The Non-Filing Spouse Dilemma

Concurrent Session

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THE NON-FILING SPOUSE'S INCOME IN BANKRUPTCY

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Courts have struggled with the appropriate way to deal with income from the non-filing spouse since Congress enacted the Bankruptcy Code in 1978. Although Section 302 permits a husband and wife to file a joint petition, nothing in the Bankruptcy Code requires that both spouses file in order for one spouse to obtain relief. Since 1978, the problem has arisen with increasing frequency in other "non-traditional" settings such as same-sex couples and couples that live together but without a formal "marriage".

In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), heralded as the "most sweeping" and "most comprehensive" revision of the Bankruptcy Code since its enactment in 1978. Few who have dealt with BAPCPA would debate these descriptions of its effect. For all of those "sweeping" and "comprehensive" revisions, BAPCPA did remarkably little to clarify the treatment of non-filing spouse income and in at least a few instances, BAPCPA introduced new issues and uncertainties, leaving it to the Courts to formulate coherent policies.

Much of the litigation involving non-filing spouses since BAPCPA has revolved around three separate but somewhat related areas: calculation of "Current Monthly Income" and the so-called "marital adjustment"; calculation of the "Applicable Commitment Period"; and "abuse" under Section 707(b)(3) and "good faith" under Section 1325(a).

Calculation of Current Monthly Income

BAPCPA introduced the concept of "Current Monthly Income" ("CMI") into the lexicon of Bankruptcy. CMI is the starting point for much of what happens in a consumer bankruptcy case, whether one filed under Chapter 7 or one filed under Chapter 13. The correct calculation of CMI impacts whether a Chapter 7 filing will be "presumed abusive"; the "Applicable

Commitment Period" under Chapter 13; and in at least some jurisdictions, the minimum distribution to unsecured creditors and, indirectly, the plan payment itself.

The definition of "Current Monthly Income" found in Section 101(10A) is deceptively simple:

> The term "current monthly income"—
>
> **(A)** means the average monthly income from all sources that the debtor receives (or in a joint case the debtor and the debtor's spouse receive) without regard to whether such income is taxable income, derived during the 6-month period ending on—
>
> **(i)** the last day of the calendar month immediately preceding the date of the commencement of the case if the debtor files the schedule of current income required by section 521(a)(1)(B)(ii);
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> …
>
> and
>
> **(B)** includes any amount paid by any entity other than the debtor (or in a joint case the debtor and the debtor's spouse), on a regular basis for the household expenses of the debtor or the debtor's dependents (and in a joint case the debtor's spouse if not otherwise a dependent) ….

In one of the early cases under BAPCPA, the Bankruptcy Court in South Carolina summarized Section 101(10A), stating:

> 11 U.S.C. § 101(10A) defines and divides a debtor's sources of "income" into the following two categories: (A) monthly income from "all sources that the debtor receives (or in a joint case the debtor and debtor's spouse receive) without regard to whether such income is taxable" and (B) "any amount paid by an entity other than debtor (or in a joint case the debtor and the debtor's spouse), on a regular basis for the household expenses of the debtor or the debtor's dependents (and in a joint case the debtor's spouse if not otherwise a dependent)...." The use of parenthetical phases in 11 U.S.C. § 101(10A) implies that the income of a non-filing spouse is not included for purposes of determining a debtor's projected disposable income under 11 U.S.C. § 1325(b) if a debtor does not "receive" this income pursuant to 11 U.S.C. § 101(10A)(A). However, 11 U.S.C. § 101(10A)(B) indicates that a non-filing spouse's income is included, regardless of a debtor's receipt of such income, if the income is paid on a "regular basis" for debtor's "household expenses." Through this definition "Congress chose to exclude that

> portion of the non-filing spouse's income devoted to personal pursuits or expenses from current monthly income."

In re Barnes, 378 BR 774 (Bankr. D.S.C. 2007) (internal citations omitted).

The Courts have uniformly interpreted CMI from the same perspective as the Court in *Barnes.* CMI includes only the debtor's income plus so much of the non-filing spouse's income that is contributed on a "regular basis" for the household expenses of the debtor or the debtor's dependents. The main issues facing the Courts are (i) how to determine whether funds are on a "regular basis"; and (ii) how to distinguish between household expenses of the debtor from expenses of the non-debtor spouse alone?

The Form B22[1] accomplishes this "separation" by presuming that all of the non-filing spouse's income is contributed to the household. Part I of the B22 requires both spouses to list their incomes, whether or not a joint case is filed. *In re Hammock*, 436 BR 343, 348 (Bankr. E.D.N.C. 2010). That portion of the non-filing spouse's income that is *not* regularly contributed is then backed out – the so called "marital adjustment" – to arrive at the debtor's CMI. *In re Sharp,* 394 BR 207 (Bankr. C.D. Ill. 2008); *In re Vollen*, 426 BR 359 (Bankr. D. Kan. 2010) (income of non-filing spouse that is not regularly contributed is "backed out' of CMI as marital adjustment).

Most Courts do not impose a "reasonableness" limit for the amount of the marital deduction, nor otherwise restrict the non-filing spouse's uses that portion of the income that is not "regularly contributed". *In re Sharp,* 394 BR 207, 214 (Bankr. C.D. Ill. 2008) ("[N]on-filing spouse is not required to adjust her expenses to meet the reasonable and necessary standard of scrutiny that the Debtor's expenses must meet."). If the non-filing spouse uses the income for the non-filing spouse's own expenses, or places those funds in a savings account or other

[1] In Chapter 7, the form is the "B22A". In Chapter 13, the form is "B22C". For purposes of calculating CMI and the "marital adjustment" the forms are virtually identical and will be collectively referred to as Form B22.

investment vehicle, or decides to be extra charitable and stand on a street corner passing out $100 bills to passing strangers, so be it. The calculation of CMI includes only that portion (if any) of the non-filing spouse's income that is regularly contributed to the debtor without imposing either an obligation to contribute funds or a limitation on the use of funds not contributed.

One Court did impose a "reasonableness" component to deny a marital adjustment for "excess utility" expenses. In *In re Trimarchi,* 421 BR 914 (Bankr. E.D. Ill. 2010), the debtor's non-filing spouse paid $250 per month to heat the swimming pool located at the residence occupied by debtor, her non-filing spouse, and their dependent child. The Court denied the marital adjustment on the basis that utilities such as pool heating were paid "on a regular basis for the household expenses of the Debtor and her son" that must be included in calculating CMI. The Court then stated that the expense to heat a swimming pool is not "reasonably necessary" and that unsecured creditors should not be required to subsidize that expense. The Court's additional statements about the "reasonableness" or "unreasonableness" of this expense were probably unnecessary. The Court already deemed the expenses as "regularly contributed" expenses that could not be deducted in the Marital Adjustment even if the expense was reasonable. The authorities relied on by the Court were all pre-BAPCPA and dealt with the concept of "projected disposable income" and luxury lifestyles outside the concept of "Marital Adjustment" or CMI. The true import of the statements in *Trimarchi* that the expenses paid by the non-filing spouse must be "reasonable" to be included in the Marital Adjustment remains debatable.

