Chapter 2: INVOKING BANKRUPTCY RELIEF

Consumer Bankruptcy Choice: Chapter 7 or 13?
[from last class -- Read pages 179-213 in Treatise, and especially 190-203, Code §§ 707(b), 101(10 A), 704(b)]

2. Limits on the Right to Choose: Dismissal for “Abuse” and the Means Test

iii. Expenses

After a debtor’s “current monthly income” is calculated, the next step in the means test is to determine what deductions should be allowed. Perhaps the clearest way to work through the maze of allowable expense deductions is to consult Official Form B22A, Part V (available at http://www.uscourts.gov/rules/BK_Forms_08_Official/B_022A_0108f.pdf). The deductions are subtracted from current monthly income to arrive at the net monthly income that is used as the foundation for the means test presumption of abuse calculation. Obviously, a debtor cannot contribute all of her monthly income to repaying debt; everyone needs something to live on for basic monthly expenses. The primary categories of allowed deductions are:


3. Priority Claims. See § 707(b)(2)(A)(iv), Form B22A, Part V, Subpart C; and


Living expenses are further subdivided into:

(a) IRS Collection Standards. See § 707(b)(2)(A)(ii)(I). See Form B22A, Part V, Subpart A, lines 19-33. The three categories of IRS Standards are:

- National Standards (primarily food, clothing, and out-of-pocket health care) (line 19 on Form B22A);
Local Standards (housing, transportation) (lines 20-24 on Form B22A); and

Other Necessary Expenses (lines 25-32 on Form B22A).

(b) Additional Living Expense Deductions. § 707(b)(2)(A)(ii)(I), (II), (IV), (V). See Form B22A, Subpart B, lines 34-41. Included are such expenses as continuing charitable contributions, educational expenses for minor children (up to $1,650 per year), costs of providing for the care of elderly or disabled household members, home energy costs in excess of the standards, costs to protect against family violence, and food and clothing expenses in excess of the standard.

(a) Living Expenses

For purposes of the means test, Congress decided that the debtor’s allowed living expenses should be those specified in the Collection Financial Standards of the Internal Revenue Service. See http://www.usdoj.gov/ust/eo/bapcpa/20090315/meanstesting.htm. The IRS uses these Standards in setting up payment arrangements with delinquent taxpayers. In the Internal Revenue Manual, § 5.15.1.7, the IRS defines these allowable expenses as those “necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income” and as “the minimum a taxpayer and family needs to live.” (Emphasis added). The underlying premise of the means test, then, is that consumer bankruptcy debtors deserve to be treated like income tax evaders and should live on the minimum necessary expenses for five years as they repay their consumer debts. A corollary concept is that private creditors are entitled to the many of the same rights and benefits the government has in collecting taxes.

What are these Standards the IRS uses? The allowed living expenses fall into three categories:

- National Standards;
- Local Standards, and
- Other Necessary Expenses.

The U.S. Trustee’s office of the Department of Justice now maintains a web site for use in applying the bankruptcy means test, and updates the allowed amounts on a periodic basis. See http://www.usdoj.gov/ust/eo/bapcpa/20090315/meanstesting.htm (applicable to cases filed on or after 3/15/09, and updated periodically). In addition, the Official Bankruptcy Form (B22A) that chapter 7 individual debtors must fill out has a detailed section (Part V, Subparts A and B) that covers the living expense deductions.

One important question in applying the means test is whether debtors are limited to their actual expenses, or whether they may deduct higher amounts as “specified” in the Standards. For the “National Standards” and the “Local Standards,” debtors may use the monthly expense amounts specified by the IRS, even if higher than their actual expenses. Conversely, debtors are limited to their actual monthly expenses for categories under “Other Necessary Expenses.” § 707(b)(2)(A)(ii). The Code states: “The debtor’s monthly expenses shall be the debtor’s applicable monthly expense amounts specified under the National Standards and Local Standards, and the debtor’s actual monthly expenses for the categories specified as Other Necessary Expenses.” § 707(b)(2)(A)(ii)(I).
National Standards

