court observed that as a practical matter, under sections 541(a)(1) and (a)(6), separate estates exist when an individual debtor files for Chapter 11 relief: the property of the estate and the property of the debtor.[148] As a matter of law, the estate and the debtor are separate entities that will recognize separate incomes and compute and pay taxes on their separate incomes.[149] 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 I.R.C. § 1398. Although forceful in its own right,

141. *Id.* at 434.

142. *Id.* at 435.

143. *Id.* 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 who were employees of the debtor. *Id.* at 436.

144. *See In re* Cooley, 87 B.R. 432, 434-35 (Bankr. S.D. Tex. 1988).

145. 150 B.R. 393 (Bankr. S.D. Tex. 1992).

146. *Cooley*, 87 B.R. at 440-41.

147. *Id.* at 441.

148. *Id.* at 437; *see also* 11 U.S.C. § 362(c) (1988) (recognizing the continuation of the automatic stay against property of the estate until that property is no longer property of the estate).

149. I.R.C. § 1398 (1988).

the judge's analysis in *Cooley* would have been substantially strengthened by an analysis of I.R.C. § 1398.

The court 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.[150] Thus, Congress drafted section 541(a)(6) well aware of its impact in such contexts. Second, the court reasoned that section 541 applies to all chapters under the Bankruptcy Code.[151] Third, the court focused on whether the Code's provisions for relief would violate the Thirteenth Amendment's prohibition against involuntary servitude which was a concern of Congress in drafting the code.[152] Thus, Chapter 13 relief, which includes postpetition earnings within the profile of the estate,[153] may only be commenced voluntarily by the debtor. Not so with a Chapter 11 case. Either creditors, without the debtor's consent, or the debtor may commence a case under Chapter 11.[154] 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 a court order.[155]

The bankruptcy court in *Cooley* assigned to creditors of the estate the ultimate burden of proof to show that an individual debtor's postpetition earnings were proceeds, products, rents, or profits derived from property which had previously accrued to the estate.[156] This portion of the *Cooley* holding was later embraced in *Molina Y Vedia*.[157]

Both *Cooley* and *Molina Y Vedia* go too far by requiring the creditors of the estate to show that postpetition earnings should not be excluded. First, section 541(a)(6) is silent as to the assignment of the burden of proof. Guidance must come from elsewhere in the Code. Second, other exclusionary provisions, like exemptions, require the debtor to make the election and sustain the burden of proof. Rather, the § 541(a)(6) issues should be addressed by requiring a debtor who seeks to exclude postpetition income from property of the estate to show by a preponderance of the evidence the following: (1) the debtor is an individual, (2) who performs services postpetition, and (3) which generates income postpetition.[158] It is then incumbent upon a party in interest to object to the exclusion of future earnings, producing some evidence that the § 541(a)(6) three-part test has not

150. *Cooley*, 87 B.R. at 439.
151. *See id.* at 440; 11 U.S.C. § 103(a) (1988).
152. *Cooley*, 87 B.R. at 440.
153. 11 U.S.C. § 1306 (1988).
154. 11 U.S.C.A. § 303(b) (West 1993 & Supp. 1995).
155. 11 U.S.C. § 1112(a) (1988).
156. *Cooley*, 87 B.R. at 441.
157. *Molina Y Vedia*, 150 B.R. at 402.
158. *See Cooley*, 87 B.R. at 441.

been met. In doing so, a party in interest meets its burden of production on the issue. It then becomes necessary for the debtor to come forward with sufficient evidence to persuade the bankruptcy judge that the exclusion should shelter future earnings from the estate. At all times, the risk of nonpersuasion remains with the debtor.

An example might help to clarify the approach suggested in this article. Assume Ryan is a lawyer, operating a law firm as a sole proprietorship. She employs three associate lawyers who are compensated by a fixed base salary plus bonuses based on billings. She also employs two secretaries and one paralegal who bills his time but works under the supervision of an attorney. She owns her own building, law library, equipment, and furniture. Assume she files a petition under chapter 11, arguing that all assets of the sole proprietorship are not property of the estate under § 541(a)(6). Under the model suggested here, she must show that (1) she is an individual, (2) who performs services postpetition, and (3) which generates earnings postpetition to exclude postpetition earnings from the bankruptcy estate under § 541(a)(6). We can dispense with the building, law library, equipment, and furniture: these assets are property of the estate under § 541(a)(1) and are not postpetition earnings. Moreover, any receivables generated prepetition or reflecting prepetition services are also property of the estate.

The more difficult issue is with postpetition income generated by the enterprise but not necessarily by Ryan. Ryan could show that those earnings arising because of her services are excluded under § 541(a)(6). Her creditors would counter with evidence that the associates and paralegal generate income apart from Ryan. Ryan must then prove that the employees do not. She will lose as to the associates. She might prevail as to at least a portion of the paralegal's time, that segment reflecting work conducted under her supervision. Furthermore, although secretaries are necessary and valuable people in a law practice, they are not primarily responsible for generating receivables.

Finally, there is the question of good-will. To the extent "good-will" is intertwined with the individual debtor as in *Cooley*, it should be treated like its economic manifestation, that is, postpetition earnings. Consequently, postpetition good-will as manifested in earnings for services performed by the debtor postpetition is not property of the estate under § 541(a)(6).