The only other "limitation" on the Marital Adjustment is that the debtor bears the burden of proof that funds received by the non-filing spouse are not "regularly contributed". If the

debtor cannot meet that burden, the Courts will presume that the non-filing spouse's income is "regularly contributed" and will include that income in calculating CMI. *In re Dugan,* 2008 WL 3558217, *6 (Bankr. D. Kan. 2008) ("Based upon Debtor's unwillingness or inability to provide any documentation to support the marital adjustments on Lines 13 and 19 of Form 22C, the Court finds that this deduction is not allowable at this time.")

Courts have had little difficulty in stating the standard for the Marital Adjustment, but have had considerably more difficulty in determining which expenditures of the non-filing spouse are not for household expenses of the debtor or a dependent of the debtor and so are properly excluded from the calculation of CMI. "A determination of the amount paid by a non-filing spouse on a regular basis for household expenses of the debtor or the debtor's dependents is necessarily fact specific and subject to interpretation." *In re Travis,* 353 BR 520, 526 (Bankr. E.D. Mi. 2006).

a. Mortgage Payments

Perhaps no one expense item better demonstrates the split of authority on what constitutes an expense that is paid on a regular basis for the household expenses of the debtor or the debtor's dependents than the mortgage payment on the home owned solely by the non-filing spouse but used as the family residence. In *In re Shahan*, 367 BR 732 (Bankr. D. Kan. 2007), the Court concluded that the debtor could take a Marital Adjustment for the amount of the house payment routinely paid by the non-filing spouse. The non-filing spouse owned the house before she and the debtor married, title was solely in the name of the non-filing spouse, and the debtor was not liable on either the note or the mortgage. The Court noted that the debtor would not be able to take the secured debt deduction on Line 47 because the debtor is not contractually obligated to make payments. If the debtor could not utilize the Marital Adjustment to offset the

non-filing spouse's mortgage payment, then the non-filing spouse's income would be fully included in the calculation of CMI without any recognition of the related expense. This, the Court concluded, would be inconsistent with BAPCPA's goal of reducing bankruptcy filings.

The same Court reached a markedly different conclusion in *In re Vollen*, 426 BR 359 (Bankr. D. Kan. 2010), holding that the non-filing spouse's mortgage payments cannot be included in the Marital Adjustment. The Court stated allowing a Marital Deduction for the mortgage on the family home "ignores the reality that the debtor benefits from the payment of the mortgage expense." 426 BR at 372 (*quoting In re Trimarchi,* 421 BR 914, 922 (Bankr. N.D. Ill. 2010)). The Court in *Vollen* attempted to harmonize its holding with the holding in *Shahan* by noting that in *Shahan* the non-filing spouse owned the home before the parties were married, while in *Vollen* the non-filing spouse acquired the property during the course of the marriage. The Court did not explain how the timing of acquisition of the property, which in both cases predated the filing of the bankruptcy case by many years, could affect whether the mortgage payments benefitted the debtor. The Court in *Vollen* also did not address whether the debtor could take a deduction on Line 47 for the secured debt payments to avoid the "double counting" problem that was at the core of the decision in *Shahan.*

The split in the holdings in *Shahan* and *Vollen* reflect the general split in other courts in dealing with the non-filing spouse's mortgage payments. In *In re Clemons*, 2009 WL 1733867 (Bankr. C.D. Ill. 2009), the Court concluded that "it is not appropriate to construe the term 'household expenses of the debtor of the debtor's dependents' as including mortgage related expenses on which the debtor has no contractual liability." 2009 WL at *5. The Court limited "household expenses" to "expenses actually incurred by a debtor or a dependent." This limitation is not consistent with Section 101(10A), which does not focus in any way on who

actually *incurs* the expenses, but on the purpose of the expenses. There are many other expenses for which the debtor is not "contractually liable" but which would undoubtedly qualify as "household expenses" that benefit the debtor. For example, if the non-filing spouse routinely purchases all of the food for the home, it would be very difficult to argue that the food expenses should be included in the Marital Adjustment merely because the non-filing spouse, and not the debtor, goes to the grocery store.

The Court in *Clemons* compounds this rather dubious construction of "amount paid … for the household expenses of the debtor" by allowing the debtor to take the IRS standard deduction for "mortgage/rent" expenses on Line 25B of the form B22C. The Court in *Shahan* concluded that the mortgage payment could be included in the Marital Adjustment because otherwise there would be no place on the B22 to account for that payment, and the debtor and non-filing spouse should not be required to include the income on the one hand and be denied any deduction for the expense on the other. The Court in *Clemons* goes one further, not only insuring (as the *Shahan* Court sought) that the debtor received the benefit of the mortgage payment deduction via the Marital Adjustment, but also in giving the debtor a second bite by allowing the standard mortgage deduction even though the debtor did not have any actual mortgage or rent expense. The validity of this second portion of the *Clemons* decision is called into serious question by the Court's holding in *Ransom v. FIA Card Services, N.A.,* 2011 WL 66438 (2011), that a Debtor who does not have an automobile payment (either loan or lease) cannot take standard "ownership" expense on the Means Test. The essence of the holding in *Clemons* is that the debtor did not have any actual mortgage or rent payment. Following *Ransom*, the debtor should not be able to deduct any "ownership" expenses. This limitation at least restores some of the balance and rationality that the *Shahan* Court sought, by allowing the debtor

to deduct from the Marital Adjustment an expense that would otherwise be included in CMI but not deductable elsewhere on the form B22.

The Bankruptcy Court in the Northern District of Illinois adopted a slightly different interpretation in *In re Trimarchi*, 421 BR 914 (Bankr. N.D. Ill. 2010). The Court first held that to the extent the non-debtor spouse's income is used to support the debtor or a dependent of the debtor, that money must be included in CMI and is not properly deducted as part of the Marital Adjustment. The non-filing spouse's debt service payments on the family home are for the support of the debtor that cannot be included in the Marital Adjustment, even if the property is owned solely by the non-filing spouse. The Court then concluded that the debtor was entitled to the IRS standard deduction for mortgage/rent expense on Line 25B. Significantly, although the Court ruled that the entire mortgage payment ($2,316) must be included in income, the Debtor could deduct only the IRS standard of $1,527.00. The Court expressed great concern that if the debtor could both deduct the payments as part of the Marital Adjustment *and* take the IRS standard deduction for mortgage/rent, the debtor would be able to "double dip" this expense. The Court did not even attempt to explain how to account for the fact that the IRS allowance was far less than the mortgage payment, thereby forcing the debtor to include income for a mortgage payment that the debtor was not also allowed to deduct, artificially increasing the combined income of the debtor and the non-filing spouse above their actual combined incomes.

