The Net Effect – Debtors with Business Income Are Permitted to Deduct Ordinary and Necessary Business Expenses in Calculating Current Monthly Income

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Introduction

A debate has evolved regarding whether debtors engaged in business may deduct ordinary and necessary business expenses when calculating their current monthly income in Part I of Official Form 22C. Form 22C directs chapter 13 business debtors to calculate current monthly income by subtracting ordinary and necessary business expenses from gross receipts. In recent decisions, courts have considered whether Part I of Form 22C is inconsistent with 11 U.S.C. § 1325(b)(2), which permits chapter 13 debtors to deduct from their current monthly income amounts necessary to operate their business. The purpose of this article is to describe these contrary approaches and examine their potential impact on debtors.

Background

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) amendments to 11 U.S.C. § 1325(b), a debtor's "disposable income" is the debtor's "current monthly income" less amounts reasonably necessary to be expended by the debtor. 11 U.S.C. § 1325(b)(2). Current monthly income is the monthly average of income that a debtor has received in the six calendar months before filing.[1] That figure is multiplied by 12 to calculate the debtor's annualized current monthly income. For debtors whose annualized current monthly income exceeds the state median family income figure issued by the Census Bureau for the debtor's state and household size, the amounts reasonably necessary to be expended are calculated in accordance with the means testing provisions contained in 11 U.S.C. § 707(b)(2)(A) and (B). 11 U.S.C. § 1325(b)(3).

Upon objection to confirmation by the chapter 13 trustee or an unsecured creditor, the

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[1] Under the statutory definition of current monthly income, average includes income from all sources, even if not taxable, and amounts paid by an entity other than the debtor (or the debtor's spouse, if a joint case) on a regular basis for household expenses of the debtor, dependents, and, if a joint case, the debtor's spouse, assuming that the debtor's spouse is not a dependent. The average does not include benefits under the Social Security Act, or payments received as a terrorism, war crimes, or crimes against humanity victim. 11 U.S.C. §101(10A); *see also* 2005-2008 Committee Note on Forms 22A, 22B, & 22C at 9.

debtor must pay all projected disposable income to unsecured creditors during the plan's applicable commitment period. 11 U.S.C. § 1325(b)(1). The applicable commitment period for above-median income chapter 13 debtors is not less than five years. 11 U.S.C. § 1325(b)(4)(A)(ii). The applicable commitment period for below-median income debtors is three years. 11 U.S.C. §1325(b)(4)(A)(i).

All chapter 13 debtors complete Official Form 22C. Using Form 22C, debtors calculate their current monthly income (Part I of Form 22C) and the plan's applicable commitment period (Part II of Form 22C). Int. Fed. R. Bankr. P. 1007(b)(6). Above-median income chapter 13 debtors also use Form 22C to calculate the section 707(b)(2)(A) and (B) deductions to determine monthly disposable income (Parts III & IV of Form 22C). *Id*.

On line 3 of Form 22C, debtors list their income from the operation of a business, profession or farm. Line 3b of Form 22C allows the deduction of ordinary and necessary business expenses from gross receipts that are listed on line 3a of the form. The deduction of these expenses "above the line," i.e., in the calculation of current monthly income, avoids an anomalous result by netting out income used to pay ordinary and reasonable business expenses in calculating whether the debtor's applicable commitment period is three or five years.

The *Wiegand* Approach

In *Drummond v. Wiegand (In re Wiegand)*, 386 B.R. 238 (B.A.P. 9th Cir. 2008), the Bankruptcy Appellate Panel for the Ninth Circuit concluded that a chapter 13 debtor may not deduct business expenses from gross receipts to calculate current monthly income, and that Part I of Official Form 22C is inconsistent with 11 U.S.C. § 1325(b)(2).[2] The *Wiegand* Court's rationale for calculating current monthly income may have significant impact on debtors. In particular, the court's approach, which is at variance with the Census Bureau's use of net business income amounts to calculate median income figures, may force debtors to complete the entirety of Form 22C, and may subject many self-employed debtors to a five-year applicable commitment period.

______In *Wiegand*, the court concluded business expense deductions were authorized under 11 U.S.C. § 1325(b)(2)(B), and had to be subtracted from current monthly income when calculating disposable income under 11 U.S.C. § 1325(b)(2). Based on this conclusion, the court stated that, to the extent that Part I of Form 22C requires a business debtor to calculate current monthly income by subtracting ordinary and necessary business expenses from gross receipts, Part I of

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[2] Other courts have joined in this debate. *See, e.g.*, *In re Sharp*, No. 07-7222, 2008 WL 3925450, *6 (Bankr. C.D. Ill. Aug. 21, 2008)(following *In re Wiegand*); *In re Bembenek*, No. 08-22607, 2008 WL 2704289, *2 (Bankr. E.D. Wis. July 2, 2008) (following *In re Wiegand*); *In re Arnold*, 376 B.R. 652 (Bankr. M.D. Tenn. July 3, 2007) (preceding *In re Wiegand* but reaching same conclusion); *but see In re Featherstone*. Nos. 07-60296-13, 07-60441-13 (Bankr. D. Mont. Sept. 28, 2007)(holding that business expenses are subtracted in calculating current monthly income for determination of the applicable commitment period).