In sum, in addition to the language in sections 541(a)(6) and 103, the language and intent of I.R.C. § 1398 provide that postpetition earnings by an individual do not constitute property of the estate. Of course, this limitation applies only to the extent postpetition earnings represent compensation for services performed by an individual debtor. If one can show that the postpetition earnings were not derived from services performed by an individual debtor but from services performed by primary employees of the individual debtor in the particular enterprise who directly generate income, then those future earnings do not comprise property of the estate. Furthermore, I.R.C. § 1398 recognizes that an individual's Chapter 11 estate is a

separate entity largely because of the postpetition earnings exclusion, a result much different than that for a partnership or corporation.[159] Likewise, I.R.C. § 1398 does not apply when an individual debtor files for relief under Chapters 12 or 13 because, under those chapters, postpetition income generated by the debtor is explicitly incorporated into the estate.

Moreover, the precise requirements of chapter 11 plan confirmation as well as the coupling of revestment and discharge to confirmation are frustrated by cases like *Herberman.* The debtor cannot retain an interest in postpetition earnings in any proposed plan without violating § 1129(b)(2)(B)(ii). Thus the persuasiveness of cases like *Herberman*[160] is significantly undercut because of the failure to include any analysis of § 1129(b)(2)(B)(ii) I.R.C. § 1398.

C. Tax Attributes as Property of the Estate

In bankruptcy one of the more important "assets" of a debtor is the debtor's ability to use certain tax attributes to shelter future income from taxes or to defer taxes. The question often presented is whether tax attributes such as net operating losses and carryovers (NOLs) are property of the estate.[161] Most courts that have addressed the issue under the Bankruptcy Code have answered yes.[162] For example, in *Official Committee of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines, Inc.)*,[163] the Second Circuit concluded that the right to use NOLs to obtain favorable tax treatment is valuable to an ongoing business and to the efforts of a debtor during a reorganization.[164] Consequently, the NOLs were property of the debtor's bankruptcy estate within the meaning of the Bankruptcy Code.[165]

In *Prudential Lines,* creditors commenced an involuntary case against the debtor corporation under § 303. After the bankruptcy court entered an order for relief, the debtor's parent corporation attempted to take a worthless stock deduction for its investment in the debtor.[166] A creditors' committee argued

159. I.R.C. § 1399 (1988).

160. *In re* Herberman, 122 B.R. 273 (Bankr. W.D. Tex. 1990).

161. Although NOLs are usually at the center of the dispute, other tax attributes also might benefit the estate. *See, e.g., In re* Goldsberry, 142 B.R. 158, 159 (Bankr. E.D. Ky. 1992) (mem.) (holding that a federal earned income credit was "property of the estate"); *In re* Buchanan, 139 B.R. 721, 722 (Bankr. D. Idaho 1992) (mem.) (holding that the earned income tax credit portion of a Chapter 7 debtor's tax refund was property of the debtor's estate); *In re* Davis, 136 B.R. 203, 207 (Bankr. S.D. Iowa 1991) (holding that an earned income tax credit constitutes property of the estate).

162. This may not be so under the Bankruptcy Act with its more restrictive definition of estate property. *See In re Luster*, 981 F.2d 277, 279 (7th Cir. 1992).

163. 928 F.2d 565 (2d Cir.), *cert. denied*, 502 U.S. 821 (1991).

164. *Id.* at 572-73.

165. *Id.* at 572.

166. *Id.* at 567.

that the parent's worthless stock deduction would effectively eliminate NOLs in the amount of $74 million otherwise available to the debtor.[167] The Committee further argued that the NOLs constituted property of the estate that was protected by the automatic stay.[168]

The bankruptcy court agreed with the committee's argument and enjoined the parent corporation from taking the worthless stock deduction.[169] The Second Circuit affirmed and concluded that the NOLs were property of the debtor's estate.[170] The NOLs represented a potential claim for tax refunds and, therefore, were potentially valuable assets to the estate.[171] Consequently, NOLs, like any other estate property, are protected by the automatic stay. Thus, the parent corporation's attempt to take the worthless stock deduction was tantamount to exercising control over the property of the estate in violation of § 362(a)(3) of the Code.[172]

Prudential Lines also recognizes that tax attributes have value from the perspective of creditors of the estate. Tax attributes allow the estate to shelter income, reduce taxes, and possibly increase the return to unsecured creditors.

An expansive view of *Prudential Lines* suggests that any tax attributes that might benefit the estate are estate property. However, the IRS has vigorously disagreed. Section 1398 of the Internal Revenue Code transfers certain enumerated tax attributes from the individual debtor to the estate at the commencement of the case.[173] The IRS asserts that only the tax attributes specifically delineated in section 1398(g) constitute property of a bankruptcy estate.[174] The IRS further argues that section 1398(g) would be redundant

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167. *Id. See generally* Kenneth Glusman, *How Far Can a Bankruptcy Court Go in Controlling a Debtor's Tax Attributes?*, 74 J. TAX'N 84 (1991).

168. *Prudential Lines*, 928 F.2d at 567.

169. *In re* Prudential Lines, Inc., 107 B.R. 832 (Bankr. S.D.N.Y. 1989), *aff'd*, 928 F.2d 565 (2d Cir.), *and cert. denied*, 502 U.S. 821 (1991).

170. *Prudential Lines*, 928 F.2d at 571.

171. *Id.*; *accord In re* Phar-Mor, Inc., 152 B.R. 924 (Bankr. N.D. Ohio 1993) (mem.) (holding that NOLs constitute property of the estate). This position is contrary to the treatment of NOLs under the Bankruptcy Act of 1898 which did not include NOLs in estate property. *See, e.g., In re* Luster, 981 F.2d 277 (7th Cir. 1992).