The National Standards establish allowances for food, clothing, and other items. For cases filed on or after March 15, 2009 (and to be updated periodically), see:

http://www.usdoj.gov/ust/eo/bapcpa/20090315/bci_data/national_expense_standards.htm

The amount of these allowances increases with family size. Originally, they also increased with income level, but that distinction was abandoned effective January 1, 2008. There is also a separate national allowance for out-of-pocket healthcare expenses. That allowance is larger for a person who is 65 or older ($144 per month) than for those younger than 65 ($60 per month). See http://www.usdoj.gov/ust/eo/bapcpa/20090315/bci_data/national_oop_healthcare.htm. For families larger than 4 people, a total per-person additional allotment is provided ($262, plus age-appropriate healthcare allowance of either $60 or $144). Under the means test, debtors can add an extra 5% to the National Standards food and clothing allowances, if such an increase is demonstrated to be “reasonable and necessary” – whatever that means! The following table provides the National Standards for a family of 4, all under age 65 (for cases filed on or after 3/15/09):

<table>
<thead>
<tr>
<th>Item</th>
<th>Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>752</td>
</tr>
<tr>
<td>Housekeeping supplies</td>
<td>74</td>
</tr>
<tr>
<td>Apparel &amp; services</td>
<td>244</td>
</tr>
<tr>
<td>Personal care products &amp; services</td>
<td>65</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>235</td>
</tr>
<tr>
<td>Out-of-Pocket Health Care</td>
<td>240</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,610</strong></td>
</tr>
</tbody>
</table>

Local Standards

The next set of IRS standards are the Local Standards. These establish allowances for:

(1) transportation (provided on a regional basis), and

(2) housing and utilities (provided on a county-by-county basis).
This data is also found on the U.S. Trustee website, and can be accessed via drop-down links. For example, the transportation allowance for the Midwest region is found at:

http://www.usdoj.gov/ust/eo/bapcpa/20090315/bci_data/IRS_Trans_Exp_stds_MW.htm

For housing and utilities, an Illinois debtor would look at:

http://www.usdoj.gov/ust/eo/bapcpa/20090315/bci_data/housing_charts/irs_housing_charts_IL.htm

The allowance for housing and utilities has two parts: (1) non-mortgage expenses, and (2) mortgage or rent expenses. These two allowances are further differentiated based on (1) the county the debtor lives in, and (2) family size. Allowances are updated every few months.

In choosing the appropriate region to use for a debtor, the area in which the debtor resides as of the date of the order of relief (i.e., the date the debtor files her bankruptcy petition) is used. To illustrate the importance of where the debtor lives (and the potential for gaming the system via careful pre-bankruptcy planning), consider the following example. The numbers used assume the case was filed on or after March 15, 2009 (and before the next periodic allowance adjustment). A debtor who lives in Cook County, Illinois has a housing allowance for a family of 4 of $2,013 ($611 for non-mortgage or rent expenses, and $1,402 for mortgage or rent costs); for neighboring DuPage County, the allowance is $2,307 – $294 per month higher. So, by moving across the county line, a debtor could insulate an additional $17,640 of income over the 60-month means test calculation period. Such a substantial sum could well make the difference between failing and passing the means test.

The transportation allowance has three components:

(1) ownership costs;
(2) operating costs; and
(3) public transportation costs.

Different caps are set depending on the number of cars the debtor has, up to a maximum of two cars.

**Operating** costs are provided on a regional basis for one or two cars. For example, in the Midwest region, Chicago Metropolitan Statistical Area, the operating allowances are $217 for one car, and $434 for two cars. A debtor who owns a car also may try to claim all or part of the public transportation cost allowance as well, but not as a matter of right; instead, she must prove the actual necessity of using public transportation.

The public transportation cost allowance is established as a national standard of $173 per month (as of March 15, 2009). A debtor who owns no cars may claim that allowance as a matter of right, and without proving any actual expenditures. As just noted, if the debtor does own a car, she could only claim public transportation on proof of actual necessity.

