



# Veterans' Benefits and Bankruptcy

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Although federal law entitles veterans to certain types of [monetary benefits](#)—such as [compensation for disabled veterans](#) injured in the line of duty—these benefits are [not always enough](#) to satisfy veterans' financial needs and obligations. Statistics from the U.S. Census Bureau indicate that the veteran poverty rate has [increased 8.7%](#) in recent years, and that [close to half](#) of disabled veterans between the ages of 55 and 64 are below the poverty line.

One way that a veteran facing particularly difficult financial circumstances may potentially obtain relief from certain debts is by filing for [bankruptcy](#). However, bankruptcy relief comes at a cost: a debtor must ordinarily [sacrifice](#) some of his income or his assets to satisfy the claims of his creditors in whole or in part. As relevant here, depending on the circumstances, a veteran [may need to relinquish](#) some of his [veterans' benefits to his creditors](#). Existing bankruptcy law thus treats veterans' benefits [less favorably](#) than [social security benefits](#), the latter of which the Bankruptcy Code [insulates from the claims of creditors](#) under specified circumstances.

[Several commentators](#)—as well as some [Members of Congress](#)—have advocated [amending the Bankruptcy Code](#) to make it easier for debtors to [shield veterans' benefits](#) from creditors. [Proponents](#) of such an amendment [argue](#) that “benefits paid to veterans through the Department of Veterans Affairs” should be treated no differently in bankruptcy “than benefits received by individuals from the Social Security Administration.” As discussed below, these proposals raise complex legal questions.

This Sidebar surveys the legal issues surrounding the treatment of veterans' benefits in bankruptcy. After providing an overview of the U.S. bankruptcy system, the Sidebar analyzes how veterans' benefits are treated in the two most common types of bankruptcy proceedings for individual debtors. The Sidebar concludes by discussing proposals to modify the treatment of veterans' benefits in bankruptcy and identifies pertinent considerations for Congress when developing and debating such proposals.

## Background on Bankruptcy Law

One way that an individual may potentially obtain relief from debts he cannot repay is by filing for [personal bankruptcy](#). “A [central purpose](#) of” bankruptcy law “is to provide a procedure by which insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy ‘a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.’” To fulfill that purpose, the federal [Bankruptcy Code](#) allows certain debtors to “[discharge](#)”—that is, eliminate his obligation to repay—some or all of his debts if he satisfies certain statutory prerequisites. [In](#)

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[exchange](#) for that discharge, however, the debtor must relinquish either a subset of his assets or a portion of his future income to his creditors.

The Bankruptcy Code creates a [menu](#) of different types of bankruptcy proceedings that a debtor may potentially utilize, each with its own [eligibility requirements](#) and substantive and procedural characteristics. Two of those types of proceedings are especially relevant for individual debtors:

- Liquidation proceedings under [Chapter 7](#) of the Bankruptcy Code; and
- Debt adjustment proceedings under [Chapter 13](#).

As explained below, whereas a veteran who declares bankruptcy under Chapter 7 may (subject to certain caveats) be able to protect his veterans' benefits from his creditors, under certain circumstances a veteran who declares bankruptcy under Chapter 13 may be required to relinquish some of his benefits before he may obtain a discharge.

## Veterans' Benefits in Chapter 7

"Chapter 7 allows an individual who is overwhelmed by debt to obtain a '[fresh start](#)' in the form of discharge of most types of debts by surrendering for distribution" some of "his or her . . . property" to a trustee. "The trustee then sells the property . . . and [distributes the proceeds](#) to the debtors' creditors." With [few exceptions](#), a discharge under Chapter 7 [absolves](#) an individual debtor of his responsibility to repay any portion of the debts that remains unpaid after the trustee has distributed those proceeds.

Although Chapter 7 requires the debtor to relinquish some of his assets in partial satisfaction of his creditors' claims, it is [not intended](#) to leave the debtor destitute. [Section 522](#) of the Bankruptcy Code permits individual debtors to shield certain "property which is [necessary for the survival](#) of both the debtor and the debtor's family" [from their creditors](#). The Bankruptcy Code's exemption scheme is [highly intricate](#). [Section 522\(d\)](#) first creates a number of [federal bankruptcy exemptions](#) that allow debtors to shield their interests in a [variety of assets](#), such as residential property, motor vehicles, clothes, household goods, and the debtor's "right to receive" certain government benefits. At the same time, however, [Section 522](#) [also](#) empowers the states to [prohibit](#) their citizens from claiming those federal exemptions. Many states have exercised this "[opt-out](#)" power, thereby forbidding their citizens from claiming the federal bankruptcy exemptions in [Section 522\(d\)](#). A debtor who lives in an opt-out state may therefore claim property as exempt only to the extent that [state or federal nonbankruptcy law](#) insulates such assets from the claims of creditors. A debtor who lives in a *non-opt-out* state, by contrast, can [choose](#) between either the federal exemptions in [Section 522\(d\)](#) *or* the exemptions available under state law and nonbankruptcy federal law. Critically, a debtor in a non-opt-out state [may not mix and match](#) those exemptions; he must choose either the exemptions available under [Section 522\(d\)](#) or those available under state and federal nonbankruptcy law.