172. *Prudential Lines*, 928 F.2d at 574; *see also In re Phar-Mor*, 152 B.R. at 926. Section 362(a) provides that "a petition filed under section 301, 302, or 303 . . . operates as a stay, applicable to all entities, of. . . any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate . . . ." 11 U.S.C. § 362(a) (1988).

173. The I.R.C. defines the commencement of a case as the date on which the case under Chapter 11 is commenced. I.R.C. § 1398(d)(3) (1988). Both voluntary and involuntary cases are commenced by filing a petition in bankruptcy under the appropriate chapter. *See* 11 U.S.C. §§ 301, 303.

174. Because I.R.C. § 1398 applies only to an individual debtor under Chapter 7 or 11, the IRS would prevent NOLs from becoming property of the estate in all nonindividual debtor bankruptcy cases.

if Congress had intended all tax attributes to pass into the estate under section 541(a) of the Code.

The BTA includes specific tax consequences and rules which apply to an individual debtor in a Chapter 11 bankruptcy. These rules provide that the bankruptcy estate of an individual debtor is treated as a separate taxable entity if the debtor files for relief under Chapter 7 or Chapter 11 of the Bankruptcy Code.[175] A separate taxable entity is not created for debtors who file under Chapters 12 or 13 or for a debtor who is not an individual.[176]

Section 1398 furthers the fresh start policy embodied in the Bankruptcy Code.[177] The Committee Reports recognize that the purpose of bankruptcy is to allow a debtor to begin his or her economic life anew.[178] Consistent with this purpose is that the income and losses of a separate taxable entity are computed separately from the individual debtor.[179] Any estate tax liability is generally confined to the estate and its assets. Furthermore, by making the short-year election,[180] a debtor might be able to shift at least part of his or her tax liability to the estate as a section 507(a)(8) priority claim.

Under I.R.C. § 1398(g), the estate succeeds to certain enumerated tax attributes of the debtor upon commencement of the case. Presently, these tax attributes include net-operating loss carryovers as determined under I.R.C. § 172; excess charitable contribution carryovers as determined under I.R.C. § 170(d)(1); the recovery of tax benefit items under I.R.C. § 111; certain credit carryovers; capital loss carryovers determined under I.R.C. § 1212; the basis, holding 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 § 1398.[181] In 1992, the Service added passive activity and at-risk activity losses and credits to the list of tax attributes that pass from a debtor to the estate.[182] Upon dismissal or termination of the estate, any unused attributes are transferred back to the debtor.[183]

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175. I.R.C. § 1398(a)-(b) (1988). Section 1398(b)(2) states that the separate-entity rules do not apply at the partnership level even if all the partners are individuals.

176. If an individual's bankruptcy case is later dismissed, the estate is not treated as a separate entity. I.R.C. § 1398(b)(1) (1988). Thus, it is appropriate to treat the tax status of the former debtor as if the case had never commenced.

177. *See* H.R. REP. NO. 833, 96th Cong., 2d Sess., at 19 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess., at 24 (1980).

178. *Id.*

179. *See* I.R.C. § 1398(c) & (e) (1988).

180. I.R.C. § 1398(d)(2) (1988).

181. I.R.C. § 1398(g) (1988).

182. 26 C.F.R. §§ 1.1398-1 & -2, 57 Fed. Reg. 53300 (1992) (to be codified at 26 C.F.R. pt. 1) (proposed Nov. 9, 1992).

183. I.R.C. § 1398(i) (1988). The tax attributes are determined as of the first day of the debtor's taxable year in which the bankruptcy case commences. For example, if the bankruptcy case was commenced on September 15, 1994, the tax attributes would be determined as of

Is I.R.C. § 1398(g) redundant and unnecessary? Are a debtor's prepetition tax attributes already property of the bankruptcy estate? If so, what is the purpose of § 1398? It would appear that section 541(a)(1) through (a)(7) already account for tax attributes as property of the estate. These tax attributes possess real value to the estate from the perspective of the unsecured creditors. Moreover, they may be viewed as a hold-out power from the perspective of the debtor, a telling sign of a property right. The tax attributes should reduce the tax claims against the estate, thus maximizing the distribution to the unsecured creditors. These tax attributes might also permit the estate to obtain a tax refund to be distributed to all creditors in accordance with the priority rules under the Bankruptcy Code. Therefore, *Prudential Lines* provides the better argument on this point.

Under my reading, however, I.R.C. § 1398(g) appears to be superfluous if its purpose were to transfer tax attributes from the debtor to the estate; section 541(a)(1) through (a)(7) already accomplish this task. There is, however, a more subtle role that § 1398(g) plays in this context. The importance of § 1398(g) is that it operates as a gate to keep certain tax attributes from passing from an individual debtor to the bankruptcy estate. Although § 1398(g) accomplishes this task through a negative inference, it recognizes that in some instances allowing certain tax attributes to remain with the debtor furthers the individual debtor's fresh start, a formidable policy under the BTA even when the fresh start is at the expense of the creditors of the estate.[184]

