

INTERNAL REVENUE SERVICE

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MEMORANDUM FOR ASSOCIATE AREA COUNSEL
(SMALL BUSINESS / SELF-EMPLOYED) CC:SB:1:BRK

FROM: LAWRENCE H. SCHATTNER
Chief, Branch 2
(Collection, Bankruptcy & Summonses)

SUBJECT: Estate of [REDACTED]:
Deductibility of Administrative Expenses of Bankruptcy Estate

On March 21, 2001, you requested our advice on whether expenses of administering a Chapter 7 bankruptcy estate are properly deducted "above the line," or whether they should instead be deducted as an itemized deduction. As is discussed below, we believe that these administrative expenses can be deducted from gross income, "above the line."

ISSUE: Is the trustee of a Chapter 7 bankruptcy estate entitled to deduct expenses of administering the estate "above the line," as a deduction from gross income pursuant to I.R.C. § 67(e), or is he or she limited to deducting the expenses as an itemized deduction subject to the two-percent "floor" imposed on miscellaneous deductions pursuant to I.R.C. § 67(a)?

CONCLUSION: Section 67(e) applies to the administrative expenses of an individual debtor's estate in bankruptcy. Therefore, deductions for expenses that would not have been incurred if the property were not held by the bankrupt estate are allowable in arriving at adjusted gross income.

LAW AND ANALYSIS: I.R.C. § 1398 allows for special tax treatment for individuals who are in bankruptcy pursuant to Chapter 7 or Chapter 11 of the Bankruptcy Code. Section 1398(c)(1) sets forth the general rule that the taxable income of the bankruptcy estate is computed in the same manner as it is computed for an individual. Section 1398(e)(3) states that, except as otherwise provided in this section, the determination of whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if the amount were paid or incurred by the debtor.

Section 1398(h)(1) provides, in pertinent part:

Any administrative expense allowed under section 503 of title 11 of the United States Code, ... to the extent not disallowed under any other provision of this title, shall be allowed as a deduction.

I.R.C. § 1398(h)(1). ^{1/}

Gross income is defined in I.R.C. § 61(a) as all income from whatever source derived, except as otherwise provided. Section 62(a) defines adjusted gross income as gross income minus the deductions listed in that subsection. Section 63(d) provides that itemized deductions are the deductions allowed under this chapter, other than the deductions allowed in arriving at adjusted gross income (i.e., those listed in Section 62(a)) and personal exemptions.

Section 67(a) provides that, for an individual taxpayer, miscellaneous itemized deductions are allowed only to the extent that the aggregate of such deductions exceeds two percent of gross income. Section 67(b) lists the itemized deductions that are not miscellaneous itemized deductions and thus not subject to the two-percent floor. Administrative expenses are not specifically listed in Section 62(a) or Section 67(b). Therefore, absent another provision, such expenses would be treated as miscellaneous itemized deductions and would be subject to the two-percent floor. However, Section 67(e) provides that deductions for costs paid or incurred in connection with the administration of an estate or trust that would not have been incurred if the property were not held in such trust or estate shall be treated as allowable in arriving at adjusted gross income.

In In re Miller, 252 B.R. 110 (Bankr. E.D. Tex. 2000), a bankruptcy court decided the issue you present in favor of the trustee, holding that no reason exists to render the Section 67(e) exception inapplicable to administrative expenses associated with bankruptcy estates. In Miller, the Service argued that bankruptcy estates are not encompassed by the “estates and trusts” contemplated by Section 67(e) and that, accordingly, the Section 67(e) exception should be viewed as inapplicable to bankruptcy estates. The court rejected this argument, however, reasoning that the Service’s interpretation of the statute was inconsistent with a plain reading of its language. The court, in addition, noted that including costs incurred by bankruptcy estates among those deductible under Section 67(e), by effectively reducing the

^{1/} B.C. § 503 specifies certain types of expenditures associated with the administration of a bankruptcy estate which are “allowed” in, or payable through, the bankruptcy case itself.

amount on which trustees are required to pay income taxes, actually is consistent with Congress's stated objective "to maximize distributions to creditors whose rights have been altered as a result of the filing of a bankruptcy case." 2/

Other decisions have upheld the Service's position that administrative expenses constitute itemized deductions. See, e.g., In re Sturgill, 217 B.R. 291 (Bankr. D. Oregon 1998)(court determined that administrative expenses were miscellaneous itemized deductions rather than business expenses of the estate, but did not address Section 67(e)). See also Pettigrew v. United States, 1999 Bankr. LEXIS 1797 (Bankr. N.D. Georgia 1999)(parties did not dispute deductibility of administrative expenses as itemized deductions). However, none of these decisions has addressed the applicability of Section 67(e) to these expenses. Moreover, the legislative history of Section 1398, which was added to the Internal Revenue Code by the Bankruptcy Tax Act Of 1980, is of no assistance in this regard. Thus, our opinion is that Section 67(e) applies to the administrative expenses of an individual debtor's estate in bankruptcy so that the deductions for expenses that would not have been incurred if the property were not held by the bankruptcy estate are allowable in arriving at adjusted gross income. 3/

Thank you for requesting our advice on this matter. Our response has been coordinated with the Office of Associate Chief Counsel (Income Tax & Accounting). If you require further assistance, please call 202-622-3620.

cc: Associate Chief Counsel (Income Tax & Accounting)
Attention: Sean M. Dwyer

2/ In Miller, the Service also argued that deductibility under Section 1398(h) should be viewed as limited by Section 1398(e)(3), maintaining that since administrative expenses could not have been deducted by the debtor (since they would not have existed before the bankruptcy petition was filed), they should not be deductible by the bankruptcy trustee. The bankruptcy court held that Section 1398(h), and not Section 1398(e)(3), applies when the amount at issue constitutes an administrative expense of a bankruptcy estate.

3/ In Mellon Bank v. United States, 47 Fed. Cl. 186 (Cl. Ct. 2000), the court held that fees for investment advice paid by trusts were subject to Section 67(a), and that Section 67(e) did not apply because the taxpayers could not establish that the fees would not have been incurred if the property were not held in trust. However, in O'Neill v. Commissioner, 994 F.2d 302 (6th Cir.1993), the Sixth Circuit held that because the trustee lacked experience in investment matters and was required to meet fiduciary duties imposed by state law, the investment advisory fees would not have been incurred if the property were not held in trust. Thus, according to the Sixth Circuit, a trust or estate may deduct payments of investment advisory fees in full under Section 67(e).