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U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT**

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**UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT**

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|-----------------------------|---|--------------------------|
| In re: |) | BAP No. CC-04-1133-PMaMo |
| |) | |
| ELIZABETH MARIE HOWE, |) | Bk. No. SV 02-11958-GM |
| |) | |
| Debtor. |) | Adv. No. 03-01186-GM |
| |) | |
| <hr/> | | |
| EDUCATION CREDIT MANAGEMENT |) | |
| CORPORATION, |) | |
| |) | |
| Appellant, |) | |
| |) | |
| v. |) | |
| |) | O P I N I O N |
| ELIZABETH MARIE HOWE, |) | |
| |) | |
| Appellee. |) | |
| |) | |
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Argued and Submitted on
September 22, 2004 at Pasadena, California

Filed - January 6, 2005

Appeal from the United States Bankruptcy Court
for the Central District of California

Honorable Geraldine Mund, Bankruptcy Judge, Presiding

Before: PERRIS, MARLAR and MONTALI, Bankruptcy Judges.

1 PERRIS, Bankruptcy Judge:

2

3 The issue in this appeal is whether the bankruptcy court erred
4 in granting the debtor a partial discharge of her student loan debt
5 pursuant to § 523(a)(8).¹ Because the bankruptcy court applied an
6 incorrect standard in determining whether the debtor could maintain
7 a minimal standard of living if forced to repay her student loans,
8 we REVERSE and REMAND.

9

FACTS

10 From 1991 through 1995, Elizabeth Marie Howe ("debtor") was
11 enrolled in a master of fine arts program, concentrating on film
12 production, at Loyola Marymount University. Debtor financed her
13 graduate education with student loans. At the time of trial, the
14 aggregate unpaid principal and interest due on the notes currently
15 held by Education Credit Management Corporation ("creditor") was
16 approximately \$81,019.22.

17 After filing her chapter 7 petition, debtor initiated an
18 adversary proceeding to determine the dischargeability of her
19 student loan debt. The bankruptcy court announced its decision on
20 the record at the conclusion of the trial. The court found that
21 debtor met her burden of proving that excepting the total debt from
22 discharge would be an undue hardship. The court discharged all of
23 debtor's student loan debt except for \$36,000, ordering that debtor
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¹ Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330.

1 pay that amount, without interest, at the rate of \$100 a month for
2 thirty years.

3 Creditor timely appeals.

4 ISSUE

5 Whether the bankruptcy court erred in granting a partial
6 discharge of debtor's student loan debt.

7 STANDARDS OF REVIEW

8 A decision that student loans impose an undue hardship is a
9 legal question to be reviewed *de novo*, but the factual findings
10 underlying that decision are reviewed for clear error. In re
11 Rifino, 245 F.3d 1083, 1086-87 (9th Cir. 2001); Brunner v. N.Y.
12 State Higher Educ. Servs. Corp., 831 F.2d 395, 396 (2d Cir. 1987).

13 DISCUSSION

14 Section 523(a)(8) provides that a bankruptcy discharge does not
15 discharge a debtor from a qualifying student loan debt, unless
16 excepting the debt from discharge would impose an undue hardship on
17 the debtor.² A debtor must satisfy the following three-part test to
18 establish undue hardship:

19 (1) that the debtor cannot maintain, based on current income
20 and expenses, a "minimal" standard of living . . . if forced to
21 repay the loans; (2) that additional circumstances exist
22 indicating that this state of affairs is likely to persist for
a significant portion of the repayment period of the student
loans; and (3) that the debtor has made good faith efforts to
repay the loans.

24 ² The parties stipulated that debtor's student loan debts
25 were "made, insured or guaranteed by a governmental unit, or made .
26 . . . under a program funded in whole or in part by a governmental
unit or nonprofit institution within the meaning of 11 U.S.C.
§ 523(a)(8)." Stipulation of Admitted Facts and Exhibits for Trial,
¶ I.8.

1 In re Rifino, 245 F.3d 1083, 1087 (9th Cir. 2001)(quoting Brunner v.
2 N.Y. State Higher Educ. Servs. Corp., 831 F.2d 395, 396 (2d Cir.
3 1987)). If a debtor proves that the undue hardship test is met as
4 to only a portion of the debt, a court can, as it did here,
5 partially discharge the debt. In re Saxman, 325 F.3d 1168, 1173
6 (9th Cir. 2003).

7 Creditor argues that debtor did not satisfy any prong of the
8 applicable three-part test, and thus that the bankruptcy court erred
9 in allowing a partial discharge of debtor's student loan debt. We
10 conclude that the bankruptcy court applied an incorrect standard in
11 evaluating whether debtor could maintain a minimal standard of
12 living if she was forced to repay her student loans. The second and
13 third prongs of the undue hardship test presuppose that a debtor has
14 satisfied the first prong. Therefore, the bankruptcy court will
15 need to reevaluate whether the requirements of the second and third
16 prongs are satisfied if, after applying the correct standard, it
17 determines that debtor cannot maintain a minimal standard of living
18 if forced to repay her student loans.