January 1, 1994. Just as the transferor in an I.R.C. § 381 transaction can no longer use its tax attributes after a reorganization, the debtor cannot use his or her attributes in determining the debtor's tax liability for periods commencing after the beginning of the bankruptcy case and before its completion. Thus, any losses or credit carryovers of the debtor for periods prior to the bankruptcy case cannot be used by the debtor. If, in the first year after commencement of the bankruptcy case, the debtor has taxable income and the bankruptcy estate has a net operating loss, then any losses or credit carryovers of the debtor for periods prior to the bankruptcy case cannot be used by the debtor. Nor can the debtor carry back any losses or unused credits arising from its activities after the bankruptcy case commenced to the debtor's prebankruptcy taxable years. I.R.C. § 1398(j)(2)(B) (1988). The trustee must have access to the prior income tax returns of the debtor to determine attribute carryovers and carry back losses and tax credits to prebankruptcy years of the debtor. The Internal Revenue Code provides that, upon written request, the income tax returns of the debtor for the taxable year in which the voluntary bankruptcy case is commenced and for preceding years are open to inspection by or disclosure to the trustee of the bankruptcy estate. 26 U.S.C.A. § 6103(e)(5)(A) (West 1988 & Supp. 1995). A debtor is given similar access to the returns of the bankruptcy estate. In an involuntary bankruptcy case, however, disclosure to the trustee is not permitted until such time as an order for relief has been entered by the bankruptcy court, or unless the bankruptcy court finds that disclosure is appropriate for purposes of determining whether an order for relief should be entered. 26 U.S.C.A. § 6103(e)(5)(C) (West 1988 & Supp. 1995).

184. My analysis of § 1398 is similar to the justification for the future-earnings carve out under section 541(a)(6) of the Code and the role exemptions play in the context of debtors creditors.

IV. SEPARATE ENTITY RULES: I.R.C. § 1398

One of the most important provisions in the I.R.C. from the perspective of individual debtors interested in a robust fresh start—a fresh start even from certain tax debts—is I.R.C. § 1398.[185] Section 1398 creates a separate entity for purposes of federal income taxes in cases in which individual debtors file for relief under Chapter 7 or Chapter 11 of the Bankruptcy Code.[186]

Under the BTA, when an individual files a bankruptcy petition under Chapter 7 or Chapter 11, a separate taxable entity is created. This new entity succeeds to the assets, liabilities, and enumerated tax attributes of the debtor.[187] The separate entity is called the bankruptcy estate and is wholly distinct from the individual for income tax purposes.[188] Thus, for example, income earned by an individual debtor after commencement of the bankruptcy case does not become part of the bankruptcy estate.[189] Furthermore, each entity must file separate income tax returns for the period of the bankruptcy case.[190]

A. Mechanics of Taxing the Estate

The taxable year of the bankruptcy estate begins as of the date the bankruptcy case is commenced.[191] Presumably, as is the case for any new entity, the estate may select whatever taxable year end it desires.[192] If, however, the bankruptcy case is terminated[193] before the end of the year

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185. For a detailed analysis of § 1398, see generally C. RICHARD MCQUEEN & JACK F. WILLIAMS, TAX ASPECTS OF BANKRUPTCY LAW AND PRACTICE, §§ 18.01-.32 (2d ed. 1994).

186. Section 346 provides similar but not identical treatment for state and local tax purposes. For a careful analysis of the state and local tax consequences of bankruptcy. *See id.* §§ 19.01-.30.

187. I.R.C. § 1398(a) (1988).

188. *See generally* I.R.C. § 1398(c), (e), (f) (1988).

189. *See* I.R.C. § 1398(e)(1) (1988).

190. I.R.C. § 1398(c)(1) (1988). No separate taxable entity is created on commencement of a case by an individual under Chapters 12 or 13 or in the case of any other entity under Chapter 11 (e.g., corporation, partnership, or trust). I.R.C. §§ 1398(a), 1399 (1988).

191. I.R.C. § 1398(d) (1988).

192. 26 U.S.C.A. § 441 (West 1988 & Supp. 1995); Temp. Treas. Reg. § 1.441-1(b)(3) (1987).

193. One of the more frustrating problems in studying the interface between bankruptcy and tax is the use of ambiguous terms by one code to define legal consequences in that and another code. The word "termination" is a good example. *See* I.R.C. § 1398(f), (i) (1988). When does a bankruptcy case terminate? Certainly, termination does not mean only that the case must be closed under § 350. If so, Congress would have used the term "closed." Termination must include not only closing a case but also dismissal of the case or even confirmation of a plan. The meaning of this term is quite significant in the context of the tax consequences of the bankruptcy abandonment of property. For a thorough analysis of the tax consequences of bankruptcy abandonment, see Jack F. Williams, *The Tax Consequences of Abandonment Under the*

chosen by the estate, the estate's tax year is closed as of the date of termination.[194]

Once the bankruptcy case is commenced, the separate entity rules apply. If the case is subsequently dismissed, then the separate entity rules are inapplicable.[195] In such an instance, the bankruptcy estate ceases to exist and, in fact, is regarded as never having existed.[196] If the bankruptcy case had extended beyond one taxable year and the bankruptcy estate had gross income and deductions in those taxable years and the case had been subsequently dismissed, then the debtor must file amended returns to report the gross income and deductions of the estate.[197] Furthermore, if the bankruptcy estate had filed an income tax return and paid any taxes, the debtor would be entitled to a refund of the tax paid by the estate.

Under § 1398 of the I.R.C., the bankruptcy estate is entitled to one change in its accounting period without the consent of the IRS;[198] The stated purpose for this rule is to allow the estate to close its tax year before the expected termination of the estate and effect an expeditious determination of its final tax liability in accordance with § 505.[199]

Consistent with its separate entity status, an estate computes its own taxable income in the same manner as an individual.[200] The estate is taxed at the same rate as a married individual filing separately[201] because this is the highest rate available for individual taxpayers.