Including the mortgage payment in CMI as the Court did in *Vollen* is more consistent with the applicable statutory provisions. Mortgage payments on the home in which the debtor resides are expenses paid for the benefit of the debtor. Debtor would have to pay this housing expense if it was not paid by the third party. The Court's limitation in *Clemons* that payments are included in CMI only if the debtor is contractually liable for the debt imposes a restriction

that is not found in the definition of CMI. Section 101(10A) does not focus on the origin of the obligations being paid by the non-filing spouse or the technical legal liability of the debtor for those obligations. Section 101(10A) speaks only of expenses "regularly paid" by the non-filing spouse without any distinction between debts for which the debtor is contractually liable and those for which the debtor is not contractually liable but which are paid for the benefit of the debtor. The mortgage payment on the residence used by the debtor is a "household expense of the debtor" that must be included in CMI.

The Court in *Shahan* allowed the Marital Adjustment based on an incorrect assertion that the debtor would not otherwise be able to deduct the mortgage expense on the B22. Although this proposition may be true for the IRS Local Standard for rent or mortgage, there is no corresponding limitation in Section 707(b)(2)(a)(iii), which allows a debtor to deduct the average monthly payments on secured debts, calculated as amounts contractually due over the next 60 months plus additional payments for the debtor to maintain possession of property necessary for the support of the debtor.

As with many of the provisions of BAPCPA, even this approach is not without its problems. Section 707(b)(2)(a)(iii) references "debtor's average monthly payments on account of secured debts". If the expense is routinely paid by someone other than the debtor, are the payments "*debtor's* average monthly payments"? A reasonable analogy can be made to CMI where payments made by others are included as expenses paid on behalf of the debtor to conclude that the payment does not have to be made *by* the debtor for it to be one of the debtor's monthly payments. The identity of the person writing the check should not determine whether the payment is one of the "debtor's".

The second difficulty with including the mortgage payment in CMI and then taking the allowable secured debt deduction arises out of Section 506 and the definition of "secured debts". Section 707(b)(2)(a)(iii) allows the deduction of payments for "secured debts". The phrase "secured debts" is not defined in the Code. Section 506 defines "secured claims" as claims that are secured "to the extent of the value of … the estate's interest in [the] property." If, as in *Shahan* and *Vollum*, the debtor does not own the property, then the estate has no interest in the property and any claim secured by the property is not a "secured claim" for purposes of the Bankruptcy Code. However, Section 109(e) references "secured debts", not "secured claims" in determining eligibility for relief under Chapter 13. Some Courts have concluded that the phrase "secured debts" means something other than "secured claims" and includes any debt that is secured, even if the collateral is not property of the estate. *See In re Belknap,* 174 BR 182 (Bankr. W.D. N.Y. 1994); *In re White,* 148 BR 283 (Bankr. N.D. Ohio 1992). *See also* Norton, *Norton Bankruptcy Law and Practice 3d,* §141:6 (2011) ("For eligibility purposes, a secured debt is a debt secured by property and includes obligations secured by assets not belonging to the debtor."). If a "secured debt" is interpreted more broadly than "secured claim" under Section 506, then the mortgage on the non-filing spouse's home would constitute a "secured debt" for purposes of Section 707(b)(2)(a)(iii) and the payments would constitute debtor's average monthly payments on account of those secured debts.

The distinction between "secured debts" and "secured claims" is not without its detractors. In *In re Fuson,* 404 BR 872 (Bankr. S.D. Ohio 2004), the Court stated "[Section] 101(12) defines 'debt' as 'liability on a claim,' a definition that the U.S. Supreme Court found sufficient to reveal 'Congress' intent that the meanings of 'debt' and 'claim' be coextensive.' *Pennsylvania Department of Public Welfare v. Davenport,* 495 U.S. 552, 558, 110 S.Ct. 2126,

109 L.Ed.2d 588 (1990). It is therefore reasonable to conclude that the language of § 506(a)(1) restricts 'secured debts' referenced in § 109(e) to those secured by property in which the estate has an interest." 404 BR at 876.

The statutory language involved leaves much to be desired. There is no single answer that avoids any statutory problems and is fully consistent with "Congressional intent" and the "plain language" of the Code. Including the mortgage payments in CMI and then allowing the secured debt deduction appears to most closely follow what appears to be Congress' intent. This gives the best approximation of the debtor's actual income by including expenses that the debtor would have to pay if the expenses were not paid by someone else. Allowing the secured debt deduction prevents the "double counting" that was at the core of the *Shahan* decision. This treatment also most closely approximates what would have been the actual income and expenses had the debtor and the spouse filed a joint case, neither "rewarding" the debtor by understating income nor punishing the debtor by "overstating" income or "disallowing" deductions. It also eliminates the potential "double dip" that results from including the mortgage payment in the Marital Adjustment and also allowing the deduction as either the IRS standard mortgage deduction or the deduction for secured debt payments.

b. Other Secured Debts

The issue of secured debts presents the same issues as the home mortgage payment, and predictably results in the same split of opinions. In *Shahan*, the debtor drove an automobile that the non-debtor spouse owned and on which only the non-debtor spouse was liable for the payment. The Court allowed the automobile payments to be included in the Marital Adjustment because the debtor who had no contractual obligation could not otherwise deduct the payments as secured debt payments on Line 47. As with the mortgage payment, if the debtor is required to

include the income in CMI and is then denied the opportunity to exclude the payments on Line 47, the calculation of "disposable income" will be artificially inflated. The Court in *Shahan* concluded that the "best" way to avoid that double counting while remaining true to the interpretation of Line 47 (that only secured debts for which the debtor was contractually liable could be deducted) was to allow the deduction of the automobile payments as part of the Marital Adjustment.

In *In re Sale,* 397 BR 281 (Bankr. M.D.N.C. 2007), the Court concluded that the loan payments and insurance payments made by the non-filing spouse on the vehicle driven by the debtor were not "amounts paid on a regular basis for household expenses", even though those expenses were paid from the bank account that debtor and her non-filing spouse held jointly and into which debtor and her spouse deposited all of their combined incomes. The Court expressed the same concern as the Court in *Shahan* – the debtor cannot deduct these payments on Line 47 and cannot take a vehicle ownership expense on Line 28, as the debtor neither owns nor has any contractual obligations relating to the vehicle. If these expenses cannot be included in the Marital Adjustment, then the inclusion of the income in CMI produces an artificially inflated "disposable income" at the end of the B22.

