

# CRS Report for Congress

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## Bankruptcy Reform: The Means Test

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### Summary

Consumer bankruptcy reform legislation — S. 256 and H.R. 685 — is again before the Congress. A key provision of the current bills, which seek to address abuse of the bankruptcy process, is to make petitions for debt relief under Chapter 7 subject to a means test. Bankruptcy petitioners with relatively high incomes could be prevented from filing under Chapter 7 (where many unsecured debts are discharged, or wiped out, by the court) and instead given the choice of converting to Chapter 13 (where some debt must be repaid out of future income) or having their petitions dismissed and receiving no bankruptcy relief at all. The means test takes into account the petitioner's income, debt burden, and allowable living expenses, which can vary significantly according to the debtor's place of residence and particular circumstances. If income minus allowable living expenses exceeds certain levels, a Chapter 7 petition is presumed to be abusive. This report sets out the details of the means test calculation. (For a general overview of bankruptcy reform legislation, see CRS Report RL32765, *The "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," S. 256, in the 109<sup>th</sup> Congress*, by Robin Jeweler.)

This report will be updated if the means test provisions are amended or if different versions are proposed.

Virtually all consumer bankruptcies are either Chapter 7 or Chapter 13 cases. Chapter 7 is the most common form of bankruptcy, accounting for 72% of non-business filings in fiscal 2004, or over 1.1 million cases. In Chapter 7, the debtor's assets are liquidated and distributed among creditors, and many remaining debts are discharged, or cancelled, leaving the debtor free to make a fresh start. (Some debts are not dischargeable, and secured debts like mortgages are not affected by bankruptcy.) In practice, most Chapter 7 filings are "zero asset" cases, where unsecured creditors get nothing. (Several types of assets are exempt from liquidation and cannot be distributed to creditors.)

In Chapter 13 bankruptcies, debtors with regular incomes agree to a plan to pay back some or all of their debt over a period of several years. At the plan's conclusion, remaining debts are discharged. An advantage of Chapter 13 for debtors is that a wider

range of debts can be discharged than under Chapter 7. If the debtor is unable to complete the series of payments required by the Chapter 13 plan, the case may be dismissed or converted to Chapter 7. Upon dismissal, remaining debts are not discharged, unless the court finds that the debtor cannot justly be held accountable for failure to complete the plan, and creditors have received at least the amount of repayment they would have received under a Chapter 7 filing. Under current law, the choice of chapters is left to the debtor.

Supporters of reform have long argued that the “excessive generosity”<sup>1</sup> of the current bankruptcy system encourages abuse and allows some debtors to repudiate debts that they can afford to repay, at least in part. The bankruptcy reform bills respond to these concerns by restricting access to Chapter 7 in cases where debtors’ income is determined to be sufficient to repay some debt, after allowing for reasonable living expenses. The means test set out in Title I of S. 256 and H.R. 685 would determine eligibility for Chapter 7 relief. Debtors who “passed” the means test would either have their Chapter 7 petitions dismissed or converted to Chapter 13 or Chapter 11.<sup>2</sup> (Conversion would not occur without the debtor’s consent, but no other form of bankruptcy relief would be available.)

## **The Basic Test**

Under the proposed means test, a Chapter 7 filing is presumed to be abusive if the debtor’s monthly income, reduced by numerous allowances and living expenses (discussed below), and multiplied by 60 (that is, over a five-year period), is greater than \$10,000. If income thus adjusted is less than \$6,000, there is no presumption of abuse, and the debtor is free to choose Chapter 7. If adjusted income is between \$6,000 and \$10,000, abuse is presumed only if income exceeds 25% of nonpriority, unsecured debt in the case. An abusive Chapter 7 filing is subject to dismissal or conversion.

## **Living Expenses and Allowances**

A key determinant in whether a debtor passes the means test is the amount by which actual monthly income<sup>3</sup> is reduced by various allowances and living expenses. The bills set out several categories of allowable monthly expenses.

Debtors’ monthly expenses are calculated primarily by referring to a set of allowances established by the Internal Revenue Service (IRS) that are used to help determine a taxpayer’s ability to pay a delinquent tax liability.<sup>4</sup> The allowances, which the IRS calls Collections Financial Standards, set out monthly living expenses in three

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<sup>1</sup> See testimony of Todd J. Zywicki before the Senate Committee on the Judiciary hearing on S. 256, Feb. 10, 2005.

<sup>2</sup> Chapter 11 is used primarily in business reorganizations. It is rarely used by individuals because of its complex and expensive procedural requirements.

