

# Withdrawals from Tax-deferred Retirement Accounts: Included in Current Monthly Income?

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Since the enactment of BAPCPA, there has been an increasing discussion among bankruptcy lawyers as to whether withdrawals from tax deferred retirement accounts should be included in the calculation of “current monthly income” (CMI) for purposes of the “means test” in chapter 7 and in calculating “projected disposable income” in chapter 13 cases. CMI is not what most people would understand to be “current” income. It is neither “current” nor “monthly.” Rather, it is a retrospective average of a subset of the cash the debtor has received over the six months immediately prior to the filing of a bankruptcy case.



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Section 101(10A) of the Bankruptcy Code defines CMI as the “average monthly income from all sources that the debtor receives... without regard to whether such income is taxable income, derived” over a certain six-month period prior to the bankruptcy filing.<sup>1</sup>

In chapter 7 cases, CMI is relevant to the calculation set forth in 11 U.S.C. §707(b)(2). That calculation takes the debtor’s CMI and subtracts certain allowed expenses. If the resulting number exceeds a defined amount, the filing is presumed to be an abuse.<sup>2</sup> If the filing is determined to be an “abuse,” the case must either be dismissed or, with the consent of the debtor, converted to a chapter 11 or 13.<sup>3</sup>

In chapter 13 cases, CMI comes into play in two circumstances. First, if the debtor’s CMI exceeds the applicable median income, the debtor’s projected

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disposable income must be committed for 60 months, or if the plan provides for a shorter commitment period, all claims must be paid in full.<sup>4</sup> Second, the debtor’s CMI is used to calculate the amount of the debtors “projected disposable income.” A debtor must pay all the debtor’s “projected disposable income” into the chapter 13 plan during the applicable commitment period when either an unsecured creditor or the chapter 13 trustee objects to confirmation.<sup>5</sup>

in the calculation of CMI. The Statement makes only two comments that are arguably relevant as to whether withdrawals from retirement accounts should be included in the CMI calculation. In the comment to Line 6, “Pension and retirement income,” the position stated is that CMI includes “all retirement (other than Social Security), including government, 401(k), and IRA.”<sup>7</sup> In the comment to Line 9, “Income from all other sources,” the stated position is: “Whether (the income) meets (the) IRS test for income could be relevant, but whether it is taxable income or non-taxable income is not a factor.”<sup>8</sup> In the few reported cases on the issue that the authors have been able to locate, all are chapter 13 cases, and it has been the chapter 13 trustee who has taken the position that withdrawals from tax deferred retirement accounts are CMI.

## Consumer Corner

### The U.S. Trustee Position



David P. Leibowitz

The U.S. Trustee (UST) has published a document entitled “Statement of the U.S. Trustee Program’s Position On Legal Issues Arising Under the Chapter 13 Disposable Income Test,” a line-by-line summary of the UST’s position on disposable income issues (the statement). Although applicable primarily to chapter 13, the Statement is intended to “reflect an intent to harmonize the chapter 7 means test with the chapter 13 projected disposable income test for above-median debtors.”<sup>6</sup> The Statement does not make a specific statement about whether withdrawals from retirement accounts within the applicable time period should be included

### Yes, It Should Be Included in the CMI Calculation

In *In re Sanchez* and *In re Zahn*, Nos. 06-40886 and 06-40865, 2006 WL 2038616 (Bankr. W.D. Mo. Jul. 13, 2006), the court was faced with two cases with an identical fact situation: The debtors withdrew funds from a 401(k) within the applicable six-month look-back period and failed to include the withdrawals as CMI in the means test. The debtors apparently proposed a plan of less than 60 months. If the withdrawals were included in the calculation of CMI, the debtors’ income would have been above the standard median, and the debtors’ commitment period would either have had to be 60 months, or if shorter, all claims would have to have been paid in full. If the withdrawal were not CMI, the debtors’ CMI would have been less than the standard median, and the debtors’ plan could have been as short as 36 months. The chapter 13 trustee objected to the proposed plan, claiming that the withdrawals should have been included

<sup>1</sup> 11 U.S.C. §101(10B) excepts certain income, such as Social Security, from the definition of CMI.