The Chapter 7 or 11 trustee (or debtor in possession in a Chapter 11 case when no trustee has been appointed) is required to file any returns required by law on behalf of the estate and to pay any taxes due.[202] The trustee must file a return for each taxable year that the estate's gross income exceeds the standard deduction and the exemption amount.

Bankruptcy Code, 67 TEMP. L. REV. 13 (1994).

194. *See* I.R.C. § 443 (1988); Treas. Reg. § 1.443-1(a)(2) (1981).

195. I.R.C. § 1398(b)(1) (1988).

196. I.R.C. § 1398(b)(1) (1988); Temp. Treas. Reg. § 301.9100-14T(b) (redesignated in 1992).

197. Proper notice must be sent to the IRS service center in which the returns for the prior years had been filed if the bankruptcy case is dismissed or converted to a Chapter 13 case. Announcement 81-96 (May 7, 1981), 1981-20 IRB 13.

198. I.R.C. § 1398(j)(1) (1988). Otherwise, like any other taxpayer, consent of the Commissioner would be required under I.R.C. § 442.

199. S. REP. No. 1035, 96th Cong., 2d Sess., at 30 (1980); H.R. REP. NO. 833, 96th Cong. 2d Sess., at 25 (1980). *See generally* 11 U.S.C. § 505(b) (1988).

200. I.R.C. § 1398(c) (1988).

201. *Id.* For state and local tax purposes, the bankruptcy estate is taxed as an estate. *See* 11 U.S.C.A. § 346(b) (West 1993 & Supp. 1995).

202. I.R.C. § 1398(c), (e) (1988).

B. Determination of Income of the Estate

Upon commencement of a bankruptcy case and the corresponding creation of the bankruptcy estate, the debtor is concerned with the treatment of income, deductions, and credits of the bankruptcy estate. The items to be included in the gross income of the bankruptcy estate consist of the following: (1) any gross income of the individual debtor that under the substantive law of bankruptcy constitutes property of the bankruptcy estate and (2) the gross income of the estate beginning on and continuing after the date the case is commenced.[203] The gross income of the debtor, however, will not include any income item to the extent that such an item is included in the gross income of the bankruptcy estate.[204] Section 1398 does not permit double counting of income or losses by both the estate and the debtor. Thus, § 1398(e)(2) of the I.R.C. provides that a debtor's gross income for any taxable year does not include any item to the extent that it is included in the estate's gross income.

In addition, the transfer of the debtor's assets to the estate at the commencement of the bankruptcy case will not give rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of any item of income or deduction merely by reason of the debtor's transfer of estate property by operation of law under § 541(a)(1) of the Code and § 1398 of the I.R.C.[205] The bankruptcy estate will receive the same tax treatment as the debtor with respect to the transferred assets. For example, a transfer of an installment obligation will not accelerate the recognition of the deferred gain, and the estate will report the deferred gain as installment payments are received.

Whether the debtor or the estate reports cancellation of indebtedness income depends on when the taxable event occurs. If a substantial modification of a debt, such as complete or partial discharge or modification of principal amount, occurs before the commencement of the case, generally the debtor should recognize the income under I.R.C. § 61(a) unless it can be excluded under I.R.C. § 108(a).[206] However, if the taxable event occurs after commencement of the case, then the estate should recognize the income under § 61(a) of the I.R.C. unless it can be excluded under § 108(a).

Prior to the BTA, the law was unclear as to whether certain expenses paid by the estate were deductible by the estate if the trustee did not actually operate the debtor's trade or business. The BTA provides that any amount paid

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203. I.R.C. § 1398(e)(1) (1988).

204. I.R.C. § 1398(e)(2) (1988).

205. I.R.C. § 1398(f)(1) (1988).

206. *See* I.R.C. § 108 (1988) (concerning treatment of cancellation of indebtedness income when taxpayer is insolvent under Chapter 11). There is a way to shift at least some of the tax consequences from the debtor to the estate through a § 1398(d)(2) short-year election by the debtor.

or incurred by the bankruptcy estate is deductible or creditable by the estate to the same extent as that item would have been deductible or creditable by the debtor had the debtor continued in the same trade, businesses, or activity as before the commencement of the bankruptcy case and had the debtor paid or incurred the amount.[207] Similar rules also apply in determining whether amounts paid by the estate are to be considered as wages for federal employment tax purposes.[208]

NOLs, other than administration and court expenses discussed below, and excess unused credits presumably can be carried back and over for the same periods allowed the debtor.[209] If the NOLs correspond to years prior to the commencement of the bankruptcy case, they can be applied in the corresponding taxable year of the debtor.[210] These NOLs are applied before any NOLs arising from the administration of the bankruptcy estate.[211]

Prior law was also unclear concerning the deductibility of administration and related expenses of the bankruptcy estate. Under I.R.C. § 1398(h)(1), the bankruptcy estate, and only the estate,[212] may deduct administrative expenses allowable under Title 11 of the United States Code and any court fees or costs assessed against the estate under Title 28 to the extent that they are not capital expenditures or otherwise nondeductible.[213] Furthermore, the estate may carry back for three years or forward for seven years any such expenses not used in the current year, but only to a taxable year of the bankruptcy estate and not that of the debtor.[214]

I.R.C. 1398(e)(3) provides that the determination of whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if paid by the debtor and as if the debtor were still engaged in the trade or business that the debtor has been engaged in before commencing the case. It appears that the same accounting method used for income should be used for deductions. Additionally, I.R.C. § 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.