The Court in *In re Vollen*, 426 BR 359 (Bankr. D. Kan. 2010) reached the contrary conclusion in connection with an automobile owned by and paid for by the non-filing spouse but used by the daughter of the debtor and non-filing spouse. The Court held that the daughter was a dependent of the debtor. The Court then summarily concluded that the automobile payments had to be included in debtor's CMI without discussing the problem of "double counting" which was at the core of the holding in *Shahan*.

Although the nature of the collateral is different, there is no reason to apply Section 101(10A) in a manner different than as applied in the home mortgage situation. The course of action that is more consistent with Section 101(10A) would be to include the secured debt payment in the calculation of CMI and then to allow the debtor the secured debt deduction under 707(b)(2)(a)(iii) .

c. Other Expenses

Courts have addressed the Marital Adjustment in various other contexts, in many cases with the same divergence of opinion. There do appear to be some areas where the Courts agree that a specific expense can be (or cannot be) included in the Marital Expense. Expenses that are part of the Marital Adjustment include:

a. Taxes withheld from the non-filing spouse's paychecks, *see, e.g., In re Shahan,* 367 BR 7532 (Bankr. D. Kan. 2007); *In re Vollen*, 426 BR 3559 (Bankr. D. Kan. 2010); *In re Travis*, 353 BR 520 (Bankr. E.D. Mi. 2006) (however, non-filing spouse's taxes cannot also be deducted on Line 30); *In re Dugan,* 2008 BR 3558217 (Bankr. D. Kan. 2008)(however, if non-filing spouse regularly receives a refund and that refund is used for expenses of the debtor or a dependent of the debtor, then the refund amount would be included in CMI).

b. Non-filing spouse's recreation and health club expenses, *see, e.g., In re Shahan,* 367 BR 7532 (Bankr. D. Kan. 2007); *In re Vollen*, 426 BR 3559 (Bankr. D. Kan. 2010).

c. Support of a child of the non-filing spouse by a prior relationship, *see, e.g. In re Barnes,* 378 BR 774 (Bankr. D.S.C. 2007).

d. Life insurance and health insurance on the non-filing spouse, *see, e.g., In re Sale,* 397 BR 281 (Bankr. M.D.N.C. 2007) (life insurance); *In re Borders,* 2008 WL 1925190 (Bankr. S.D. Al. 2008) (health insurance); *In re Hammock*, 436 BR 343 (Bankr. E.D.N.C. 2010) (but debtor cannot take health insurance deduction for non-filing spouse on Line 36).

e. Credit Card payments on the non-debtor's credit cards, *see, e.g., In re Borders*, 2008 WL 1925190 (Bankr. S.D. Al. 2008); *In re Barnes,* 378 BR 774 (Bankr. D.S.C. 2007); *but see In re Vollen,* 426 BR 359 (Bankr. D. Kan. 2010) (cannot take marital deduction for credit card payments where cards were used to pay expenses of debtor or dependent of debtor).

f. Non-filing spouse's retirement contributions and repayment of retirement loans, *see, e.g., In re Vollen,* 426 BR 359 (Bankr. D. Kan. 2010).

g. Clothing and other "personal items" for the non-filing spouse or for third person who is not a dependent of the debtor, *see, e.g., In re Travis,* 353 BR 520, 526 (Bankr. E.D. Mi. 2006) (expenses for non-debtor spouse's mother, adult children and grandchildren, none of whom were dependents of the debtor).

Ultimately, the determination as to whether an expense is one for the benefit of the debtor or a dependent of the debtor; or rather is one that benefits either the non-filing spouse exclusively or some other person who is not either the debtor or a dependent of the debtor, is a factually driven and specific conclusion. The only "rules" that appear consistent throughout both BAPCPA and the case are:

1. In calculating CMI, the debtor must include only those funds paid to the debtor or paid by third parties (including the non-debtor spouse) for the benefit of the debtor or a dependant of the debtor. To the extent that the non-filing spouse has income that is not paid to or for the benefit of the debtor or a dependent of the debtor, that income is not counted in the calculation of CMI, regardless of how the non-filing spouse uses that income.

2. If an expense is included in the Marital Adjustment, it cannot also be deducted in the balance of the B22. Courts will not permit "double counting" of these expenses.

3. Where it is not clear whether the expense is one solely for the non-debtor spouse or for the benefit of the debtor, the debtor bears the burden of proof that the income should be included in the Marital Adjustment (and therefore excluded from CMI).

The goal of the analysis should be to arrive at a CMI calculation that accurately reflects the debtor's actual income plus the debtor's "imputed" income – those funds that the debtor does not receive but which pay expenses that, but for the payment by third parties, would have to be paid by the debtor. Using this test provides the most consistent method to account for the debtor's expenses while simultaneously excluding income of third parties that those parties choose to keep or spend on themselves or others.

Determination of Applicable Commitment Period

Under BAPCPA, the calculation of CMI is the beginning, not the end, of the process. Proper calculation of CMI will determine the Applicable Commitment Period which will impact

the Plan Length under Section 1325. Debtors with Annualized CMI that is less than the applicable state median income will have an Applicable Commitment Period, and a minimum plan length of not less than 36 months. Debtors with Annualized CMI that is greater than the applicable state median have an Applicable Commitment Period, and a minimum plan length, of 60 months (unless the unsecured creditors receive full repayment in a shorter time). *Baud v. Carroll,* 2011 WL 338001 (6th Cir. 2011). The proper calculation of CMI and its relationship to the Applicable Commitment Period is vital to a debtor in Chapter 13.

Determining the Applicable Commitment Period involves two different sections of the Bankruptcy Code, Section 1325(b) and Section 101(10A). Section 1325(b) (4) provides:

> For purposes of this subsection, the "applicable commitment period"--
>
> (A) subject to subparagraph (B), shall be—
>
> (i) 3 years; or
>
> (ii) not less than 5 years, if the current monthly income of the debtor and the debtor's spouse combined, when multiplied by 12, is not less than [the applicable median family income]

Section 101(10A) provides:

> The term "current monthly income"—
>
> **(A)** means the average monthly income from all sources that the debtor receives (or in a joint case the debtor and the debtor's spouse receive) without regard to whether such income is taxable income … and
>
> **(B)** includes any amount paid by any entity other than the debtor (or in a joint case the debtor and the debtor's spouse), on a regular basis for the household expenses of the debtor or the debtor's dependents (and in a joint case the debtor's spouse if not otherwise a dependent) ….

