

BANKRUPTCY BY THE NUMBERS

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MEANS-TESTING AND PRE-BANKRUPTCY PLANNING:

As we noted in our November 1999 **ABI JOURNAL** article², recent studies have been in general agreement on the basic financial characteristics of chapter 7 debtors, but have come to very different conclusions on the number of debtors who would be able to repay their unsecured creditors under various means testing proposals. This is because the terms of the means tests, based on standards promulgated by the IRS for their own purposes, are subject to legitimate differences of interpretation and need to be supplemented by judgment calls during the calculations.

In that article we examined the affairs of a particular debtor with an annual income of approximately \$55,000, and concluded that he would probably remain eligible for chapter 7 under means testing. In this article we extend this approach to a sample of 1,938 recently closed chapter 7 no asset cases.³ The sample includes cases from all judicial districts except for those in North Carolina and Alabama. We applied the various provisions proposed in S. 625 and H.R. 833 to see how many current chapter 7 debtors would be ineligible for chapter 7.⁴ Out of our entire sample we found only two cases where the debtor, with careful pre-

¹ All views expressed in this article are those of the authors, and do not necessarily represent the views of the Executive Office for United States Trustees.

² See Flynn, Ed and Bermant, Gordon, "Means testing: Lessons Learned from a Single Case" 18 ABI Journal, November 1999, p. 30-31.

³ The sample was drawn in four stages from November 1998 to August 1999 from the 84 districts served by the United States Trustee Program. The sample amounted to about 1/500th of annual chapter 7 filings in each district.

⁴If bankruptcy reform legislation is enacted, it will probably contain a mix of the provisions in previous House and Senate bills. In this article we used the more expansive income and expense provisions from both bills.

bankruptcy planning and a rather broad interpretation of the proposed means testing provisions, could not remain eligible for chapter 7.

INCOME: The first screen under means testing is an income test. Three different income standards were included in the 1999 legislative proposals. They were based on the median national, regional, and state incomes for families of various sizes. The most restrictive of these measures is national median income. Of our 1,938 sample debtors, 365 (18.8%) had incomes above the national median for their family size. (If all the petitions contained complete income information the actual number would be a little higher, because 121 of the debtors in our sample were married but did not report any information on spousal income.) Use of the regional medians as the income threshold reduces the number of chapter 7 ineligible debtors to 334 (17.2%). Use of the state medians⁵ for debtors in the 23 higher cost states and the District of Columbia reduces the number to 304 (15.7%). (This includes a few debtors who are eligible under the regional medians, but become ineligible using the state standards.)

As we noted in our July 1999 **ABI JOURNAL** article⁶, the HUD county medians would be a more effective income screen, because they are a better measure of a debtor's actual economic environment. If these were used on the sample population the number of ineligible debtors would fall to 246 (12.7%).

BASIC EXPENSES: The accompanying graph shows the impact the following adjustments would have on the number of debtors who would be prevented from chapter 7 relief. Starting with the 304 debtors in our sample with incomes above their state median, our second cut was to develop an adjusted gross income measure to account for business receipts that are reported as income (affecting 4.2% of the sample debtors), and support and alimony payments that are made for persons who are not included as dependents of the debtor in determining family size (affecting

⁵ The Bureau of the Census currently publishes State-level median incomes only for families of four persons. For other family sizes we assumed that the relation to the national average in a state would be the same as for four-person families.

⁶See Bermant, Gordon, "Bankruptcy Reform: Finding the Best Gross Income Test" 18 *ABI Journal*, July/August 1999, pp. 18-19, & 35.

11.0% of the sample debtors).⁷ This adjustment reduced to 260 the number of debtors who were ineligible for chapter 7 under means testing.

Our next step was to apply the IRS expense guidelines for food, housing, and transportation (operating expenses only) to the remaining debtors' reported after-tax income. This preliminary expense analysis reduces the count of ineligible debtors to 241. Subtracting medical costs, actual charitable contributions and other taxes reported on Schedule J further reduces it to 233 debtors, and amortizing priority debt payments from Schedule E over 60 months eliminates four additional debtors.

OTHER EXPENSES: Now we turn to consideration of a number of items where pre-bankruptcy planning would make a difference under means testing. Please note that this analysis is based on two large assumptions: that various expense allowances contained in either S. 625 or H.R. 833 will be enacted into law, and that all debtors will take advantage of each of these allowances.

