

# Veterans' Benefits and Bankruptcy

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Federal law entitles veterans to certain types of monetary benefits, such as [compensation for disabled veterans](#) injured in the line of duty. [Recent statistics](#) from the U.S. Census Bureau suggest, however, that many veterans with service-connected disabilities fall below the poverty line. One way that a veteran facing severe financial circumstances may potentially obtain relief from certain debts is by filing for [bankruptcy](#). However, bankruptcy relief comes at a cost: debtors must ordinarily [sacrifice](#) some of their income or assets to satisfy their creditors' claims in whole or in part. From 2005 to [2019](#), the federal Bankruptcy Code commonly required veterans to [relinquish](#) some of their veterans' benefits to their creditors in order to obtain bankruptcy relief. The Bankruptcy Code thereby treated veterans' benefits less favorably than [Social Security benefits](#), which federal law typically [insulates from creditors' claims](#). Last year, however, in response to calls to [amend federal law](#) to [shield veterans' benefits](#) from creditors, Congress enacted the Honoring American Veterans in Extreme Need Act of 2019 ([HAVEN Act, Pub. L. No. 116-169](#)), which modified the legal treatment of certain veterans' benefits in bankruptcy.

This Sidebar surveys 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 bankruptcy cases under Chapters 7 and 13 of the Bankruptcy Code, the two most common types of bankruptcy proceedings for individual debtors. In doing so, the Sidebar describes how the HAVEN Act has altered the legal treatment of certain veterans' benefits. The Sidebar concludes by identifying legal issues that remain unresolved by the HAVEN Act.

## Background on Bankruptcy Law

The federal Bankruptcy Code generally attempts to [balance two competing goals](#). The first goal is to give financially distressed debtors a “[fresh start](#).” As the [Supreme Court](#) has explained, bankruptcy law creates “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 effectuate that fresh start, the Bankruptcy Code allows certain debtors to [discharge](#)—that is, eliminate their obligation to repay—some or all of their debts if they satisfy certain statutory prerequisites. At the same time, the Bankruptcy Code also attempts to promote a second, countervailing goal: creating a fair, orderly, and efficient mechanism through which creditors may recover [as much of their unpaid debts](#) as is feasible. Thus, in exchange for receiving a bankruptcy discharge, the

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debtor must ordinarily [relinquish](#) either a subset of his assets or a portion of his future income to his creditors.

The Bankruptcy Code creates [several different chapters](#)—that is, different types of bankruptcy proceedings—that a debtor may potentially use to obtain relief from debts he cannot fully repay. Each chapter has distinct [eligibility requirements](#) and substantive and procedural characteristics. Two of those chapters are especially relevant for individual debtors facing economic distress:

- [Chapter 7](#), which governs liquidation of a debtor’s assets; and
- [Chapter 13](#), which creates a procedure by which individuals with regular income may adjust their debts through a repayment plan.

Each of these chapters treats veterans’ benefits slightly differently.

## Veterans’ Benefits in Chapter 7

A liquidation proceeding under Chapter 7 empowers eligible individuals to obtain a discharge of many of their debts by surrendering some of their property to a [trustee](#). The trustee then sells that property and [distributes the proceeds](#) to the debtor’s creditors. With [limited exceptions](#), after the trustee has distributed those proceeds, the debtor is [no longer obligated](#) to repay any portion of his debts that remain unpaid.

Although Chapter 7 requires the debtor to sacrifice 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 numerous 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 states to prohibit their citizens from claiming those federal exemptions. Many states have exercised this “opt-out” power to forbid 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.

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 under [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. The answer to that question may depend on which exemption statute the debtor has invoked. [Section 522\(d\)\(10\)](#), for instance, 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 a debtor receives money from an exempt source and places it in a bank account, that money is generally **no longer exempt** under Section 522(d)(10). A debtor who attempts to claim veterans' benefits as exempt under Section 522(d)(10) in one of these jurisdictions 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 may cover unspent benefit payments the debtor received before filing for bankruptcy. 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 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** instead of the Section 522(d)(10) exemption. 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 deposited in bank accounts that are traceable to federal veterans' benefits qualify as 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 cannot claim other federal exemptions codified in Section 522(d).