Although not immediately apparent, there is an inherent tension in these two sections. Section 1325 defines ACP based on current monthly income of the debtor *and the debtor's*

spouse combined. Section 1325 does not limit the inclusion of the CMI of the debtor's spouse only to "joint" cases, unlike Section 101(10A) which expressly differentiates between income of the debtor in an individual case and the debtor and spouse in a joint case. Congress clearly knew how to distinguish individual cases from joint cases – it did so in Section 101(10A). Congress must have presumed to include the CMI of both the debtor and the spouse regardless of whether the case was an individual case or a joint case. This means that the non-filing spouse's CMI is included in determining ACP and Plan Length.

Except, by definition CMI does not include any income of the non-filing spouse. The definition of CMI is limited to "income … that the debtor receives." Section 101(10A) says nothing about calculating CMI for anyone other than the debtor, except perhaps to state that income received by third parties and not used to pay expenses of the debtor is, by definition, *not* CMI. Can a non-filing spouse even *have* CMI?

As with other sections of BAPCPA, the Courts rely on the "plain language" of these "unambiguous" statutes to reach diametrically opposing results. In *In re Ariyaserbsiri,* 2008 WL 5191200 (Bankr. E.D. Tx. 2008), the debtor asserted that the Marital Adjustment allowed debtor to include only that amount of the non-filing spouse's income that was "regularly contributed" in determining the Applicable Commitment Period. The Chapter 13 Trustee contended that Section 1325(b)(4) uses the total income of both the debtor and the spouse in determining Applicable Commitment Period, because Section 1325(b)(4). The Court held that Section 1325(b)(4) specifically includes "the current monthly income of the debtor and the debtor's spouse combined" when calculating plan length. The debtor's argument would interpret Section 1325(b)(4) to mean "current monthly income of the debtor and the debtor's spouse *in a joint case",* language that Section 1325(b)(4) does not contain. The Court noted that Congress knew

how to limit the non-filing spouse's income solely to joint cases – Congress included the parenthetical in Section 101(10A) to accomplish exactly that goal – yet Congress chose not to include that limitation in Section 1325(b)(4). The Court also noted that the legislative history of Section 1325 required inclusion of the entirety of the non-filing spouse's income. "Senator Dianne Feinstein proposed amending §1325(b)(4)(A)(ii) by striking the phrase 'debtor and the debtor's spouse combined' and inserting 'debtor, and in a joint case, the debtor and debtor's spouse….' Senator Feinstein's proposed amendment was withdrawn without debate." 2008 WL at *4. If Congress intended to include the spouse's income only in a joint case, not only did Congress know how to limit the scope of Section 1325(b)(4), but it has the clear opportunity to incorporate that limitation yet elected not to do so. For the Court to now limit the spouse's income only to joint cases would constitute "an impermissible enlargement or modification of [Section 1325(b)(4)] by the Court." 2008 WL at *3. The Court concluded that the Court must consider the total "Current Monthly Income" of both the debtor and the non-debtor's spouse in determining the Applicable Commitment Period.

The majority of Courts, however, have concluded that the calculation of Applicable Commitment Period includes only the income of the non-filing spouse that income is regularly contributed to the expenses of the debtor or a dependent of the debtor. These Courts focus on the reference to Section 1325(b) to the "current monthly income" of the non-filing spouse. These Courts note that "Current Monthly Income" is statutorily defined to include the income of the non-filing spouse only to the extent that income is "regularly contributed" to the expenses of the debtor. Any income that is received by the non-filing spouse that is not "regularly contributed" cannot constitute "Current Monthly Income". "The definition of 'current monthly income' includes income received by the debtor's spouse only when the debtor has filed a joint case with

his or her spouse. Because the debtor's [non-filing] spouse has no current monthly income, the applicable commitment period will be based only on the debtor's current monthly income." *In re Grubbs,* 2007 WL 4418146, *2 (Bankr. E.D. Va. 2007).

Other Courts that conclude that the non-debtor spouse does not have any "current monthly income" include:

- *In re Stansell,* 395 BR 457 (Bankr. D. Id. 2008) – by definition, a non-filing spouse has no current monthly income.
- *In re Green,* 2008 WL 7880899 (Bankr. N.D. Ga. 2008) – current monthly income as defined in Section 101(10A) is limited to income received by the debtor.
- *In re Dugan*, 2008 WL 3558217 (Bankr. D. Kn. 2008) – income of non-filing spouse that is not available to cover household expenses because the non-debtor spouse demonstrates an intent not to contribute to or cover the debtor's expenses is not included in debtor's current monthly income and so is not included in determining the Applicable Commitment Period.
- *In re Borders*, 2008 WL 1925190 (Bankr. S.D. Al. 2008) – non-filing spouse's income used to pay non-filing spouse's individual expenses is not included in determining applicable commitment period.
- *In re Clemons,* 2009 WL 1733867 (Bankr. C.D. Ill. 2009) – recognizing the "incongruity" between Sections 101(10A) and 1325(b)(4), court concluded that current monthly income is limited to income received by the debtor, therefore non-debtor spouse has no "current monthly income"

Although the majority of courts have excluded the non-filing spouse's gross income in determining the applicable commitment period, the statutory basis for this conclusion is not readily apparent. Section 1325(b)(4) incorporates the income of the non-filing spouse without limitation. Although Current Monthly Income as defined in Section 101(10A) focuses on the income of the debtor, there is no statutory prohibition against calculating the current monthly income of the non-filing spouse using the same formula – gross income received by the non-filing spouse plus any amounts regularly contributed to the expenses of the non-filing spouse.

Nonetheless, the Courts appear more willing to resolve the apparently conflict between Sections 101(10A) and 1325(b)(4) by excluding from 1325(b)(4) any consideration of the non-filing spouse's income in determining the applicable commitment period.

Allocation of Non-Filing Spouse Income for Purposes of Section 707(b)(3), Section 1325(b) and "Good Faith"

Outside of Bankruptcy, when a husband and a wife each have income, they either expressly or impliedly allocate their respective incomes to the payment of household bills and expenses. Some couples will comingle all of their incomes and use their combined incomes to pay household expenses. Other couples, particularly those who may be on second or subsequent marriages, may specifically allocate income of one spouse to pay certain expenses, with little or no comingling of funds. A couple may determine that one spouse's income pays all of the household expenses while the other spouse's income is saved, invested, or used to purchase luxury goods such as second homes or boats.