<sup>2</sup> 11 U.S.C. §707(b)(2)(A)(i).

<sup>3</sup> 11 U.S.C. §707(b)(1).

<sup>4</sup> Code §1325(b)(4)(B). If the debtor’s CMI does not exceed the applicable median income, the commitment period need only be 36 months. 11 U.S.C. §1325(b)(4)(A)(i).

<sup>5</sup> 11 U.S.C. §1325(b)(1). If an unsecured creditor objects, that objection may be overcome if the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim. 11 U.S.C. §1325(b)(1)(A).

<sup>6</sup> [www.usdoj.gov/ust/ea/bapcpa/docs/Disposable\\_Income\\_Ch13\\_UST\\_Policies.pdf](http://www.usdoj.gov/ust/ea/bapcpa/docs/Disposable_Income_Ch13_UST_Policies.pdf) at 1.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 2.

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support of the client or constituency to whom you are presenting your results. Regardless, one should expect a certain amount of back and forth during this phase.

### Phase 5: Recovering Preferences

The preference team should understand that the key to a successful preference process is to have a workable and efficient recovery strategy. Availability of strategies will depend on a number of factors, including (1) how close you are to the expiration of the two-year period within which the debtor must commence avoidance action proceedings and on (2) which constituency—the debtor or the committee—is managing the process. If the committee is managing the process post-confirmation, there may not be much wiggle room in terms of timing and availability of company personnel to assist.

We've seen some estates file hundreds of lawsuits just before the statutory period expires. That's one way to do it. Another way to do it is to develop a process that includes the ability to settle preference claims through the use of demand letters without litigation. Initiating an informal settlement process might require a lot of time from company personnel on the front end, but it has a number of benefits. First, it will help open a settlement dialogue. Second, not only will previous informal discussions make it easier during the actual litigation process, if it comes to that, but it will allow the company to negotiate on its own terms with its critical vendors that may have received preferential payments. Third, an informal settlement strategy is that the parties will be in a position to conduct informal discovery. Fourth, the Code now requires the debtor

to commence preference actions against parties who received less than \$10,000 in jurisdictions in which the defendant's business is located. Adopting an informal settlement process could alleviate the need to pursue preference actions in multiple forums. Finally, well-executed informal settlement programs result in lower administrative costs for the estate.

### Conclusion

The key to any successful initiative is education and communication. Although much of the preference process is conducted through the use of consultants and lawyers, it cannot succeed without the assistance of company personnel and data. Thus, the next time you launch a preference program, consider providing the preference team with a roadmap similar to the one we suggest. ■

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in the CMI calculation, and therefore the plan could not be confirmed.

The court looked at the language of §101(10A) and focused on the words "received" and "derived" (which the court equated to "received"). The court defined "received" as "to come into possession of" or "acquire" and equated "derived" to "received."<sup>9</sup> The court reasoned that because the debtors could not use the retirement funds until the funds were disbursed, therefore, the funds were not "received" or "derived" until withdrawn from the accounts.<sup>10</sup> In spite of the plain language of §101(10A) that whether income is taxable is not relevant to the issue, the court found support for its finding in the fact that the IRS considers withdrawals from 401(k) accounts to be income.<sup>11</sup> The debtors' argument that the funds were income when earned (outside of the six-month look-back), and not when withdrawn, was rejected out of hand by the court.<sup>12</sup>