## Veterans' Benefits in Chapter 13

**Chapter 13** of the Bankruptcy Code similarly allows individual debtors to obtain a discharge of many of their debts. However, 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*. To that end, 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 his projected disposable income to unsecured creditors over the duration of the plan.

For the purposes of Chapter 13, "**disposable income**" includes "income from **all sources** that the debtor receives" minus certain statutorily specified **expenses** and **exclusions**. One example of such an exclusion is **Social Security benefits**, which the Bankruptcy Code exempts from the definition of disposable income. Until Congress enacted the HAVEN Act, the Bankruptcy Code **did not include** a comparable exclusion for veterans' benefits. Courts therefore **overwhelmingly** concluded that veterans' benefits **qualified** as "**disposable income**" that debtors generally needed to relinquish to their creditors before they could obtain Chapter 13 relief. The HAVEN Act, however, **created a new exemption** from disposable income for certain veterans' benefits, such as disability benefits and combat-related injury compensation. Chapter 13 debtors therefore **no longer need** to surrender those benefits to their creditors when their bankruptcy plan does not pay unsecured creditors in full.

## The Means Test

The HAVEN Act may also affect whether particular debtors file for bankruptcy under Chapter 13 or Chapter 7. Because Chapter 7 ordinarily allows debtors to obtain a discharge more quickly than Chapter 13, many (but not all) debtors **would prefer** to file under Chapter 7, especially if their debts significantly outweigh their assets. However, because creditors typically **receive more money** in Chapter 13 cases than in Chapter 7 liquidations, Congress has enacted a **provision** known as the "**means test**" that shifts certain 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 (with limited exceptions) the means test requires the court to 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" minus certain statutorily specified exclusions, such as Social Security benefits. Until Congress enacted the HAVEN Act, veterans' benefits were [not among the enumerated exclusions](#) from current monthly income. Thus, under prior law, veterans' benefits could cause debtors' current monthly income to exceed the means test threshold, thereby forcing them to file for bankruptcy under Chapter 13 when they might prefer Chapter 7. The HAVEN Act, however, amended the definition of "current monthly income" to [exclude certain veterans' benefits](#), such as disability benefits and combat-related injury compensation. As a result, those types of benefits, standing alone, will [no longer disqualify](#) debtors from Chapter 7 relief.

Notably, the [HAVEN Act](#) also retained [11 U.S.C. § 707\(b\)\(2\)\(D\)](#), which establishes a [special exception](#) from the means test for disabled veterans. Section 707(b)(2)(D) [provides](#) that if the debtor is a disabled veteran who incurred the indebtedness that he seeks to discharge while he was on active duty, the court "may not dismiss or convert" his bankruptcy case "based on any form of means testing." Veterans who qualify for this exception may therefore be eligible for Chapter 7 bankruptcy [even if](#) their current monthly income exceeds the means test threshold. However, this exception to the means test does not protect veterans whose indebtedness occurred outside a period of active duty.

## Legal Considerations for Congress

Although the [HAVEN Act addressed calls](#) to exempt certain veterans' benefits from the statutory definitions of disposable income and current monthly income, it also raises interpretive questions that bankruptcy courts or Congress may need to resolve in the future. Courts may have to consider, for instance, whether (or to what extent) the HAVEN Act applies [retroactively](#). Although [at least one court](#) has noted that it is not immediately clear whether the HAVEN Act applies to pending bankruptcy cases filed [before the act became law](#), that court has suggested (without deciding) that it does.

Additionally, while the HAVEN Act modified the treatment of certain veterans' benefits under Chapter 13 and the means test, it left [Section 522's](#) exemption scheme [unchanged](#). Congress may thus consider changing the treatment of veterans' benefits in Chapter 7 cases as well. For example, 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 the debtor may trace them to an exempt source. Doing so could potentially provide more uniform treatment of veterans' benefits in Chapter 7 cases no matter where the debtor resides or which set of exemptions the debtor selects. 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.

Apart from these legal considerations, Congress may also want to evaluate the HAVEN Act's practical consequences. By allowing veterans who declare bankruptcy to retain a greater portion of their income and affording veterans greater freedom to invoke Chapter 7 when liquidation would be more economically advantageous, the HAVEN Act recalibrates the balance between providing debtors a fresh start and maximizing creditor recovery. Thus, by benefiting certain classes of debtors, the HAVEN Act may [reduce the amount of money](#) that certain creditors recover through the bankruptcy process.

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