When one spouse files for Bankruptcy protection, however, creditors acquire a definite interest in the allocation of income and expenses. If the income of the debtor is used to pay all of the household expenses, that could leave the debtor with no income to pay creditors in bankruptcy while leaving the non-filing spouse free to use his or her income as the non-filing spouse deems appropriate, in essence forcing creditors of the debtor to subsidize the living expenses of the non-filing spouse. "Failure to consider the impact of the nondebtor spouse's income and proposed expenditures therefore would leave the debtor's unsecured creditors to subsidize the spouse's expenses." *In re Stampley,* 437 BR 825, 827 (Bankr. E.D. Mi. 2010).

Courts have wrestled with the proper method of imputing income and allocating expenses in three contexts – "abuse" under Section 707(b)(3); calculation of "projected disposable income" under Section 1325(b); and "good faith" under Section 1325(a)(3). Although decided

under these various Code sections, the issues presented and the analyses used by the Courts cut across Code lines and in many ways are equally applicable in all three contexts.

a. The "proportion of income" method

The "proportion of income" approach, sometimes referred to as the "pooling" approach, considers the amount of income available to each spouse after paying their individual expenses, and then allocates the "joint" or "household" expenses between the debtor and spouse in proportion to their respective incomes or, in some cases, on an arbitrary 50-50 basis.

In *In re Stampley,* 437 BR 825 (Bankr. E.D. Mi. 2010), debtor's Schedule I listed debtor's net income of $4,705.54 and her non-filing spouse's net income of $2,450.89, for total household net income of $7,156.43. Debtor's Schedule J indicated that debtor had separate, personal expenses of $650.00. Debtor's spouse had separate, personal expenses totaling $1,406.00. Subtracting the personal expenses of the debtor and her non-filing spouse from the total expenses on Schedule J left net "household" expenses of $4,946.00. The Court rejected an arbitrary 50-50 split of these household expenses, finding that "a more equitable and logical approach would be to have the Debtor and her spouse proportionally bear reasonable and necessary family expenses to maintain the family in the same relative ratio as their respective net incomes." 437 BR at 828, *quoting In re McNichols,* 249 BR 160 (Bankr. N.D. Ill. 2000). Debtor's net income represented 66% of the household income. Therefore, 66% of the household expenses, or $3,264.00, would be allocated to the debtor. Debtor's monthly net income of $4,705.00, less her "individual" expenses of $650.00 and less her proportionate share of the household expenses of $3,264.00, left debtor with net income of $802 per month that could be used to satisfy debtor's creditors. Based on debtor's scheduled debt, a Chapter 13 Plan payment would easily pay a 100% dividend to unsecured creditors. "[T]he debtor's stated net

disposable income is significantly lower because the debtor and her husband allocate a large portion of [debtor's] monthly net disposable income for [the spouse's] sole expenses. This is unfair to the debtor and even more unfair to the debtor's sole creditors. For all practical purposes, the excess is a gift, and it is a gift from the spouse who is in bankruptcy and insolvent to the spouse who is not in bankruptcy and to that spouse's creditors." 437 BR at 828. Debtor's Chapter 7 case was an "abuse" under Section 707(b)(3).

Other Courts have concluded that expenses should be allocated equally, without regard to the actual percentages of respective incomes. In *In re McCain*, 2006 WL 4458679 (Bankr. M.D.N.C. 2006), debtor's Schedule I indicated that debtor had monthly net income of $3,050.00, and debtor's spouse had net income of $3,884.00. The Court concluded that the "reasonable" expenses of debtor and his spouse totaled $4,540.00. The Court then "allocated" one half of the family expenses, or $2,270.00, to the debtor, leaving the debtor with $780.00 to devote to a Chapter 13 Plan payment, which would produce a dividend of approximately 25%. Given the possibility of such a substantial dividend, the Court concluded that debtor's petition for relief under Chapter 7 would be an "abuse" under Section 707(b)(3). *See also In re Coup,* 2008 WL 2388114 (Bankr. N.D. Ohio 2008)(court should assume that each spouse shares equally in paying family living expenses).

Regardless of whether the Court uses a "proportionate" sharing or an equal allocation, the objective is to insure that the debtor's creditors are not forced to unfairly subsidize a luxury lifestyle of either the debtor or the non-filing spouse by having the debtor assume a disproportionate amount of household debt while allowing the non-filing spouse to "shield" income. The Courts recognize that the non-debtor spouse cannot be forced to use their income to

pay debts of the debtor. However, the income of the non-debtor must be considered in determining whether the debtor has available disposable income.

The danger in the "proportional" approach to calculating disposable income is that is still leaves a risk of forcing a debtor's creditors to subsidize the non-filing spouse. The "proportional" approach recognizes that the debtor and the non-filing spouse will each have individual creditors as well as the "household" expenses. The "proportional" cases begin with the separate incomes of each and deduct the separate expenses of each before arriving at the respective percentages for allocation of the household expenses. Taken literally, if the non-filing spouse has "separate" expenses for a luxury good such as a vacation home, expensive automobile or boat, the payments and related expenses would be deducted from the non-filing spouse's income, potentially exhausting that income before ever reaching the allocation of household expenses.

In response, the Courts have sometimes imposed a "reasonableness" concept even to the non-debtor's expenses. However, Section 707(b)(3) does not depend on whether the non-filing spouse is abusive, but whether the *debtor* is abusive. There is no authority in the Bankruptcy Code to dictate to a non-debtor how to spend their individual income. "Congress expressed no intention that 707(b) should effect [sic] a non-debtor or that any non-debtor should be required to tighten his or her belt in order to assist the debtor in paying debts." *In re Falke,* 284 BR 133, 138 (Bankr. D.N.D. 1991). There is a substantial question as to whether the Courts, in the guise of limiting the non-debtor's expenses to "reasonable" amounts, are exceeding their authority under the Code.

b. "Projected Disposable Income"

The Courts that apply the "proportional" approach based their holdings on pre-BAPCPA case law, holding that Congress did not intend to eliminate those cases while interpreting post-

BAPCPA cases. Those Courts, particularly in cases under Section 707(b)(3), note that Congress did not eliminate the concept of "abuse", but actually lowered the standard from "substantial abuse" required pre-BAPCPA. Where Congress did not indicate an express intent to overrule prior holdings, those holdings remain valid in applying later Congressional enactments.

Other Courts have concluded that Congress did express its intention to overrule prior case law in the area of non-filing spouse's income. These Courts point to the definition in Section 1325(b) of "disposable income", defined as Current Monthly Income less only statutorily authorized expenses. Current Monthly Income is calculated solely on the debtor's income plus so much of the non-filing spouse's income as is actually contributed to the expenses of the debtor and debtor's dependents. To the extent that the non-filing spouse uses his or her income for any reason other than contributing that income to the debtor, that income cannot be considered in determining either the amount of debtor's Chapter 13 Plan Payment or "abuse" under Section 707(b)(3).