As relevant here, several federal laws permit Chapter 7 debtors to claim their entitlement to veterans' benefits as exempt assets. If the debtor lives in a state that permits its citizens to claim the federal bankruptcy exemptions (i.e., a non-opt-out state), he may exempt his "right to receive . . . a veterans' benefit" by invoking [Section 522\(d\)\(10\)](#). If the debtor instead lives in an opt-out state—or lives in a non-opt-out state but claims the exemptions available under state law and federal nonbankruptcy law—then he may [instead](#) claim veterans' benefits as exempt pursuant to [38 U.S.C. § 5301](#), which provides that "payments of benefits due or to become due under any law administered by the Secretary [of Veterans Affairs] . . . shall be exempt from the claim of creditors."

[Depending on the circumstances](#), however, it may be [unclear](#) whether a Chapter 7 debtor may exempt veterans' benefits he has *already* received, such as unspent benefits he deposited into a bank account before declaring bankruptcy. [Section 522\(d\)\(10\)](#) does not authorize an exemption for "veterans' benefits" *per se*; the provision only entitles a debtor who lives in a non-opt-out state to claim an exemption in his

“*right to receive* . . . a veterans’ benefit.” Courts have [not agreed](#) what this “right to receive” language means. [Some courts](#) have concluded that the “right to receive” an asset does not include the asset itself. Under this interpretation, “once money from an exempt [source] is paid out and placed in a bank account, such money typically [loses its exempt status](#)” under Section 522(d)(10). A debtor who lives in one of these jurisdictions who attempts to claim veterans’ benefits as exempt under Section 522(d)(10) may therefore be unable to exempt benefits he has received in the past. A few other courts, however, have reached the opposite conclusion that the Section 522(d)(10) exemption is [not “limited](#) to payments not yet received when the bankruptcy case was filed.” Under this approach, “a deposit of exempt funds in a bank [does not affect](#) a debtor’s exemption, nor change the exempt character of the fund, so long as the source of the exempt funds is reasonably traceable.” Thus, debtors in jurisdictions that have adopted this alternative interpretation of Section 522(d)(10) may be entitled to shield at least a portion of the veterans’ benefits sitting in their bank accounts from their creditors.

The question of whether a debtor may claim an exemption in veterans’ benefits he has already received [does not arise](#), however, when a debtor invokes the exemption for veterans benefits codified at [38 U.S.C. § 5301](#) as opposed to [Section 522\(d\)\(10\)](#). Unlike Section 522(d)(10), 38 U.S.C. § 5301 explicitly states that veterans’ benefits retain their exempt status even “[after receipt](#) by the beneficiary.” Courts have therefore concluded that “funds in . . . bank accounts traceable to . . . federal veterans benefits [are exempt](#)” if the debtor claims an exemption under 38 U.S.C. § 5301. Because the “selection of one form of exemptions or another is [exclusive](#),” however, a debtor in a non-opt-out state who invokes 38 U.S.C. § 5301’s broad exemption for veterans’ benefits will be disqualified from claiming other federal exemptions codified in Section 522(d).

## Veterans’ Benefits in Chapter 13

Veterans’ benefits do not necessarily receive the same protection in Chapter 13 cases as they do in Chapter 7 cases. Whereas Chapter 7 contemplates that the debtor will partially repay his creditors out of his *existing non-exempt assets*, [Chapter 13](#) contemplates that the debtor will instead partially or completely repay his debts out of his *future income*. Specifically, a Chapter 13 debtor must propose a [plan](#) to pay a portion of his [income](#) to his creditors in regular installments over a [three- to five-year period](#). If that plan does not propose to pay [unsecured creditors](#) in full, and if a party to the case objects, “then the court [may not approve](#) the plan unless” the debtor commits to pay “all of the debtor’s projected disposable income . . . to unsecured creditors” over the duration of the plan.