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207. I.R.C. § 1398(e)(3) (1988).

208. *Id.*

209. *Id.*

210. I.R.C. § 1398(j)(2) (1988).

211. I.R.C. § 1398(h)(2)(C) (1988).

212. I.R.C. § 1398(h)(2)(D) (1988).

213. Expenses that would otherwise be nondeductible include those under 26 U.S.C.A. § 265 (West Supp. 1995).

214. I.R.C. § 1398(h)(2) (1988).

C. Short-Year Election

I.R.C. § 1398(d)(1) provides that as a general rule, the taxable year of an individual debtor should be determined without regard to the bankruptcy case. Nonetheless, an individual debtor is entitled to one irrevocable election to close his or her taxable year. Thus, § 1398(d)(2) creates an election that a debtor may make to split his or her taxable year into *two* shorter taxable years. If the election to have two short taxable years is made, the debtor is required to annualize his or her taxable income for each short taxable year in the same manner as if a change of annual accounting period has been made.[215]

The § 1398(d)(2) election is an important prebankruptcy planning tool that is often overlooked. The first short taxable year begins on the first day of the debtor's normal tax year and ends on the day before the day the bankruptcy case was commenced. The second taxable year begins on the commencement date and ends at the end of the debtor's normal tax year.[216] Thus, if a bankruptcy case were commenced on July 15, a calendar-year debtor may elect to file a short period return for January 1 through July 14 and a second short period return for the balance of the calendar year (July 15 through December 31). As a result of such an election, the debtor's tax liability for the first short taxable year becomes an allowable claim against the bankruptcy estate. If the election is not made, the taxable year of the debtor is determined without regard to the bankruptcy case, and the taxes for the current tax year are not an allowable claim against the estate.[217]

The election is not available to a debtor who has no assets other than property which may be treated as exempt property under 11 U.S.C. § 522.[218]- The election is denied in this instance because there are no assets in the bankruptcy estate out of which the debtor's tax liability for the period prior to the commencement date could be collected.

A nondebtor spouse may timely join in the § 1398(d)(2) election. Generally, all assets of a married couple filing a joint petition will become property of a single estate, including separate and community property of each spouse.[219] This, however, is not always the case. A court has the authority to determine to what extent the estates should be consolidated.[220] When are the estates not consolidated? Generally, in cases in which the spouses have separate creditors and significant separate property, a bankruptcy court might decide not to consolidate the estates.[221]

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215. I.R.C. § 1398(d)(2)(F) (1988).
216. I.R.C. § 1398(d)(2)(A) (1988).
217. I.R.C. § 1398(d)(1) (1988).
218. I.R.C. § 1398(d)(2)(C) (1988).
219. 11 U.S.C. § 541(a)(1), (c)(2) (1988).
220. 11 U.S.C. § 302 (1988).
221. Note that the right to file joint returns under I.R.C. § 6013 is limited to a husband and

In the case of a married debtor who files a joint return with his or her spouse, the spouse may join in the debtor's election of two short taxable years.[222] The parties are required to file a joint return for the first short taxable year. However, the parties need not file a joint return for the second short taxable year. If, subsequent to joining in the debtor's election, a separate bankruptcy case is commenced by or against the debtor's spouse, the spouse is not precluded from making a separate election for two short taxable years.[223] The original debtor would then be able to join in the election made by the spouse to have two short taxable years if the debtor's spouse has joined in the debtor's election or if no election was made by the debtor. Conceivably, the debtor and spouse could have three short taxable years.

The irrevocable election regarding the taxable year must be made on or before the fifteenth day of the fourth month following the close of the first short taxable year, that is, the day before the commencement date.[224] For example, if a bankruptcy case is commenced on March 1, the debtor must file his or her election on or before June 15. This is the same amount of time an individual taxpayer normally has to file a tax return after the close of the taxable year.[225]

The short-year election must be made by the debtor on or before the date for filing his or her return for the short-taxable year. I.R.C. § 6072 requires that returns be made on or before the fifteenth day of the fourth month following the close of a fiscal year. A Treasury Regulation further provides that the short-term return be filed on or before the fifteenth day of the fourth *full* month following the close of the taxable year.[226] Again, the election must be made on the return. Once made, the election is irrevocable.

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wife. Since their bankruptcy estates are separate entities from the individuals, the privilege to file joint returns has not been extended to the bankruptcy estates. Accordingly, separate returns must be filed for each estate. For example, assume a husband and wife have both filed for bankruptcy, and they have filed joint returns both before and during the bankruptcy case. Separate returns must be filed for each estate, and the losses of one estate cannot be offset against the income of the other estate.

222. I.R.C. § 1398(d)(2)(B) (1988).

223. Temp. Treas. Reg. § 301.9100-14T (f) (redesignated in 1992).

224. I.R.C. § 1398(d)(2)(D), 6072(a) (1988).

225. Under temporary regulations, the election can be made by filing the return for the first short period on or before the due date or by submitting a statement of election attached to an application for extension of time for filing the first short period return on or before such date. Temp. Treas. Reg. § 301.9100-14T(d) (redesignated in 1992). To facilitate processing, the taxpayer should write "Section 1398 Election" at the top of the tax return. For further guidance regarding the short-year election, see MCQUEEN & WILLIAMS, *supra* note 185, §§ 18.16-.22.