In *In re Quarterman*, 342 BR 647 (Bankr. M.D. Fl. 2006), the Court noted that BAPCPA amended the definition of "disposable income". Prior to BAPCPA, Section 1325(b) defined "disposable income" as "debtor's total income less reasonably necessary expenses". BAPCPA now defines "disposable income" as "Current Monthly Income" less "reasonably necessary expenses" for a below-median income debtor; or less the IRS standard expenses for an above-median income debtor. BAPCPA then defined Current Monthly Income in Section 101(10A) as the total income derived by the debtor plus amounts contributed by third parties including debtor's non-filing spouse. "[B]ased upon the explicit language of section 101(10A), current monthly income does not include *all* the income of the non-debtor spouse, but rather only amounts expended on a regular basis for household expenses. If income is not (1) expended

regularly (2) on household expenses, then it is not included in the debtor's current monthly income." 342 BR at 651. Therefore, in calculating "disposable income" under Section 1325(b), the Court would include only that income of the non-debtor spouse that is contributed to the expenses of the debtor. The evidence presented indicated that although the non-filing spouse had separate income, he did not contribute all, or even substantially all, of that income to the debtor. Therefore, the income of the non-filing spouse could not be included in calculating "disposable income" under Section 1325.

In *In re Baldino,* 369 BR 858 (Bankr. M.D. Pa. 2007), debtor had monthly gross income of $1,204.00, and her non-filing spouse had monthly gross income of $6772.33. Debtor's spouse contributed $1,978.00 per month to the household expenses and retained the balance of $4,794.33 for the spouse's own use. The Court rejected the U.S. Trustee's argument that the significant income of the non-filing" spouse rendered debtor's filing "abusive", noting that incorporating the non-filing spouse's income that is not contributed to household expenses would be "at odds with the explicit definition of current monthly income as amended by BAPCPA." 369 BR at 862. As a result, debtor had "current monthly income" of $3,182.00, an amount which, based on debtor's reasonable expenses, did not produce a finding of "abuse" under Section 707(b)(3).

The "projected disposable income" test has the advantage of mathematical certainty (or at least as much "certainty" as is possible under BAPCPA"). Courts do not have to wrestle with determining "proportionality" of income or determine which expenses are solely the debtor's versus the non-filing spouse. Courts do not have to calculate the "true amount" of "joint expenses". Courts do not have to determine whether a "proportional" allocation or a flat 50-50 allocation of joint expenses is appropriate. Debtors and creditors will not have to engage in what

could be "hair splitting" analyses of specific expenses to determine whether some portion of a claimed expense benefitted the debtor even if paid by the non-filing spouse. If the non-filing spouse owns a boat and the debtor occasionally rides in the boat, does that boat payment become a "household expense"? If the debtor only uses the boat 10 days per year, should the Court allocate the expense by pro-rating the total expenses for the year and then "assigning" 10 days' worth of those expenses to the household? Although the CMI test does have its shortcomings, such as the potential for abuse by the non-filing spouse at the expense of the debtor's creditors, it does have the advantage of at least a certain amount of mathematical precision.

The "projected disposable income" test also appears to be more consistent with the definition of "disposable income" added by BAPCPA. And in those Courts which equate "disposable income" with "projected disposable income", there does not appear to be any legal basis to include in the debtor's income any amounts received by the non-filing spouse that are not "regularly contributed" to the debtor's household income. As noted by the Court in *In re Baldino,* "Further, I have not found a provision in the bankruptcy code which mandates a non-filing spouse to live modestly or to devote his or her income to the repayment of the filing spouse's debts. If the legislature is unhappy with the effect of the statute, it is free to amend it within the limits of the Constitution." 369 BR at 862.

c. The "case by case" approach

Yet a third approach used by some courts is the "case by case" approach. These Courts will not automatically presume that the non-filing spouse's income is included as the "proportion of income" Courts do; nor that the non-filing spouse's income is irrelevant as the "current monthly income" Courts do. The "case by case" Courts do not presume that a married couple is a single marital unit with pooled income and shared expenses or that the Bankruptcy Code

imposes on the non-filing spouse an obligation to turn over a portion of the spouse's income to the debtor so the debtor can pay his or her creditors. Instead, these Courts examine the debtor's financial affairs and those of the non-filing spouse on a case-by-case basis to determine whether the filing is an "abuse" under Section 707(b)(3) or whether the debtor is contributing all of their disposable income under Section 1325(b).

In *In re Welch,* 347 BR 247 (Bankr. W.D. Mi. 2006), the Court looked first at the debtor's monthly net income of $2,251.06 as if the debtor was a single individual. The Court noted that debtor's income, standing alone, was "certainly not sufficient to fund a lifestyle that could be described as 'substantially abusive' within the meaning of Section 707(b)." 347 BR at 256. The Court then examined the non-filing spouse's income of $2,853.00 per month, finding that the non-debtor spouse's income was "not so great as to justify ignoring that the reality is that it is [debtor], not [spouse] who is seeking bankruptcy relief." The Court would not impose its judgment on how the spouse is to spend his income unless the amount of that income was so great that the debtor would not be truly be in need of bankruptcy protection, and permitting the non-filing spouse to retain the income would allow the debtor to live a lavish lifestyle at the expense of creditors.

In *In re Travis*, 353 BR 520 (Bankr. E.D. Mi. 2006) the Court used a similar approach to reach a similar conclusion. Although the Court agreed with the United States Trustee that the non-filing spouse's income and expenses are relevant under Section 707(b)(3), the Court found that the non-filing spouse's income "should be considered only if his/her income is substantial enough to significantly raise the debtor's standard of living and generate total household income in excess of the reasonable costs of food, clothing, shelter and other necessities." The Court found that the non-filing spouse's net income of $2,310, which was spent on the nonfiling

spouse's taxes, transportation and individual credit card debts, with the balance being contributed to the household income, did not enable the debtor to "significantly improve" his standard of living, but merely made it possible for debtor to provide food, clothing and shelter for the debtor and his dependents. The Court did warn that it was possible that a non-filing spouse's budget may contain expenses which would constitute an "extravagant" lifestyle. "If the Debtor's non-filing spouse's extra income was funding a vacation home or an expensive car for the Debtor, the Court could reach a different conclusion." 353 BR at 531.