Car Payments: The next adjustment applies to car payments. Previous researchers have disagreed on how these would be treated under means testing⁸. The IRS guidelines allow a monthly payment of \$372 for the first vehicle and an additional \$274 for the second vehicle. Allowing for either one or two car payments (depending on family size) reduces the number of ineligible debtors in our sample from 229 to 158.

Charitable Contributions: A second controversial area will involve charitable contributions. Under H.R. 833 debtors would be allowed to contribute up to 15% of gross income to charity. The debtors in our group reported very little in charitable contributions, with only about 2% of debtors giving more than 5% of their gross income to charity. Under means testing it would be in the interest of the above-mentioned 158 debtors to make the maximum allowable charitable contribution, if they wished to either be eligible for

⁷These adjustments are not specifically included in the income provisions of the proposed legislation. However, we believe such expenses would be allowable in the expense analysis portion of means testing. Administratively, it is simpler to exclude these items from gross income than to account for them in an analysis of expenses.

⁸ See for example General Accounting Office, Personal Bankruptcy: Analysis of Four Reports on Chapter 7 Debtors' Ability to Pay. GAO/GGD-99-103 (June, 1999)

chapter 7 or to reduce their payments in a chapter 13 plan. If it is assumed that the remaining debtors will donate the maximum⁹, the number of debtors ineligible for chapter 7 falls to 82.

ADDITIONAL FACTORS: Separated Couples: Seven of the remaining debtors were separated couples who had filed jointly. If they had filed separately, all would have been eligible for chapter 7 under means testing.

Overtime and Second Jobs: Approximately six percent of the debtors in our sample reported income from overtime or a second job. Eliminating this source of income would reduce our pool of ineligible debtors down to 69.

Private School Tuition: H.R. 833 would allow debtors to spend up to \$10,000 per year for private school tuition. If the children of the debtors in our sample attended private schools, the ineligible pool would shrink to 44 debtors.

Minimum Chapter 13 Plan Payment: At this point only about 25 of these debtors- a little over one percent of our original sample- would have at least \$250 per month available income or enough to pay at least 25% of their unsecured debt over five years, as provided in S. 633.

Home Ownership Costs: Eight of the remaining debtors were homeowners whose combined mortgage, utility, and other home ownership costs reported on Schedule J. were far higher than the IRS expense allowance. If their total housing costs are allowed (by allowing them to claim their mortgage payment as secured debt, and their home utility, repair, and insurance costs under the IRS housing allowance) they would remain eligible for chapter 7.

Other Allowable Expenses: Our analysis has still not exhausted all of the possible expenses that might be allowed under means testing. Of the remaining 17 debtors, examination of the petitions shows that 15 probably could justify enough additional expenses to demonstrate chapter 7 eligibility (e.g., other secured debt payments, student loan payments, support provided to parents, life insurance, union dues, an adult child in college that we did not count as a dependent, etc).

⁹ To make this calculation we assumed a marginal tax rate of 30% for these debtors. Therefore, to factor in the potential tax savings from charitable donations for debtors we calculated the additional allowable charitable contribution as 10.5% (15% X 70%) of gross income less the amount that the debtor already had reported on Schedule J.

CONCLUSION: Most chapter 7 debtors clearly have little if any capacity to repay their debts at the time of filing. A small proportion appear to be able to repay but means testing will not necessarily make this happen. Out of our sample of 1,938 cases, we only found two petitions that could not justify chapter 7 eligibility under a very broad reading of the proposed statutes. These results are consistent with the findings of Professors Culhane and White¹⁰ who found a total of six can-pay debtors from a sample of 1,041 cases who could make payments if 15% tithing were assumed. (The number of can-pay debtors in their sample would have been further reduced if they had allowed all of the categories of expenses in our analysis.) In fact, we believe that only a very small proportion of current chapter 13 debtors would be prohibited from filing under chapter 7 when subjected to a similar income and expense analysis.

This is not to say that we believe that these were the only two debtors in the sample who *should* be prohibited from filing under chapter 7. However, means testing will give debtors a road map of exactly what they would have to do to qualify for Chapter 7 relief. Virtually all debtors who want to file under chapter 7 will probably be able to do so under means testing.

¹⁰Culhane, Mariannne B., & White, Michaela M., "Taking the New Consumer Model for a Test Drive: Means-Testing Real Chapter 7 Debtors" ABI Law Review, Spring 1999

DEBTORS INELIGIBLE FOR CHAPTER 7 (OUT OF ORIGINAL SAMPLE OF 1,938)