Form 22C is inconsistent with § 1325(b)(2).

Section 1325(b)(2), upon which the *Wiegand* court based its decision, is a pre-BAPCPA provision of chapter 13 that has been retained, in significantly altered form, by BAPCPA. One part of the revised section, 11 U.S.C. § 1325(b)(2)(B), provides that the disposable income of a debtor engaged in business should be calculated by deducting from the debtor's income "expenditures necessary for the continuation, preservation, and operation of such business." *See* 11 U.S.C. § 1325(b)(2)(B). In relying on the statutory language in this section, the court in *Wiegand* translated income to mean gross receipts because, as the court stated, "[i]f business expenses are deducted from gross receipts to determine a chapter 13 debtor's current monthly income, then there would be no need for § 1325(b)(2)(B), which provides for the same deductions." *In re Wiegand*, 386 B.R. at 242.

The *Weigand* court also took note of the fact that the Bankruptcy Code defines "current monthly income" but does not define "income." *See In re Wiegand*, 386 B.R. at 242. In examining the definition of current monthly income found at 11 U.S.C. § 101(10A), the court concluded that the language "without regard to whether such income is taxable income" evinced Congressional intent that tax code concepts did not apply when determining current monthly income. *Id*. Furthermore, because Congress explicitly imported Internal Revenue Service standards into 11 U.S.C. § 707(b)(2), but not into the definition of current monthly income, and because there was no "plain language" reference to deductions in the definition, ordinary and necessary business expenses were not intended to be deducted from gross receipts. *Id*.

The court in *Wiegand* concluded by proposing that, until Form 22C is changed, in addition to other approaches, above-median debtors might fill out the remainder of Form 22C and use the Internal Revenue Standards under 11 U.S.C. §§ 1325(b)(3) and 707(b)(2)(A)(ii)(I) for "Other Necessary Expenses," as discussed in the Internal Revenue Service Financial Analysis Handbook. *See In re Wiegand*, 386 B.R. at 243, n.11.

The *Wiegand* approach is arguably problematic. Section 707(b) permits debtors to deduct their "actual monthly expenses for the categories specified as Other Necessary Expenses" by the Internal Revenue Service. *See* 11 U.S.C. § 707(b)(2)(A)(ii)(I). The Internal Revenue Service, however, does <u>not</u> list business expenses as a specific category. *See Internal Revenue Manual*, Financial Analysis Handbook § 15.15.1.10, *available at* http://www.irs.gov/irm/part5/ch15s01 (stating that other expenses "may be considered if . . . they must be for the production of income" but not listing business expenses in a table of 15 "expense items"). Therefore, it appears that, because business expenses are not listed as a specific category, chapter 13 debtors may not deduct their business expenses under "Other Necessary Expenses" as the court advised. The Official Form 22C avoids this problem because it requires debtors to calculate current monthly income by subtracting ordinary and necessary business expenses from gross receipts.

The court in *Wiegand* raised the worthy concern that using net business income to determine a debtor's current monthly income might result in chapter 13 debtors deducting the same expenses twice – once when using Official Form 22C to calculate current monthly income, and again to determine disposable income under 11 U.S.C. § 1325(b)(2) or (3). *See In re*

Wiegand, 386 B.R. at 241; *see also In re Arnold*, 376 B.R. 652, 654 (Bankr. M.D. Tenn. 2007). When it approved Official Form 22C, the Advisory Committee on Bankruptcy Rules recognized that using net business income to determine a debtor's current monthly income created a redundancy with section 1325(b)(2)(B)'s instruction to subtract business expenses from current monthly income to calculate disposable income. Official Form 22C addresses this problem for above-median income debtors by instructing debtors not to deduct, in Part IV of Official Form 22C, any business expenses that they have already deducted to calculate business income on Line 3 of the form. With respect to chapter 13 debtors who are at or below the median income, the need to avoid the double deduction of ordinary business expenses applies equally. The chapter 13 trustee is well positioned to object if an above- or below-median income debtor claims a double deduction for any category of expenses.

The *Weigand* and *Arnold* Courts did not go so far as to articulate a reason why Congress would require a debtor with income from the operation of a business, profession or farm to use a gross income figure for purposes of calculating the applicable commitment period. The court in *In re Dugan*, 2008 WL 3558217 (Bankr. D. Kan. August 12, 2008), faced a similar issue when it was asked to determine whether income of a non-filing spouse that is not made available to pay for household expenses of a chapter 13 debtor should be included in current monthly income for purposes of calculating the applicable commitment period. Likewise, the *Dugan* court found no reason for including such income, and concluded that "the additional income of a spouse is completely irrelevant if that spouse's income is not made available to cover household expenses so that the debtor has more money available to make the plan payment." *Id*. at p. 4. Similarly, receipts from the operation of a business, profession or farm that the debtor uses to pay operating expenses are not available for plan payments by a debtor with business income.

