COMMENTS

WILLAMETTE LAW REVIEW

40:3 Summer 2004

A DEBT, OR NOT A DEBT, THAT IS THE QUESTION: CLASSIFICATION OF PENSION AND RETIREMENT LOANS IN CHAPTER 13 BANKRUPTCY

MISTY M. WILLITS*

> debt: a legally enforceable obligation to pay a fixed or determinable sum of money at a future date. The debt must be genuine in that from the outset, the lender must intend to seek repayment, rather than to engage in a transaction out of friendship, affection, or so forth.[1]
>
> expense: outlay or cost. Expenses are classified into those that are a *current expense* nature and those that must be *capitalized* (or added to *inventory*), and further classified into those that are of a *nondeductible* personal, as opposed to being of a *gain*-seeking or otherwise *deductible*, nature.[2]

A debt has an obligation to repay a set sum of money and an expense has no such obligation. However, the treatment and classification of pension loans in Chapter 13 bankruptcy has blurred this distinction.

When a Debtor, who has borrowed from his retirement fund and now owes unpaid loan balances, files for bankruptcy under Chapter 13, the unpaid balances are most often treated not as debts, but as expenses; the loan payments are lumped into the same category as expenditures for rent, food, and clothing. These loans, taken for a variety of reasons—but subject to very strict limitations—are usually treated as debts up to the time that the Debtor files for bankruptcy under Chapter 13. At that point, they are transformed into expenses, and are most often disallowed to prevent unfair discrimination against the Debtor's unsecured creditors, who are compensated from the Debtor's disposable income. When the expenses are disallowed, the outstanding balance of the loan is now subject to setoff against the remaining balance in the Debtor's retirement plan.

Such treatment by the bankruptcy system has three far-reaching implications. First, the Debtor is subject to taxes and penalties for early withdrawal, and reduction of the funds available at retirement. Second, the retirement plans face the possible loss of tax qualification of the entire plan from the early distribution of retirement funds as a result of the setoff. Third, litigating the question of whether these loans will be allowed in the bankruptcy consumes resources and time better spent elsewhere. While the Debtor may not be able to avoid the adverse effects, clarification of the debt/expense analysis can largely eliminate most of the litigation surrounding this question.

Part II discusses the definitions, distinctions, and inconsistencies of the terms [illegible]

ance available to the Debtor at retirement is potentially reduced by approximately $67,000.[8] Furthermore, the tax consequences to the participant as a result of the early distribution would result in penalties and income tax that would need to be paid out of the participant's current year salary as an increased withholding.[9] The result is, in fact, a decrease in the amount of disposable income available to general creditors, since the withholding will come out of gross income before the reasonable and necessary expense calculation under § 1325(b) of the Bankruptcy Code.

8. This figure is arrived at using the average outstanding balance of $6,644 owed by a Debtor with thirty years left until retirement, calculated at an interest rate of eight percent. Calculating the future value of money, Future Value = Present Value $(1 + r)^n$ [where r is the interest rate, and n is the number of periods of deferral].

9. There is a ten-percent penalty imposed on the early distribution, in addition to the income tax owed on the distribution amount.