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Chicago Judge Devises a Better Method to Allocate Income Tax Refunds Between Spouses

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Whoever was overwithheld is entitled to the IRS refund when one spouse doesn't file, Judge Michael Slade says.

Bankruptcy Judge Michael B. Slade of Chicago said he was confronted with “competing lines of authority regarding how to allocate a tax refund between a debtor’s estate and a non-debtor spouse where, as here, they file a joint return.”

“Ultimately,” Judge Slade said that he was “not persuaded that any of the methodologies typically chosen by courts around the country suits as a general rule applicable in all cases.”

The Couple’s Withholdings and Estimated Tax Payments

A husband filed a chapter 7 petition in mid 2022. His wife did not file. For 2021, the couple had filed a joint federal income tax return giving them a refund of about \$150,000.

The husband’s chapter 7 trustee filed a turnover motion aiming to glom half of the refund, about \$75,000.

Here’s how the refund arose: In the 2021 taxable year, the husband had gross income of about \$105,000. In his February 18 opinion, Judge Slade said there was no evidence that that “the Debtor’s withholdings overestimated his actual tax obligations.”

The nondebtor wife was in a different category. Her income was from real estate investments, and she had no tax withholdings. Instead, she made almost \$580,000 in estimated tax payments for 2021. Because the estimated payments were too large, the joint return gave the couple a \$150,000 refund.

The Methods of Allocation

Judge Slade described the methods that bankruptcy courts have used to allocate tax refunds between a debtor and a non-debtor spouse. He described the shortcomings of each and said that the Seventh Circuit had not taken sides.

Judge Slade described the 50/50 rule as based on an assumption that each spouse contributes equally to the household, including through nonmonetary contributions. He said that the 50/50 rule “appears to have nothing to do with state or federal law entitlement; it also produces random results that either could massively (and at all times artificially) help or harm estates and creditors depending on the facts.”

The income rule, Judge Slade said, divides refunds proportionately based on each spouse's income. That method, he said, "could produce similarly inaccurate results; a tax refund is the difference between taxes paid and taxes owed, which may or may not neatly correlate with income."

The majority method, known as the withholding rule, was described by Judge Slade as making an allocation between spouses based on the proportion of their relevant withholdings. He said it "suffers from the reality that what is 'withheld' can be a matter of choice."

Last, there is the separate filing rule, which allocates a refund based on what each spouse's contributions and tax liabilities would have been had they filed separately. Judge Slade said that "it requires new, potentially complex calculations to be run that have no value other than to artificially understand tax obligations in a hypothetical world where the debtor and his or her spouse are not married."

The Best Method

Judge Slade framed the question as asking who would get the refund if the husband and wife were to fight over it. "Neither the filing of a joint return nor filing a chapter 7 case should change the answer," he said.

Judge Slade quoted the Fifth Circuit at length:

The case law overwhelmingly establishes that overpayments by married couples are apportionable to each spouse to the extent that he or she contributed to the overpaid amount. Filing jointly does not give one spouse an interest in the income of the other. **A premarital or postmarital loss or credit may be applied only against the income of the person who incurred the loss or credit.** A joint income tax return does not create new property interests for the husband or wife in each other's income tax overpayment.

Ragan v. Comm'r, 135 F.3d 329, 333 (5th Cir. 1998). [Emphasis in original.]

“A debtor’s entitlement to such refunds should depend on why the refunds exist,” Judge Slade said. In the case before him, he said the answer was “easy.”

“It is not hard to see (and impossible to ignore) how the estimated payments made by the Debtor’s wife here created the tax refund that the couple was entitled to for tax year 2021,” Judge Slade said. He had “no reason to believe that, outside of bankruptcy, the Debtor would prevail (before the IRS, an arbitrator if the parties agreed to arbitrate, or a state or federal court).”

Judge Slade said that the trustee had “offered no state or federal law suggesting that, outside of bankruptcy, [the debtor] would receive any part of this refund.”

Concluding that the debtor’s estate is entitled to no part of the refund, Judge Slade denied the turnover motion.