The Bankruptcy Code [defines “disposable income”](#) to include “income from [all sources](#) that the debtor receives” minus certain [expenses](#) and [exclusions](#) specified by statute. Notably, the Bankruptcy Code explicitly “excludes benefits received under the [Social Security Act](#)” from the [calculation of disposable income](#). The Bankruptcy Code does [not](#), however, contain a comparable exclusion for veterans’ benefits. [Courts](#) have therefore [overwhelmingly](#) concluded that veterans’ benefits [qualify](#) as “[disposable income](#)” that a debtor [may be required to relinquish to his creditors](#) before he may obtain bankruptcy relief under Chapter 13. Significantly, the fact that [Section 522\(d\)\(10\)](#) and [38 U.S.C. § 5301](#) would allow the debtor to claim an exemption in veterans’ benefits ordinarily [does not protect](#) those benefits from the claims of creditors in a Chapter 13 case because the Bankruptcy Code’s [definition of disposable income](#) implicitly [includes](#) income from exempt assets.

## The Means Test

Because veterans’ benefits qualify as “disposable income” for the purposes of Chapter 13, an indebted veteran might prefer to protect his benefits by declaring bankruptcy under Chapter 7 instead. Depending on the circumstances, however, a debtor who receives veterans’ benefits [may be ineligible](#) to proceed under Chapter 7. Because “creditors often [receive more money](#) under successful Chapter 13 plans than

they would under a Chapter 7 liquidation bankruptcy,” Congress has enacted a [provision](#)—known as the “[means test](#)”—intended to [shift](#) consumer debtors [out of Chapter 7](#) and into Chapter 13. If a Chapter 7 debtor’s “current monthly income” reduced by certain allowable expenses [exceeds certain statutory thresholds](#), then the court must (with limited exceptions) either dismiss the debtor’s Chapter 7 case or convert the case to a Chapter 13 proceeding.

The Bankruptcy Code [defines “current monthly income”](#) as “the average monthly income from all sources that the debtor receives.” Although the Bankruptcy Code explicitly “[excludes](#) benefits received under the Social Security Act” from the definition of current monthly income, it contains [no comparable exclusion](#) for veterans’ benefits. A debtor’s entitlement to veterans’ benefits could therefore potentially cause his current monthly income to [exceed the means test threshold](#), thereby rendering him ineligible for Chapter 7 relief. Instead, some veterans may be required to [seek relief under Chapter 13](#), where they may need to [relinquish some of their benefits](#) to creditors for the reasons described above.

The means test does, however, contain a [special exception for veterans](#). [Section 707\(b\)\(2\)\(D\)](#) of the Bankruptcy Code provides that a court “may not dismiss or convert a case based on any form of means testing” if “the debtor is a disabled veteran,” but only if “the indebtedness occurred primarily during a period during which he or she was . . . on active duty.” Veterans who qualify for this exception may therefore be eligible for Chapter 7 bankruptcy [even if](#) their veterans’ benefits cause their current monthly income to exceed the means test threshold. As some commentators have noted, however, this exception to the means test “is narrow, offering [no protection](#) for a veteran” whose indebtedness occurred outside a period of active duty.

## Legal Considerations for Congress

In response to calls to modify the legal principles discussed above, Members of a recent Congress introduced a [legislative proposal](#) to change the way bankruptcy law treats veterans’ benefits. Proposals to treat veterans in bankruptcy more favorably raise a variety of legal questions.

One question is whether—and, if so, how—to alter the Bankruptcy Code’s definitions of “[disposable income](#)” and “[current monthly income](#).” Amending these definitions to exclude veterans’ benefits could [insulate](#) those benefits from the claims of creditors in certain categories of Chapter 13 cases. Excluding veterans’ benefits from the calculation of “current monthly income” could also result in the means test [shifting fewer debtors](#) from Chapter 7 to Chapter 13.

A related question is whether to grant veterans greater flexibility to choose between Chapter 7 and Chapter 13. For instance, Congress could expand [Section 707\(b\)\(2\)\(D\)](#) to exempt a broader subset of veterans from the means testing requirement and thereby reduce the likelihood that veterans for whom Chapter 7 bankruptcy would be most favorable will instead be forced to proceed under Chapter 13.

An additional question is whether to modify [Section 522](#)’s exemption scheme. For instance, Congress could expand [Section 522\(d\)\(10\)](#) to explicitly cover not just “the debtor’s *right to receive* . . . a veterans’ benefit,” but also the proceeds of those benefits so long as those proceeds remain [traceable](#) to an exempt source. Alternatively, Congress could also grant veterans who live in opt-out states greater flexibility to pick and choose between federal bankruptcy exemptions, federal non-bankruptcy exemptions, and state exemptions, thereby allowing veterans to select whichever exemptions are most favorable.

Notably, allowing debtors to shield a larger share of their income or their assets from their creditors would likely decrease the amount of money creditors may recover in bankruptcy. Similarly, granting debtors increased flexibility to select whichever Chapter of the Bankruptcy Code would be most favorable to them might also [decrease total creditor recovery](#).

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