The court also concluded that §101(10A) must be interpreted broadly because of the broad language contained therein, referring to "income from all sources...."<sup>13</sup> Finally, the debtors did not

argue, and the court did not find, that §101(10A) was ambiguous.<sup>14</sup>

### No, It Should Not

In *In re Wayman*,<sup>15</sup> the debtor withdrew \$13,000 from her IRA and within six months filed a chapter 13 case. She failed to include the withdrawal as income on her means test form, and proposed a 48-month plan that calculated her projected disposable income without regard to the withdrawal. The chapter 13 trustee objected to the plan, arguing that because the withdrawal was taxable in the year the funds were withdrawn, it constituted income to be included in the CMI calculation when withdrawn. The court rejected that argument, citing that portion of §101(10A) that states that whether income must be included in CMI is to be determined "without regard to whether such income is taxable income." The court concluded that the income was actually received when she obtained the funds as part of a divorce settlement.<sup>16</sup> Because that settlement occurred outside of the applicable six-month period, the court held that the withdrawal did not have to be included as income in the CMI

calculation.<sup>17</sup> Interestingly, the court noted that because the debtor received the retirement funds as part of a divorce settlement from her husband's 401(k) in exchange for equity in her former homestead, arguably the debtor did not "receive" income at all, but merely obtained cash equivalent to that property interest.<sup>18</sup>

The court in *Simon v. Zittel*<sup>19</sup> was faced with the same fact situations as in *Sanchez* and *Zahn*: debtors who withdrew funds from tax-deferred retirement accounts within the applicable six-month period and did not include them in the means test, followed by an objection by the chapter 13 trustee to the proposed plan, which did not take the withdrawals into account when calculating the debtors' CMI. The trustee argued that the withdrawals constituted income for purposes of calculating CMI because the funds were defined as "income" by the Internal Revenue Code and taxable upon the withdrawal. The court refused to use the Internal Revenue Code definition of "income" to decide the issue, citing 11 U.S.C. §101(10A), which expressly states that what constitutes CMI

<sup>9</sup> *Sanchez and Zahn* at 2.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 3.

<sup>14</sup> *Id.* at 3.

<sup>15</sup> 351 B.R. 808 (Bankr. E.D. Tex. 2006).

<sup>16</sup> 351 B.R. at 811.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> Case Nos. 07-31616, 07-31805 and 07-31719, 2008 WL 750346 (Bankr. S.D. Ill. March 19, 2008).

is to be determined “without regard to whether such income is taxable income.” The court then reviewed the *Wayman*, *Sanchez* and *Zahn* decisions at some length. The *Simon* court disagreed with the court’s reasoning in the *Sanchez* and *Zahn* cases, finding that a debtor “receives” or “derives” funds deposited into retirement accounts when earned and not when withdrawn. The court, stating that just because “there may be hoops to jump through in order to access” the retirement funds, such did not mean the funds were not available. The court saw no distinction between a debtor receiving income and placing it into a checking or savings account and a debtor depositing that income into a retirement account.<sup>20</sup> Furthermore, the court pointed out that the court’s decisions in *Sanchez* and *Zahn* were based in part on the assumption that the funds were not taxed until withdrawn, when in fact, wages that are deposited into 401(k) tax deferred retirement accounts are subject to social security, Medicare and federal unemployment taxes upon being earned, and it is only the federal income taxes that are deferred. Finally, the trustee also argued that because withdrawals from retirement accounts are not specifically excluded from the definition of CMI by §101(10A)(B) (which excludes Social Security along with certain other income), the withdrawals had to be “income” for purposes of the CMI calculation. Again the court disagreed, stating that this argument presupposes that the withdrawals were income in the first instance. If they were not, then there would be no need to exclude them under §101(10A)(B).

## Conclusion

None of these courts addressed the real issue: whether the six-month look-back period is a proper proxy for future income, either within the plain meaning of the statute or otherwise. While perhaps the premise behind the means test was to force chapter 7 debtors who “make too much money” (as defined by the means test) to convert to a chapter 13 case in order to repay some of their future income to creditors, courts rightfully consider it their responsibility not to think of the sponsors’ intent but rather to look to the text of the statute. The court’s response to the chapter 13 trustee’s argument that the intent of chapter 13 was to force debtors who could pay more to do so was rebutted as follows in *In re Carlton*,<sup>21</sup> where the court stated:

The Court’s role is not one of choosing sides but rather one of following basic rules of statutory construction. A court must give the words of a statute their plain meaning. When the meanings of the words of a statute are plain and unambiguous, a court must enforce the statute according to its own terms. *U.S. v. Ron Pair Enterprises Inc.*, 489 U.S. 235, 241, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989). Similarly, a court must give meaning to each word in a statute and, if at all possible, not construe a statute so as to render some words or phrases meaningless or superfluous. *TRW Inc. v. Andrews*, 534 U.S. 19, 31, 122 S.Ct. 441, 151 L.Ed.2d 339 (2001).