There are persuasive reasons for the Official Form approach of including ordinary and necessary business expense deductions in the calculation of current monthly income. First, to determine whether a debtor is above- or below-median income level, which determines the applicable commitment period, a debtor will compare annualized current monthly income to the Census Bureau's median income figures under 11 U.S.C. § 1325(b). In fact, the Judicial Conference of the United States approved and published, effective January 1, 2008, amended Official Forms 22A, 22B and 22C to provide that current monthly income should include only net business expense amounts. *See* Lines 4 and 5 on Official Form 22A; Lines 3 and 4 on Official Form 22C. This decision was made to be consistent with the usage in the Internal Revenue Manual and the American Community Survey of the Census Bureau.[3] The Census Bureau's median income figures are based on net business and rental income.[4] Therefore,

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[3] *See* 2005-2008 Committee Note on Forms 22A, 22B, & 22C at 9. The Internal Revenue Manual permits taxpayer entities to reduce their income by "deducting expenses paid to earn that income." *See Internal Revenue Manual*, Financial Analysis Handbook § 15.15.1.13, *available at* http://www.irs.gov/irm/part5/ch15s01 (last visited Aug. 14, 2008).

[4] *See, e.g.*, U.S. Census Bureau, *Income, Earnings, and Poverty Data from the 2006 American Community Survey* at 13, http://www.census.gov/prod/2007pubs/acs-08.pdf (last visited Aug. 14, 2008) (instructing that net income be reported after deducting expenses).

following the *Wiegand* approach to calculating current monthly income would result in an inconsistent "apples to oranges"comparison of the debtor's income figure based on gross business receipts with the Census Bureau's median income figures, which are based on net income amounts.

Second, the use of gross receipts for self-employed debtors would lead to distinctions in the calculation of current monthly income based merely on the business form under which the debtor has chosen to operate. Under the *Wiegand* approach, a self-employed debtor with gross business receipts of $250,000 will be above the applicable median family income of any state, even if she has a net income of only $40,000. If that same debtor instead were operating her business as an LLC and taking a salary of $40,000, she would most likely be below her state's median family income. Although not addressing this specific argument, the *Wiegand* court observed that the result it reached was not absurd "because the Code is replete with rules and requirements that impact sole proprietors differently than wage earners." *Id.* at 243.

From a debtor's perspective, there are also administrative reasons for preferring the Official Form rationale. As discussed, the *Wiegand* approach requires that ordinary and necessary business expenses be deducted by debtors "below the line," i.e., <u>after</u> the calculation of current monthly income. Consequently, whether business expenses are deducted to calculate current monthly income or disposable income determines the applicable commitment period. If business expenses are deducted to calculate a debtor's current monthly income, then a debtor's current monthly income will be more likely to be below-median income and enable the debtor to qualify for a shorter three-year applicable commitment period. Thus, under the *Wiegand* approach, the inability to deduct business expenses when calculating current monthly income may cause otherwise below-median income chapter 13 debtors to be above-median, which would unnecessarily require such debtors to complete the <u>entirety</u> of Form 22C in order to calculate the amounts reasonably necessary to be expended in accordance with sections 707(b)(2)(A) and (B). Moreover, this approach mandates a five-year, instead of a three-year, applicable commitment period.

There is no parallel to 11 U.S.C. § 1325(b)(2)(B) in chapter 7 cases. However, if the *Wiegand* rationale for determining current monthly income were extended to chapter 7 cases, a larger number of Chapter 7 debtors, unable to deduct ordinary and necessary business expenses from gross receipts, would be considered above-median debtors. As a result, the presumption of abuse under the means test would arise more often, unless debtors could show that their business expenses fit into the Internal Revenue Service categories of "Other Necessary Expenses," which are permitted under 11 U.S.C. § 707(b)(2). These subparagraphs point to Internal Revenue Service expense standards and expense categories that include only personal and household, rather than business, expenses. As a result, many below-median income debtors with income from a business, profession or farm would nonetheless be required to complete the more burdensome expense portion of the means test – Official Form 22A, which is applicable to chapter 7 debtors. Official Form 22A avoids this problem because it reaches the reasonable conclusion that, for purposes of determining whether a debtor is above or below the applicable median, the income of self-employed debtors should consist of net, and not gross, income.

Conclusion

This article describes two contrary approaches for calculating a chapter 13 debtor's current monthly income, and it examines the potential impact these different methods have on debtors. As the case law in this area continues to develop, practitioners and policy makers alike will have further opportunity to determine whether these contrary approaches have the predicted impact on debtors and whether they achieve results that benefit the bankruptcy system.