19 We have rejected a rule "that a person must fall below the
20 Poverty Guidelines to discharge a student loan[.]" In re
21 Nascimento, 241 B.R. 440, 445 n.4 (9th Cir. BAP 1999). See also 4
22 Lawrence P. King, COLLIER ON BANKRUPTCY ¶ 523.14[2] (15th ed. Rev.
23 2003)("[T]he federal poverty level is too strict a standard for
24 measuring whether the debtor's standard of living is at a minimal
25 standard level and should not be employed for that purpose.").
26 Creditor's attorney conceded at oral argument that a minimal

1 standard of living under § 523(a)(8) is something better than that
2 afforded under the federal poverty guidelines.

3 However, although the bankruptcy court suggested to the
4 contrary in its findings, a minimal standard of living under
5 § 523(a)(8) does not equate to a middle class standard of living.³

6 The *Brunner* standard meets the practical needs of the debtor by
7 not requiring that he or she live in abject poverty . . .
8 before a student loan may be discharged. On the other hand,
9 the *Brunner* standard safeguards the financial integrity of the
10 student loan program by not permitting debtors who have
11 obtained the substantial benefits of an education funded by
12 taxpayer dollars to dismiss their obligation merely because
13 repayment of the borrowed funds would require some major
14 personal and financial sacrifices.

15 In re Faish, 72 F.3d 298, 305-06 (3d Cir. 1995).

16 Application of the first prong of the undue hardship test
17 requires an examination of a debtor's current finances. Id. at 305.
18 The meaning of a "minimal standard of living" must be determined
19 "'in light of the particular facts of each case.'" In re Cota, 298
20 B.R. 408, 415 (Bankr. D. Ariz. 2003)(quoting In re Afflitto, 273
21 B.R. 162, 170 (Bankr. W.D. Tenn. 2001)). The bankruptcy court
22 concluded that "the Internal Revenue Service Collection Financial
23 Standards [("The IRS Standards")] establish what is a minimal
24 standard of living and Plaintiff only has \$100.00 a month in income
25 above what the IRS Standards provide[.]" Judgment, at 2. The
26 bankruptcy court erred both in its application of the IRS Standards
to Debtor's finances and in simply adopting the IRS Standards,

³ The bankruptcy court stated as follows: "I don't think
it's the intent of Congress to force middle class people into
poverty in order to repay student loans." Transcript of January 15,
2004 Trial, 96:4-6.

1 rather than conducting an individualized analysis of debtor's
2 expenses as is required by § 523(a)(8).

3 A. *Description of the IRS Standards*

4 The IRS Standards are used in determining a taxpayer's ability
5 to pay delinquent taxes in two distinct contexts: (1) in determining
6 the rate at which delinquent taxes must be paid under installment
7 agreements, and (2) in determining the amount of delinquent taxes
8 that will be written off in connection with determining whether to
9 accept a taxpayer's offer in compromise. See 26 U.S.C. § 7122; 34
10 AM.JUR.2D FEDERAL TAXATION ¶ 70361 (2004). However, allowable expenses
11 are viewed more restrictively in compromise cases than in
12 installment cases. See Priv. Ltr. Rul. 99-48-028 (December 3,
13 1999).

14 The IRS Standards, which can be found at
15 www.irs.gov/individuals/article/0,,id=96543,00.html (July 27, 2004),
16 were developed to ensure that a taxpayer would have "adequate means
17 to provide for basic living expenses." 26 U.S.C. § 7122(c)(2)(A);
18 In re Ivory, 269 B.R. 890, 906 (Bankr. N.D. Ala. 2001).

19 Allowable expenses include those expenses that meet the
20 necessary expense test. The necessary expense test is defined
21 as expenses that are necessary to provide for a taxpayer's and
22 his or her family's health and welfare and/or production of
income. The expenses must be reasonable. The total necessary
expenses establish the minimum a taxpayer and family needs to
live.

23 Internal Revenue Manual 5.15.1.7 (2004).

24 The IRS Standards consist of three categories of expenses. The
25 first category is the National Standards for Allowable Living
26 Expenses ("the living expense allowance"), which is based on income

1 level and family size. The living expense allowance covers five
2 types of expenses: food, housekeeping supplies, apparel and
3 services, personal care products and services, and miscellaneous.
4 The second category is the Local Housing and Utilities Allowable
5 Living Expenses ("the housing and utility allowance"), which is
6 based on county of residence and family size. The final category is
7 the Local Allowable Living Expenses for Transportation ("the
8 transportation allowance"), which "consist[s] of nationwide figures
9 for monthly loan or lease payments referred to as ownership costs,
10 and additional amounts for monthly operating costs broken down by"
11 location. IRS Standards.