*Given the plain-language textual approach we are instructed to follow by the Supreme Court, there is really no room for a discretionary analysis of text.*

Here, there is a split of authority among the courts, all of which purport to read the “plain meaning” of the text. Obviously, the “plain meaning” is not so plain here. If the premise of a six-month retrospective examination of income is to predict future income, then exigent withdrawals from retirement accounts, particularly retirement accounts not serving to provide periodic income payments for a retiree, could not in any way provide any indication of future income. Specifically, withdrawals within the six-month look-back period frequently result in the exhaustion of funds in the debtor’s retirement account. And if not, the funds remaining are rarely sufficient to allow the debtor to continue making withdrawals in the same amount over the life of a chapter 13 plan. Moreover, early withdrawals from a retirement account always give rise not only to income taxation but excise tax penalties for the early withdrawal.

By contrast, where regular periodic withdrawals have been made from a retirement account and may be expected for an extended period of time, such as in the case of a retiree, withdrawals from the Individual Retirement Account serve the

same function as a pension, and accordingly, inclusion of such periodic payments as an element of CMI would be appropriate, at least for purposes of the chapter 7 means test.

In chapter 7 cases, it may be that withdrawals should be initially considered CMI, and in most cases, the UST would decline to move the court to dismiss under §707(b) simply because the withdrawals skew the means test unfairly against the debtor. If the UST insists on proceeding with a motion to dismiss, the court has the opportunity to deny the motion to dismiss the case under the “special circumstances” provision of §707(b).<sup>22</sup> Therefore, in chapter 7 cases, there are ample protections for the debtor.

Given the plain-language textual approach we are instructed to follow by the Supreme Court, there is really no room for a discretionary analysis of text. CMI was drafted a “black box,” with judges not entitled to exercise discretion. Withdrawals from retirement accounts either are, or are not, CMI. There is no discretion in the Code for a chapter 13 trustee to either consider a retirement account withdrawal as CMI or not to consider it as CMI for purposes of the calculating projected disposable income. Likewise there is no authority in the Code for the court to subtract the withdrawals from CMI in the calculation of projected disposable income.

Some courts have determined that “disposable income,” which is defined partly by CMI, is different from “projected disposable income,” and therefore in chapter 13 cases, the court could find that withdrawals from tax-deferred retirement accounts were not part of “projected disposable income” even if they were “disposable income.”<sup>23</sup> In those courts, debtors are protected from unreasonable inclusion of the withdrawals in the calculation of projected disposable income. However, in courts that consider “disposable income” the equivalent of “projected disposable income,” debtors would be forced to pay what would otherwise normally be exempt retirement funds<sup>24</sup> into a plan, which is not consistent with the policies expressed in §522. “The meaning of a...statute must be determined in the context of the...statutory scheme as a whole.”<sup>25</sup> ■

<sup>22</sup> 11 U.S.C. §707(b)(2)(B). However, it is important to note that in at least one case, a court, albeit in *dicta*, has stated: “Without more, a situation as common as the withdrawal of one’s retirement funds cannot be a ‘special circumstance’ within the accepted definition of this term.” *Eisen v. Thompson*, 770 B.R. 762, 773 (U.S. Dist. Ct. N.D. Ohio, June 29, 2007).

<sup>23</sup> See fn. 7, *Waymans* at 811.

<sup>24</sup> 11 U.S.C. §522(d)(12).

<sup>25</sup> *In re Armstrong*, No. 06-02476-PCW13, 370 BR 323, 327 (Bankr. E.D. Wash. June 12, 2007).

<sup>20</sup> *Id.* at 3.

<sup>21</sup> Case no. 06-71322 (Bankr. C.D. Ill. June 8, 2007).