COMMENTS

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

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> 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]

I. INTRODUCTION

The distinction between debt and expense seems simple enough.

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1. WG&L TAX DICTIONARY 161 (2002-2003).
2. *Id.* at 257.

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 *debt* and *expense* within the bankruptcy system; the disposable income test in § 1325(b) of the Bankruptcy Code and how the concept of debt versus expense has been distorted. It also demonstrates how the application of the test has altered the definition of debt, and contrasts this new definition with the tax treatment of debts and expenses. Further, this part discusses the disparate treatment of pension loan equity and home equity in the bankruptcy sphere.

Part III covers the development of the debt versus expense debate in bankruptcy law, and why and how pension loans should be properly treated as debts. Part IV lays out the timeline in a bankruptcy proceeding and considers some practical options. Part V gives a brief background of the Chapter 13 process and discusses the history of how pension loans have been treated within that system, including the flaws in the analysis of the leading cases. It also briefly

discusses the Internal Revenue Code requirements for tax qualifications of retirement plan systems.

Part VI covers equitable subordination of claims under § 510(c) of the Code, and how this section is a suitable solution to the treatment of pension and retirement loans in Chapter 13 bankruptcy cases. This Part proposes that retirement loan repayments be classified as debts, but subordinated under § 510(c) to avoid unfairly discriminating against the Debtor's unsecured creditors. Admittedly, this solution would not necessarily benefit the individual Debtor, but it would "tidy up" the classification and plan development process, thus greatly reducing the litigation costs involved in Chapter 13 bankruptcy.

The ramifications of bankruptcy treatment of retirement plan loans has the potential to become a large problem due to the greater number of American workers with retirement plans and their increasing ability to take loans from those plans. According to the Employee Benefit Research Institute (EBRI), by the end of 2001, approximately 64.9 million of the 150.9 million American workers participated in some type of employer- or union-sponsored pension or retirement system.[3]

In a study of 401(k) plans for the same year, the EBRI found that 45 million workers held 401(k) plans with approximately $1.75 trillion in assets.[4] Approximately sixteen percent of eligible participants had outstanding loan balances at the end of 2001.[5] The average outstanding loan balance at the end of 2001 was $6,644,[6] with a median loan balance of $3,659.[7] This translates to 7.2 million workers with outstanding loan balances for a median aggregate of approximately $26.3 billion.

Using the EBRI 2001 statistics for outstanding loan balances, if the balance of the loan is not allowed as a claim, the resulting loss to Debtor is not merely the $6,644 he is not permitted to repay. The bal-

3. *Employment-Based Retirement and Pension Plan Participation: Geographic Differences and Trends*, April 2003 Brief Executive Summary No. 256, *available at* http://www.ebri.org/ibex/ib256.htm (last visited July 5, 2003). According to the same study, 83.5 million worked for an employer or union that sponsored some type of pension or retirement plan.

4. Sarah Holden & Jack VanDerhei, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2001*, at 3 (March 2003), *available at* http://www.ebri.org (on file with author).

5. *Id.* at 4.

6. *Id.* at 13.

7. *Id.* at n.35.

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.