226. Temp. Treas. Reg. § 301.9100-14T(d) (as redesignated in 1992). For a discussion regarding whether an individual debtor may obtain an extension of time by which to make the election, see MCQUEEN & WILLIAMS, *supra* note 185, § 18.19.

When an involuntary petition is filed, one court has held that for purposes of the I.R.C. § 1398 election, the commencement date is the date of the entry for the order of relief.[227] This case is clearly wrong. Section 1398(d)(3) provides that for purpose of § 1398(d)(2), a case is commenced on the date the individual case begins.

In *Kreidle* the court concluded that the debtors timely elected to terminate their taxable year pursuant to § 1398(d)(2).[228] Creditors commenced an involuntary case against the debtors on June 20, 1986. The order for relief, however, was entered on October 2, 1986. The debtors made their election on January 15, 1986.[229] The January 15 election would be timely if the four-month period began to run from the order for relief but would be untimely if measured from the commencement of the case, that is, the filing of the bankruptcy petition.[230] The *Kreidle* court chose to tie the beginning of the four month period to the entry of the order for relief. There are a number of laudable reasons to do so: why prejudice a debtor's ability to elect under § 1398(d)(2) when he or she might be focused on fighting an involuntary case? Nonetheless, § 1398 and the Bankruptcy Code are clear. Section 1398 provides that the "commencement date" is the measuring date.[231] That section further defines "commencement date" as "the day on which the case under Title 11 of the United States Code to which this section applies commences."[232] Bankruptcy Code §§ 301 and 303 are equally clear. Section 301 provides that a voluntary case is *commenced* by the filing of a petition by an eligible debtor. That section further provides that the commencement of a voluntary case constitutes an order for relief.[233] Section 303 provides that an "involuntary case against a person is *commenced* by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title . . . ."[234] Under § 303(h) the order for relief is entered by the court at some later date. *Kreidle* is wrong.

One final point in this section deals with the mechanics of the short-year election under § 1398(d), under which an individual debtor must *elect* to bifurcate his tax year to take advantage of the tax benefits in I.R.C. § 1398. Failure to make the election in a timely manner results in a waiver of the § 1398 tax benefits.

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227. *In re* Kreidle, 146 B.R. 464, 470 (Bankr. D. Colo. 1991), *aff'd*, 143 B.R. 941 (D. Colo. 1992).

228. *Id.* at 470.

229. *Id.* at 466.

230. *See* 11 U.S.C. § 301 (1988); 11 U.S.C.A. § 303 (West 1993 & Supp. 1995).

231. *See* I.R.C. § 1398(d)(3) (1988).

232. *See id.*

233. *See* 11 U.S.C. § 301.

234. 11 U.S.C.A. § 303(b) (West Supp. 1995) (emphasis added).

Most individual debtors benefit from the § 1398(d)(2) short-year election. Yet, many debtors fail to make a timely election because of miscalculations or lack of advice from counsel. I.R.C. § 1398 should be modified to provide for its automatic application absent an election opting out of § 1398(d)(2) short-year treatment. This modification should reduce the failure to use the benefits provided by I.R.C. § 1398, thus furthering the fresh start policy embodied in both the Bankruptcy Code and Internal Revenue Code.

D. Consequences of the Election

The short-year election is one of the most potent pre-bankruptcy planning tools because of its wide availability to individual debtors. The most significant effect of the election is that any tax liability for the first short-year becomes an allowable § 507(a)(8) priority claim against the estate. Thus, the debtor may essentially force his or her unsecured creditors to pay all or a portion of the first short-year tax claim. Of course, if there are insufficient assets to pay the short-year tax claims in full, they do survive the bankruptcy as a nondischargeable claim under § 523(a)(1) of the Code. If the debtor fails to make the election, then any tax liability for the complete year is not an allowable claim against the estate because it is a postpetition claim, and, is, therefore, nondischargeable. Moreover, if a debtor makes the election, then a debtor's tax attributes as of the end of the first taxable year are transferred to the estate to be used by the estate to shelter income. Absent the election, the estate will succeed to the attributes as they existed on December 31 of the prior year (assuming a calendar year taxpayer). Finally, if the election is made, the debtor is required to annualize his or her taxable income for each short taxable year in the same manner as if a change of annual accounting period has been made.

An example might help clarify the potent effect of a timely election.[235] Will Riker files a Chapter 11 petition on March 8, 1995. From January 1 through March 7, 1995, Will earned $25,000 as salary and capital gains of $15,000. From March 8 through December 31, 1995, Will earned $75,000 as salary.

No election made: Will will file one return for the full 1995 tax year, reflecting $100,000 in salary income and $15,000 in capital gains. Because Will failed to make the election, no part of the tax claim attributable to his 1995 income is an allowable claim against Will's bankruptcy estate. Will, continues, however, to owe the tax.

235. This example is borrowed from MCQUEEN & WILLIAMS, *supra* note 185, § 18.20. Numerous example of the § 1398(d)(2) election may be found in sections 18.16 through 18.21 of the article.

Election made: Will files two tax returns. The first return is for the first short-tax year from January 1 through March 7, reflecting $25,000 in salary and $15,000 in capital gains. The second return is for the second short-tax year from March 8 through December 31, reflecting the salary of $75,000 earned postpetition.[236] By making the short-year election, Will converts the tax claim arising out of the first short year into an allowable claim against the estate. Moreover, this allowable claim is paid out as a § 507(a)(8) priority claim under the Code. However, any portion of the claim not satisfied in bankruptcy survives the discharge under § 523(a)(1)(A). Thus, the debtor is liable for any deficiency in payment of the tax.