12 The IRS Standards have some flexibility. Necessary expenses
13 are determined according to the facts and circumstances of a
14 particular case. 26 U.S.C. § 7122(c)(2)(B). Officers and employees
15 of the IRS are instructed to depart from the IRS Standards if
16 adherence to them would result in a taxpayer having inadequate means
17 to provide for basic, necessary living expenses. Id.; 34 AM.JUR.2D
18 FEDERAL TAXATION ¶ 70361. Thus, necessary expenses may include
19 expenses other than, or in excess of, those set forth in the IRS
20 Standards. As is particularly relevant in this case, health care
21 expenses may be allowed if necessary to the health or welfare of the
22 taxpayer. See Internal Revenue Manual 5.15.1.10.

23 B. *Application of the IRS Standards to Debtor*

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1 Debtor's net monthly income is \$3,172. Her monthly expenses
2 are \$3,626.⁴ Exhibit D. Under the IRS Standards (as of July 27,
3 2004), debtor's maximum living expense allowance is \$722, her
4 maximum housing and utility allowance is \$1,539, and her maximum
5 transportation allowance is \$824. These three numbers total \$3,085.
6 The difference between debtor's income and the maximum expenses
7 allowed under the IRS Standards set forth above is \$87. The
8 bankruptcy court apparently rounded this number up in determining
9 that debtor has \$100 available each month to pay on her student
10 loans. There are a number of problems with the bankruptcy court's
11 reliance on and application of the IRS Standards in this case.

12 First, while the IRS Standards allow taxpayers the total living
13 expense allowance without regard to the amount actually spent, the
14 housing and utility and transportation allowances are limited to the
15 lesser of the maximum allowance amounts or the amounts a taxpayer
16 actually spends. In this case, the bankruptcy court allowed debtor
17 the maximum amounts allowed under the IRS Standards for housing and
18 utility and transportation expenses, even though debtor's actual
19 expenditures for these expenses are less than the maximum amounts
20 permitted under the IRS Standards.

21 Second, the bankruptcy court erred in its application of the
22 IRS Standards by not considering debtor's medical expenses. Debtor
23 was diagnosed with major depression in 1999. Her budget includes
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25 ⁴ Debtor's estimated monthly expenses at the time of trial
26 were \$638 more than those shown in her Schedule J. Debtor explained
that her expenses increased, because she no longer has health
insurance.

1 expenses totaling \$943⁵ for psychotherapy and medication for
2 depression and other medical conditions. Debtor testified that she
3 has a \$454 deficit each month, and that she makes ends meet by
4 juggling expenses and doing without necessities, specifically
5 including health care and prescription drugs for her depression.

6 As the bankruptcy court noted in its ruling, there was no
7 evidence that debtor's medical expenses were unnecessary or
8 excessive. See Transcript of January 15, 2004 Trial, 99:6-8. We
9 reject creditor's argument that a minimal standard of living under
10 § 523(a)(8) does not encompass necessary healthcare expenses.

11 Nothing in the record suggests that the bankruptcy court found
12 debtor's budget unreasonable. In fact, the bankruptcy court stated
13 in its oral ruling that debtor's "total expense picture is fine."⁶
14 Transcript of January 15, 2004 Trial, 97:18. Even so, the court
15 determined that debtor had a monthly surplus of \$100 based solely on
16 the amount by which her income exceeds the maximum amounts allowed
17 under the living expense, housing and utility, and transportation
18 allowances.

19 The following chart demonstrates how the bankruptcy court erred
20 in applying the IRS Standards, and the impact of consideration of
21 debtor's healthcare expenses:

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23 ⁵ There is a \$15 addition error in the subtotal for
24 prescriptions in Exhibit D.

25 ⁶ While one can argue, as creditor does, that \$50 per month
26 for internet and \$140 per month for pet expenses is not necessary,
the argument is academic in this case, given that debtor's expenses
exceed her income by \$454 per month.

| IRS Category | Debtor's Actual Expense (per Ex. D) | IRS Maximum | Amount Permitted by IRS |
|-----------------------------|--|--------------------|----------------------------|
| Living Expense Allowance | Food \$589 Laundry 12 Tax software 5 Personal care 80 Clothing 25 Cats 140 Total <u>\$851</u> | \$722 | \$722 |
| Housing & Utility Allowance | Rent \$1000 Maintenance & miscellaneous 20 Brush clearance 8 Utilities 314 Total <u>\$1342</u> | \$1539 | \$1342 ⁷ |
| Transportation Allowance | Car payment \$203 Insurance 100 License, registration 13 Oil changes 20 Other service 13 Repairs 50 Gas 91 Total <u>\$490</u> | \$824 | \$287 ⁸ |
| Sub-total | \$2683 | \$3085 | \$2351 |
| Medical | \$630 | Actual & Necessary | \$630 |
| Prescriptions | \$313 | Actual & Necessary | \$313 |
| Total | \$3626 | \$4028 | \$3294 |

⁷ IRS Standards permit the lesser of actual expenses or maximum amount allowed for housing and utility expenses.

