CONSUMER BANKRUPTCY

Court Revisits Tax Refund of Non-Filing Spouse

Recent decision addresses how to allocate spouse's share

By Craig D. Robins

April may be tax time for most consumers, but bankruptcy judges seem to address bankruptcy tax issues year round. That's because tax refunds have been a constant and significant source of potential funds for trustees, who are often quite willing to litigate the issues involved. However, with the increased bankruptcy exemptions in New York, perhaps there will be fewer tax refund disputes.

I devoted two columns in the past two years on the topic of tax refunds of non-filing spouses. A recent decision by Central Islip Bankruptcy Judge Robert Grossman now requires that I write a third column on the subject.

In my May 2009 column I raised the issue of who owns the non-filing spouse's tax refund in a bankruptcy case, and how if should be apportioned. The Marciano case out of the Southern District of New York adopted the 50/50 Rule -- a simple and straight-forward approach in which the refund is apportioned equally between the two spouses regardless of the source of income or tax withholding. In re Marciano, 372 B.R. 211 (S.D.N.Y. 2007). Local bankruptcy practice since that time has adopted that rule.

In January 2011 I focused my column on a decision by Judge Grossman which addressed this issue: What happens when only one spouse files for Chapter 13 relief? Does the non-filing spouse also have to surrender his or her tax refund to the trustee?

Craig D. Robins

At the time, Judge Grossman held that a non-filing spouse is not obligated to devote his or her share of a joint tax refund to plan payments made to the Chapter 13 trustee.

In that case, In re Malewicz, No 8-09-74807-reg, 2010 WL 4613119 (Bankr. E.D.N.Y., Nov. 4, 2010), the court ruled that a non-debtor spouse's share of a joint tax refund received post-confirmation is not property of the debtor's estate or part of the "projected disposable income." Therefore, unless the non-debtor spouse specifically consents to contribute the refund to the plan, the non-debtor spouse's share of tax refunds received post-confirmation need not be turned over to the trustee.

Thus, the non-debtor spouse in that case was not required to devote his share of tax refunds to the Chapter 13 plan. The non-filing spouse's share of the tax refund is not property of the estate and it should not be included in the calculation of Chapter 13 plan payments.

At the time, the Malewicz case seemed to be the end of the road on the issue. You had the 50/50 rule, so what else could come up?

In October 2010, Carlos Duarte, a typical consumer, filed for Chapter 13 relief individually, without his wife. Through his attorney, Lawrence S. Lefkowitz, he offered 50 percent of the couple's joint 2010 tax refund into the plan and asserted that the other 50 percent belonged to his wife and was hers to keep. After all, the 50/50 Rule for determining each spouse's respective rights to a tax refund is a test employed by a majority of Bankruptcy Courts in New York.

The debtor also pointed out a 2009 decision by Judge Alan S. Trust which held that "spouses filing joint returns, who equally share the liability for payment of the taxes, should equally share the benefit of any tax refund." In re Spina, 416 B.R. 92 (Bankr. E.D.N.Y. 2009).

However, Chapter 13 trustee Michael J. Macco noticed an unusual aspect of the family's tax situation - only the husband paid withholding tax during the 2010 tax year; the wife did not pay anything.

The trustee then objected to confirmation of the plan, arguing that the entire 2010 refund resulted from an overpayment made solely by the debtor-husband. The trustee argued that there was only a presumption that the 50/50 Rule should be used, and that the facts of this case rebutted the presumption. He insisted that the debtor pay 100 percent of the tax refund into the plan based on a different rule known as the "Withholding Rule."

Under the Withholding Rule, which is considered the majority approach, the tax refund is divided based upon the extent to which the refund is attributable to the separate withholdings of each spouse.

At the confirmation hearing, Judge Grossman granted confirmation, but reserved decision as to whether the non-filing spouse was required to turn over 50 percent of the tax refund.

In a decision issued in July 2011, Judge Grossman ruled that neither the 50/50 Rule should be applied, nor the Withholding Rule. Instead, he adopted a totally different formula known as the "Separate Filings Rule," first enunciated by the Tenth Circuit in the case, In re Crowson, 431 B.R. 484 (10th Cir. BAP 2010). In re Carlos Duarte, no. 8-10-78606-reg, (Bankr. E.D.N.Y. July 12, 2011).

The judge clarified the issue before the court saying that since the debtor consented to turn over his share of the tax refund, the sole issue was determining how to calculate the debtor's interest in the tax refund.

After reviewing in detail the considerations for rejecting the other rules (there are four of them), Judge Grossman held that it was necessary to use a formula based on a calculation of what each spouse's tax obligation would have been if the spouses had filed separate tax returns. Then, he said there should be a calculation of the contributions each spouse had actually

(Continued on page 20)

Consumer Bankruptcy (Continued from Page 13)

made toward the total tax payment.

Unfortunately, this new method will be messy and the judge even pointed out that this approach "is not a 'bright-line rule' and therefore it is not simple to understand or apply."

The judge stated that "This Court is not ruling that the Trustee, the debtor and the non-debtor spouse in each case must undertake this analysis in order to determine each parties interest in a joint income tax refund, but this formula shall be employed where the parties do not agree on the proper allocation."

Judge Grossman's "Separate Filings Rule" approach will certainly produce the fairest result to all concerned, but if the parties cannot reach a resolution, they'll certainly have a fair amount of work on their hands and they'll have to study the formula details set forth in the Duarte and Crowson cases.

I recently spoke with the debtor's attorney who had just prepared the separate tax returns (for bankruptcy calculation purposes only), and he was optimistic that he and the trustee would work out a resolution as to the actual numbers without the need for further litigation.

On a separate note, I anticipate we'll see another bankruptcy tax case in the near future. The court did not address whether the Bankruptcy Code requires a debtor to turn over pre-confirmation tax refunds as opposed to post-confirmation tax refunds. Judge Grossman went so far as to point this out in a footnote. Since I have seen this issue arise several times recently, it is likely to come before the court in a case where the parties cannot reach a resolution on their own.

Note: Craig D. Robins, a regular columnist, is a Long Island bankruptcy lawyer who has represented thousands of consumer and business clients during the past 20 years. He has offices in Coram, Mastic, West Babylon, Patchogue, Commack, Woodbury and Valley Stream. (516) 496-0800. He can be reached at CraigR@CraigRobinsLaw.com. Please visit his Bankruptcy Website: www.BankruptcyCanHelp.com and his Bankruptcy Blog: www.LongIslandBankruptcyBlog.com.