E. Termination of the Estate

Upon termination of the bankruptcy estate, any assets held in the estate are transferred to the debtor. The transfer of the assets upon termination, if not a sale or exchange, will not be treated as a disposition for purposes of recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions.[237] With respect to any transferred asset, the debtor will receive the same basis, holding period, and character as the estate. Hence, for certain nondepreciable assets, the debtor might be in the same tax position as before the commencement of the bankruptcy case.

In addition to the return of assets to the debtor upon termination of the bankruptcy case, a debtor succeeds to the categories of tax attributes of the estate that were originally transferred to the estate by the debtor under § 1398(g).[238] In the event a debtor succeeds to a net operating loss or unused credit of the bankruptcy estate, such loss or credit must be used only prospectively. Losses incurred by a bankruptcy estate may be carried back to its prior years and applicable prebankruptcy years of the debtor but not against postbankruptcy years of the debtor. Losses incurred by the debtor can be applied against its postbankruptcy income but cannot be carried back to the

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236. When is it advisable for a debtor to make the short-year election? There is no easy answer to the questions posed. Whether a debtor should make the I.R.C. § 1398 election depends on the particular facts and circumstances at hand. As a general rule, it appears that in most cases the election should be made. By making the election, a debtor is able to shift at least some of the tax liability to the estate as an allowable § 507(a)(8) priority claim. However, if the claim is not satisfied it will be nondischargeable and survive the bankruptcy. There might be circumstances present to dissuade a debtor from making the election when substantial net operating losses are involved. For examples of when to and when not to make the election, see McQueen and Williams, *supra* note ___, at §§ 18.16-18.21.

237. I.R.C. § 1398(f)(2) (1988).

238. I.R.C. § 1398(i) (1988); *see also* proposed regulations 26 C.F.R. § 1.1398-1 & -2, 57 Fed. Reg. 53300 (1992) (to be codified at 26 C.F.R. pt. 110) (proposed Nov. 9, 1992).

prebankruptcy years of the debtor nor applied against any taxable income of the bankruptcy estate.[239]

There is no provision that permits the debtor to carry back any losses or credits inherited from its bankruptcy estate to prior years of the debtor. For example, if, in the last years of the bankruptcy, the estate incurred a net operating loss of $10,000 which is transferred to the debtor, the loss cannot be carried back to any prior years of the debtor. If, however, the estate is terminated in the middle of the year, the debtor can apply the losses against its income for that same year.

V. CONCLUSION

Individual debtor Chapter 11 cases present wonderfully complex and challenging bankruptcy and tax issues. There is no reason to believe that the recent amendments to the Bankruptcy Code[240] that increase the debt ceiling limits in Chapter 13 cases will alleviate the need for further discussion regarding these issues.[241] Although the individual debtor seeks as broad a discharge as possible, by the nature of the beast, he or she also seeks to reorganize, even if, ultimately, this means an orderly liquidation. This tension is at the core of many of the issues posed by the individual debtor in Chapter 11. For example, a narrow reading of the postpetition earnings exclusion in § 541(a)(6) favors reorganization in the first instance even over the debtor's right to a fresh start. In contrast, a broad reading gives priority to a debtor's fresh start above the concerns of creditors about the reorganization.

So too with I.R.C. § 1398. Treating the estate as a separate taxable entity furthers a debtor's fresh start by confining taxes owed by the estate to the estate. Additionally, I.R.C. § 1398 provides a specific tax benefit to an individual debtor who has filed for relief under Chapter 7 or 11. By making the § 1398(d)(2) election, a debtor is able to convert what otherwise would be a postpetition tax claim into a prepetition § 507(a)(8) priority claim that may be satisfied with estate assets. Nonetheless, § 1398 extracts a price for its benefits. The price a debtor must pay is the transfer to the estate of the enumerated tax attributes in I.R.C. § 1398(g),[242] and any remaining tax

239. I.R.C. § 1398(j)(2)(B) (1988).

240. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106-4150 (1994).

241. For debtors willing to pay the increased cost of administration, Chapter 11 may be a more attractive alternative to Chapter 13 because of the greater autonomy in the former type of cases. No one quite knows what role the Chapter 13 standing trustee will play in the expanded use of Chapter 13 by sole proprietorships.

242. Often, this cost is illusory. With proper prebankruptcy training, most, if not all, of the tax attributes listed in I.R.C. § 1398(g) will already have been used up by the debtor before the bankruptcy petition is filed.

claim after the § 1398(d)(2) election has been made is nondischargeable under § 523(a)(1).

The drafters of I.R.C. § 1398 and the Bankruptcy Code recognized an obvious fact that was not quite as obvious as one might initially think. The drafters recognized that all is not clear and certain in an organic bankruptcy system. Bankruptcy, tax, and bankruptcy taxation are complex systems because economic life is complex. For these systems to maintain a pragmatic and philosophical rhythm, they must be organic; they must grow and adapt. Growth in the law is not a painless process. Conflict is reality. There are those who will look at the conflict inherent in bankruptcy and tax and see the debtor's discharge and nothing else. Then there are those who will look at the conflict and see a thief at some level of abstraction shirking his or her responsibility to creditors and government. In § 1398, the drafters envisioned a bankruptcy world somewhere between the two termini, a bankruptcy world of vagueness and not exactitude.