The **ownership** cost is based on a national standard of $489 per car, up to the two-car maximum. Obviously, if a debtor does not own a car, she cannot claim an ownership expense deduction. A significant debate that has arisen with regard to the transportation ownership standard is whether a debtor is entitled to take the ownership deduction even if she owns her car free and clear. The Code provides that the debtor may deduct the “applicable monthly expense amounts specified” under the National and Local Standards. § 707(b)(2)(A)(ii)(I). The first court of appeals case to decide the issue was *In re Ross-Tousey*, 549 F.3d 1148 (7th Cir. 2008), in which the Seventh Circuit held that the debtors could claim the ownership expense deduction.
for a car they owned free and clear. Courts that have gone the other way argue that if the debtor owes nothing on the car, then the Local Standard for ownership is not “applicable.” Note, though, that even for courts in this latter camp, if the debtor owes even a dollar on her car, she would be entitled to claim the full ownership deduction of $489 for that car.

Under the means test, as explained in the next subsection of this book, debtors are entitled to take a deduction for scheduled secured debts in addition to that for the IRS standards. § 707(b)(2)(A)(iii). An important issue is how the secured debt deduction and the ownership cost allowance under the IRS standards interact, if at all. Significantly, § 707(b)(2)(A)(ii), which deals with the allowances pursuant to the Standards, states that “Notwithstanding any other provision of this clause, the monthly expenses of the debtor shall not include any payments of debt.” The most plausible interpretation of this provision is to require the debtor to subtract from IRS living expenses all payments on secured debts that otherwise would fall within the IRS categories. The theory would be that a debtor could not double count: that is, she could not deduct both secured debt payments on a car and the full IRS transportation ownership allowance, or the home mortgage payment and the full housing allowance. Therefore, under this interpretation, a debtor would need to subtract “any payments of debt” from the ownership component of the transportation allowance and from the mortgage portion of the housing allowance. This is the approach taken in Form B22A (see lines 20B, 24).

Of course, recall that a debtor is entitled to the full transportation allowance “specified” in the IRS Standards – even if higher than actual expenses. Thus, if the debtor’s secured debt payment is less than the ownership portion of the Standard, then under the Standard the debtor would get the net balance left after subtracting the secured debt payment. The full secured debt payment then would be subtracted under the secured debt provision. For example, assume debtor owns one car, and thus gets a $489 ownership allowance, and debtor has a $339 monthly secured debt payment on the car. Under the prevailing interpretation of the provision, the debtor then would get: (1) a transportation ownership allowance of $150 ($489 “specified” less secured debt payment of $339), and (2) a secured debt deduction of $339 – for a total of, surprise, $489. Under this view, the debtor would not get both the full transportation ownership deduction of $489 plus the $339 secured debt deduction.

It should be noted that there is a competing view, which argues that secured debt payments do not have to be deducted from the amount “specified” in the standard. See, e.g., Henry J. Sommer, Trying to Make Sense Out of Nonsense: Representing Consumers Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 79 AM. BANKR. L.J. 191, 197-99 (2005). The argument rests on a proffered strict reading of the statutory text (with a dash of policy thrown in). Essentially the pitch is twofold: first, the deduction for secured debt payments is in a separate subsection of § 707(b)(2)(A), and second, the amounts deducted under the Standards are “amounts specified” and are not “payments for debts” and thus do not fall within the prohibition against including any payments for debts. Under this view, the debt payment prohibition would only apply to the “Other Necessary Expenses” Standard, which does not “specify” an amount, but looks to the actual expenses of the debtor. If this view is upheld in the courts (ultimately we do not think it will be, and so far virtually all courts have agreed with us), then in the example in the preceding paragraph, the debtor would get to deduct both the full transportation allowance of $489 and the secured debt payment of $339, for a total of $828.