<sup>3</sup> “Current monthly income,” as defined in the bills, includes nontaxable income and payments from third parties (such as alimony or child support) but excludes Social Security benefits.

<sup>4</sup> In other words, the IRS will take all the taxpayer’s disposable income except for these allowances. See [<http://www.irs.gov/individuals/article/0,,id=96543,00.html>]

basic categories: (1) food, clothing, and other items; (2) housing and utilities; and (3) transportation. The allowable living expenses are subject to several variables.

In the food, clothing, and other<sup>5</sup> category, the IRS sets out living expenses that vary according to the size of the household and gross monthly income. For example, a single person with a gross income of \$832/month would be allowed \$403 in living expenses, while a family of four earning \$5,834/month would be allowed \$1,564 for expenses in this category. These amounts are uniform across the contiguous 48 states; higher schedules are provided for Alaska and Hawaii.

The allowance for housing and utilities varies according to size of household and geographical location. The standards provide separate dollar figures for each county in the nation, for households of one or two, three, and four or more persons. A single person living in Wilkinson County, in southwest Mississippi, would be allowed to deduct \$774/month, while a family of four in Manhattan would be allowed \$4,799.

The transportation standards provide regional allowances,<sup>6</sup> with variations for persons living in any of 28 specified metropolitan areas. Allowable living expenses include ownership costs (\$475 for one car, an additional \$338 for a second car) and operating costs (or public transportation costs, for those with no car). Operating or public transportation allowances range from \$161 per month for nondriving Pittsburghers to \$479 for New York City residents with two cars.

These allowances are not reduced if actual expenditures are less than the standard. In some cases, the IRS recognizes actual expenses that exceed the standards; under S. 256 and H.R. 685, a debtor's monthly expenses may include actual expenses in categories specified as Other Necessary Expenses by the IRS for the area in which the debtor resides.

Beyond the IRS allowances, the reform legislation would permit current income to be reduced by several other types of expenses. Reasonable and necessary expenses to maintain the safety of the debtor's family from family violence (as identified under Section 309 of the Family Violence Prevention and Services Act) are recognized. (These expenses would normally be for counseling services.)

In addition, monthly expenses for purposes of the means test may include:

- reasonable and necessary spending to care for an elderly, chronically ill, or disabled member of the debtor's immediate family or household;
- actual expenses for the primary or secondary education of a dependent child (under age 18), up to \$1,500 per child per year;
- home energy costs in excess of the IRS housing and utility standards, with proper documentation and justification;

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<sup>5</sup> "Other items" include housekeeping supplies, personal care products and services, and miscellaneous.

<sup>6</sup> The regions are Northeast, Midwest, South, and West.

- average monthly payments on secured debts (most commonly home mortgages and car loans);
- average monthly payments on priority claims (e.g., child support, student loans, alimony, etc.); and
- administrative costs incurred in a Chapter 13 bankruptcy plan.

Finally, a debtor may claim higher monthly expenses if special circumstances exist that require additional expenditures. To establish special circumstances, the debtor must itemize such expenses and explain in detail why each of them is reasonable and necessary.

Given the number of factors that may reduce monthly income for purposes of the bankruptcy means test, it is clear that simple gross income is not a good indicator of whether a debtor will be allowed to file Chapter 7. Because some of the allowable expenses can be very large in dollar terms (e.g., support for the elderly or infirm), it is not difficult to imagine hypothetical cases in which a debtor with a relatively high money income would be allowed to make a fresh start under Chapter 7, while a lower-income filer might have to choose between Chapter 13 and dismissal. Other provisions of the reform legislation address this potential disparity by creating safe harbors for lower-income individuals and households.

## **Safe Harbor Provisions for Below-Median Income Households**

Under S. 256 and H.R. 685, a motion must be filed in bankruptcy court to dismiss or convert a Chapter 7 petition. Who may bring such a motion would depend on the debtor's income.

The bills provide that if the debtor's income exceeds the median family income (adjusted for household size) as calculated by the Bureau of the Census for the applicable state, any party in interest, including a creditor, may bring an abuse motion under section 707(b).

If the income of the debtor (or debtor and spouse, in a joint filing) is less than or equal to the median family income (taking household size into account) for the applicable state, only the judge or a bankruptcy trustee or administrator may file a motion to dismiss or convert a Chapter 7 petition.

If the *combined* income of the debtor and the debtor's spouse is equal to or less than the state median income for a single-earner household (again adjusted for household size), no motion to dismiss or convert may be filed.