⁸ IRS Standards permit the lesser of actual expenses or maximum amount allowed for transportation expenses. In addition, the IRS Standards would not allow the \$203 car payment savings account allowed by the bankruptcy court, because debtor is not actually making a car payment.

1 C. *The Role of the IRS Standards in Undue Hardship Determination*
2 *under § 523(a)(8)*

3 While a bankruptcy court may consider the IRS Standards as one
4 piece of evidence in relation to its first prong analysis, see In re
5 Cota, 298 B.R. 408 (Bankr. D. Ariz. 2003); In re Ivory, 269 B.R. 890
6 (Bankr. N.D. Ala. 2001), it should not use the IRS Standards as the
7 sole measure of what is necessary to maintain a minimal standard of
8 living.

9 The IRS Standards may lead to an erroneous calculation in the
10 § 523(a)(8) context for a number of reasons. First, the living
11 expense allowance under the IRS Standards increases not only with a
12 debtor's family size, but also with his or her income. What is
13 necessary for a minimal standard of living may differ depending on
14 certain factors commonly associated with income. For example, a
15 debtor employed in a professional occupation may require a higher
16 clothing budget than a non-professional debtor. However, all other
17 factors being equal, the amount necessary to maintain a minimal
18 standard of living under § 523(a)(8) should not be adjusted upward
19 just because one debtor has a higher income than another.

20 Second, a bankruptcy court should not allow a debtor more than
21 the debtor's actual expenses. Sometimes the amount that a debtor
22 actually spends will be less than the amount permitted under the IRS
23 Standards. Allowing a debtor more than he or she actually spends is
24 inconsistent with the requirements of economy and sacrifice
25 necessary to obtain discharge of student loan debt under
26 § 523(a)(8).

1 Third, the IRS Standards do not provide for certain expenses
2 that courts have recognized as necessary to the maintenance of a
3 minimal standard of living in § 523(a)(8) cases. For example, this
4 Panel has held that, depending on the circumstances, a bankruptcy
5 court may properly find that the requirements of the first prong are
6 met, even where the debtor's budget includes an allowance for the
7 purchase of a new car. See In re Birrane, 287 B.R. 490, 496 (9th
8 Cir. BAP 2002). This is so because, in determining what is required
9 to maintain a minimal standard of living, it is necessary to budget
10 for the long-term. In this case, the bankruptcy court ordered a
11 thirty-year repayment period.

12 Debtor made her last \$203 car loan payment shortly before the
13 trial in this matter. Even so, the bankruptcy court allowed debtor
14 to include \$203 in her monthly budget as a savings device for a new
15 car, because the court found that debtor would need to replace her
16 car soon, given its age and condition. The bankruptcy court did not
17 err in allowing this expense, but the IRS standards would not permit
18 such a result.

19 We reject creditor's argument that the IRS Standards are useful
20 only as establishing a ceiling on a debtor's expenses. Creditor
21 states that the IRS Standards represent an average standard of
22 living, not a minimal standard of living. This argument
23 mischaracterizes the nature of the IRS Standards. The IRS Standards
24 represent average expenditures only for certain categories of basic
25 living expenses. The IRS Standards do not represent an average or
26 middle class standard of living. In addition, as we point out

1 above, the IRS Standards do not provide for certain expenses that
2 courts have recognized as necessary to the maintenance of a minimal
3 standard of living in § 523(a)(8) cases.

4 Our decision only requires use of the proper methodology to
5 determine whether debtor is entitled to discharge the student loans
6 at issue. The result on remand ultimately may not be any more
7 favorable to creditor. We reject creditor's argument that a debtor
8 should be required to relocate to reduce her housing expense to the
9 lowest possible amount, if the debtor's current housing expense is
10 within the amount allowed under the IRS Standards, and the
11 bankruptcy court finds that the expense satisfies § 523(a)(8)'s
12 minimal standard of living requirement.

13 CONCLUSION

14 We conclude that the bankruptcy court applied an incorrect
15 standard in considering the first prong of the undue hardship
16 analysis, because it erred in its application of the IRS Standards
17 and in simply adopting the IRS Standards instead of conducting an
18 individualized analysis into whether debtor's actual expenses are
19 necessary to the maintenance of a minimal standard of living.
20 Therefore, we REVERSE and REMAND.

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