Other Necessary Expenses
The final category of IRS expenses allowed for use in the means test are those specified as an “Other Necessary Expenses.” Recall that only actual expenses of the debtor in these categories are allowed. No allowance is specified by the IRS. What sorts of expenses fall under “Other Necessary Expenses”? The IRS defines these as “the allowable payments you make to support you and your family’s health and welfare and/or the production of income.” Examples from the Internal Revenue Manual, § 5.15.1.10, and from Form B22A (lines 25-32) include income and social security taxes, involuntary deductions for employment (e.g., mandatory retirement contributions), term life insurance, court-ordered payments (e.g., child support or alimony), child care, health care, education (if required for one to keep her job), education for a disabled child, and telecommunication services. In all categories, the basic requirement is that such expense must be necessary for providing for the health and welfare of the taxpayer and family or aid in the production of income. Note that § 707(b)(2)(A)(ii) specifically provides that “reasonably necessary health insurance, disability insurance, and health savings account expenses” may be deducted. For the “Other Necessary Expenses” category, there is no question that secured debt payments may not be double-counted: there is no “amount specified” under the IRS Standard that otherwise could be allowed without reference to the debtor’s actual expenses.

The bankruptcy judge will have to exercise discretion in determining how much to allow to the debtor as “Other Necessary Expenses.” This is of course necessary, but it flies in the face of one the primary goals of the means test, which was to take discretion out of the hands of the judge and instead institute a mechanical test.

(b) Secured Debts

A debtor is allowed to subtract the average monthly payments on account of secured debts due over the five years a chapter 13 plan would be carried out. First the debtor must compute the total payments scheduled as contractually due to secured creditors in the 60 months following the date of the petition, and then add payments necessary to retain her primary residence, motor vehicle, and any other necessary property. The second category is usually payments to cure arrearages. That total is divided by 60 to give the average monthly payments for secured debts. § 707(b)(2)(A)(iii).

The deduction for secured debts in calculating the means test is understandable, since the Bankruptcy Code allows secured creditors to insist on full payment out of their collateral in chapter 13. Here again, given the premise of the means test to sort out of chapter 7 those debtors who could succeed under chapter 13, the test must take the realities of chapter 13 into account. The problem that arises is one of perverse incentives. The debtor may be rewarded for having large amounts of secured debt by getting a break on the means test.

Imagine a case of two debtors. In all regards but one they are identical: their current monthly income is the same; they are allowed the same monthly expense deductions; their priority claim deductions are the same; they even have the same amount of unsecured debt. However, the first debtor has more secured debt than the second. In this hypothetical, assume that the first debtor passes the means test because of her higher level of secured debt, but the second debtor, with less secured debt, does not. Thus, the debtor with less debt is the one found to be a presumed abuser!

In applying the means test, the bankruptcy judge is not asked to examine the circumstances under which the debtor incurred secured debt, or to question the amount of that secured debt. Such inquiries would only arise in a general good faith or “totality of the circumstances” assessment under § 707(b)(3). The reported cases do indicate that a high level of secured debt is
a factor often taken into account by a bankruptcy judge in dismissing a chapter 7 case as an abuse under the totality or bad faith test of § 707(b)(3).

A debtor might try several strategies to help her pass the means test. First, she could take on additional secured debt in the months before bankruptcy. Second, the debtor could choose to pay down her unsecured debts, at the expense of her secured debts, leaving her with more secured debt when the means test is computed. Finally, the debtor could choose to let payments on her primary residence or motor vehicle lapse, since she could subtract any arrearages in the calculation of her secured debt.

(c) **Priority Claims**

A debtor is allowed to subtract expenses for payment of all priority claims (including priority child support and alimony claims). The amount is determined by summing the total payments on priority debt owed and dividing by 60. § 707(b)(2)(A)(iv). The logic and problems associated with the priority claim deduction are similar to those for secured debt. Recall that priority claims are the first paid among unsecured claims after the satisfaction of secured claims. These claims cover payments of domestic support obligations, administrative expenses, and pre-petition taxes, among other things. A chapter 13 plan can be confirmed only if it provides for the full payment of priority claims. § 1322(a)(2). For the means test to be a fair assessment of the debtor’s ability to pay unsecured creditors in chapter 13, debtors have to be allowed to deduct of such payments.

The problem again is one of perverse incentives. A debtor who is considering filing chapter 7 and whose net income is close to the margin for triggering the presumption of an abuse might choose not to pay priority claims, paying her unsecured debt instead. Such actions would reduce the amount of unsecured debt that applied in the means test while increasing the allowable deduction for priority debts. A disturbing consequence, then, is that a debtor with significant alimony or child support debt – the very sorts of debts Congress cares most should be paid – might put off paying those very debts in order to pass the means test!

(d) **Chapter 13 administrative expenses**

A debtor who is eligible for chapter 13 (viz., an individual debtor with regular income and debt below the debt ceilings) also can deduct the actual administrative expenses of administering a chapter 13 case in the district where the debtor resides. The U.S. Trustee’s office publishes on its website schedules of permissible chapter 13 expenses. See: [http://www.usdoj.gov/ust/eo/bapcpa/20090315/bci_data/ch13_exp_mult.htm](http://www.usdoj.gov/ust/eo/bapcpa/20090315/bci_data/ch13_exp_mult.htm)

The debtor is capped at deducting 10 percent of the projected plan payments, § 707(b)(2)(A)(ii)(III), but a smaller percentage may be scheduled, depending on the judicial district. For example, in Illinois, debtors in the Central District are permitted the full 10%, but debtors in the Northern District are only allowed 6.8%. This deduction makes sense, as a test motivated by a desire to move “can-pay” debtors into chapter 13 must take into account the realities of a chapter 13 case.
Note on Charitable Contributions.

When the court is determining whether to dismiss a case because of either the presumption of abuse in § 707(b)(2) or general abuse under § 707(b)(3), “the court may not take into consideration whether the debtor has made, or continues to make” charitable monetary contributions to a qualified religious or charitable organization. § 707(b)(1). Exactly how the debtor’s charitable contributions are figured into the means test is unclear, as such expenses are not explicitly included as any sort of deduction in the means test calculations. Form B22A simply includes a line (line 40) for the deduction in the “Additional Living Expense Deductions.” Note that the statutory exclusion does not specify any limit on the amount of charitable contributions a debtor may make for means test and dismissal purposes.

As an example, assume that for purposes of the means test the applicable trigger payment amount was $10,000 (under § 707(b)(2)(A)(i)), and the debtor had net monthly income of $250, not including charitable contributions. Without more, this debtor would fail the means test (multiplying 60 months times $250, she has $15,000 in repayment capacity, which is more than the “abuse” trigger amount of $10,000). Assume now that this debtor contributes $150 a month to her church. The court, when examining the case of such debtor, apparently would not be allowed to dismiss the case for presumption of abuse. Why? The court can only view the debtor’s net monthly income as $100 a month, not $250, because of the debtor’s charitable contribution. Multiplying this new net monthly income figure of $100 by 60 gives $6,000, less than the applicable $10,000 trigger, meaning that the debtor now passes the means test.

Problem 2.8

Debtor’s monthly paycheck includes deductions for the following items. She wants to know if the expense is deductible under the means test.

a.. Income tax withholding
b. Term life insurance
c. Mandatory contribution of 8% of salary to state retirement plan
d Voluntary contribution to 401(k) retirement plan.
e.. Charitable contribution to United Way
Problem 2.9

When Debtor files chapter 7, she owns a Ferrari automobile. How much can she deduct under the means test with regard to her ownership of the Ferrari in the following cases:

a. She has 60 remaining payments of $900 per month
b. She has 10 remaining payments of $900 per month
c. She has 60 remaining payments of $300 per month
d. She owns the car free and clear

Problem 2.10

Debtor and his spouse live alone. First, two of their grown children, who have lost their jobs, move back into the house. Then Debtor’s 80-year old mother moves in. At the end of his rope, Debtor files chapter 7. How much can Debtor deduct as living expenses under the National Standards?

Problem 2.11

Debtor owes alimony and child support payments of $3,000 per month to his ex-wife. For a year prior to filing chapter 7, Debtor does not make any of the required alimony and child support payments, and thus owes her $36,000 when he files. May Debtor take any deductions on the means test for the unpaid alimony and support debt? If so, how much?