The difficulty with a "case by case" analysis is determining where to draw the line between a "reasonable" and an "extravagant" lifestyle. Some cases make the decision fairly easy. In *In re Staub,* 256 BR 567 (Bankr. M.D. Pa. 2000), the debtor had nominal income but his wife had net income of more than $16,000.00 per month. The Court dismissed the case, stating that the Court would not ignore a circumstance where the non-filing spouse's income was so great that the debtor could pay off the entirety of his unsecured debt in only a few months; and the totality of circumstances indicated that the debtor was not the "needy but unfortunate" debtor that Chapter 7 was designed to aid.

Similarly, in *In re Harter,* 397 BR 860 (Bankr. N.D. Ohio 2008), debtor had $30,000 in unsecured debt that the debtor sought to discharge while relying on the non-filing spouse's income to support a home valued at $400,000.00 and paying for debtor's transportation expenses in excess of $1,000 per month. "Where the non-debtor spouse has a substantial income that supports a comfortable lifestyle or significant discretionary purchases of luxury items, courts have sometimes considered more of the spouse's income to be available to supply basic necessities, making more of the debtor's income available to repay her obligations." 397 BR at 865. *See also In re Adams,* 2007 WL 3091583 (Bankr. D. Md. 2007) (non-filing spouse income

was sufficient to support more than $6500 per month mortgage on residence valued at more than $1.3 million plus debtor's vehicle lease payment of $1,225.00 per month – case dismissed as abuse).

The difficulty with the "case-by-case" approach is the lack of any standards for determining whether a particular case will be abusive, leading debtors and counsel to "guess" as to whether a particular case may be found to be "abusive" or not. Certain cases may be easily identified as abusive and others may be just as easily identified as not abusive. In between those two extremes lies a great majority of cases where the non-filing spouse's income may be sufficient to improve the debtor's standard of living somewhat, but not to an obvious extreme. At what point does a Court decide that "enough is enough" or that "this level of luxury is too much"? At what point does the analysis of "abuse" amount to nothing more than a "smell test", a standard of "I cannot define abuse, but I know it when I see it"? And how does this type of subjective test square with one of the stated goals of BAPCPA, to reduce judicial discretion and to promote greater certainty and predictability?

Carried to an extreme, the "case by case" approach can produce a very harsh result. In *In re Stanley,* 441 BR 37 (Bankr. M.D.N.C. 2010), the Court found the Debtor's Chapter 13 case in bad faith and denied confirmation. Debtor was the sole wage earner for the household, earning on average $3,500 from his self employment. Debtor's non-filing spouse was unemployed and received unemployment compensation of $1,000.00 per month which she used solely to pay her car payment, college debt and two credit cards, contributing nothing to the "household" expenses. Debtor's non-filing spouse's income was not sufficient to pay her individual expenses in full, so the debtor's budget included "household" expenses of $2,697.00 plus payments on the spouse's credit cards of $395.00 per month, which left $430.00 per month available for Chapter

13 Plan payments, which the debtor proposed to pay each month for 60 months. There was nothing in this case that appeared even remotely abusive – the debtor and his spouse had a modest budget, lived in a modest home, did not have excessive car payments and did not live an "ostentatious" or "luxurious" lifestyle. Nonetheless, using the "case by case" approach, the Court found that the debtor's Chapter 13 Plan lacked good faith, as it "diverted" money away from debtor's budget to pay the non-filing spouse's credit card payment. The Court concluded that debtor was "choosing" to pay his spouse's credit cards in full while paying his own creditors a dividend of only 9%. The Court did not address the fact that if the debtor instead applied to his Chapter 13 Plan the $395.00 that he used to pay his wife's credit cards, the plan would still yield less than 20% to unsecured creditors while simultaneously forcing the spouse into a bankruptcy proceeding of her own. The Court acknowledged "denying confirmation of the Plan puts the Debtor in a difficult position, but the receipt of a Chapter 13 discharge is not an inalienable right." The Court suggested that the debtor "convert his case to Chapter 7". The Court, using the "case-by-case" analysis, denied confirmation of a plan that would pay unsecured creditors 9% of their claims to force the debtor into a Chapter 7 which would pay unsecured creditors nothing at all, while still allowing the debtor to subsidize his wife's credit card bills and expenses in an even greater amount that originally proposed.

The other question that does not appear to be answered is, is there a limit to how much of the non-filing spouse's income can be included in the calculation of the debtor's disposable income. In *Harter,* the Debtor worked and had monthly net income from her employment of $950.00 per month, while her husband had monthly net income of more than $7,500.00 per month. If debtor had filed Chapter 13, could the Court force the debtor to make a plan payment in excess of the debtor's entire net income? Even if the debtor committed $950 per month to a

Chapter 13 Plan, the debtor would still be able to enjoy a substantial lifestyle based solely on the income of the non-debtor spouse. Could the Court conclude that a failure to commit more than the debtor's entire net income was somehow a "lack of good faith"? For that matter, it is indisputable that a debtor who earns $950.00 per month still has individual expenses. Could the Court essentially require the debtor to commit $950 per month to fund a plan, shifting the entire burden of debtor's personal expenses onto the non-filing spouse?

How does a Court deal with a debtor who has no individual income at all, and relies entirely on the non-debtor spouse for 100% of the debtor's expenses? Can that debtor, who admittedly has no income and may not be eligible for Chapter 13 (the debtor does not have "regular income" as required by Section 109(e)) nonetheless be found to be "abusing" the spirit of the Code by filing a petition under Chapter 7? The non-debtor spouse may have substantial income, but at what point can the non-debtor spouse be compelled to contribute to the debtor's bankruptcy case. As noted in *In re Boatwright,* 414 BR 526, 535 (Bankr. W.D. Mo. 2009), "As objectionable as [the non-filing spouse's] behavior, the Court must be mindful that the conduct of a non-debtor, no matter how obnoxious, cannot serve as the basis for denying a debtor her discharge, as long as the debtor is not conspiring with the non-debtor or benefitting from his conduct."

The evaluation of "abuse" and the calculation of plan payments where only one spouse files is a complicated process and involves multiple competing interests and policy positions. The outcome for a particular debtor may depend less on the facts and circumstances of the case and may turn far more on the Court's choice of a "test" to use. In a "CMI" district, the debtors in *Adams* and *Stanley* would have easily survived, although in "case by case" districts both cases were dismissed. Conversely, cases such as *Quaterman* and *Baldino* which passed the "CMI" test

would most likely fail the "case by case" test and would be very interesting decisions under the "proportion of income" test. Counsel considering filing an individual case for a married debtor would be well advised to search out information concerning the position not only of the Judges in their particular District, but also the positions of the local office of the United States Trustee.

INTERACTION OF ENTIRETIES PROPERTY WITH THE BANKRUPTCY ESTATE

Hon. Jeffrey R. Hughes
United States Bankruptcy Court
for the Western District of Michigan
One Division N.
Grand Rapids, MI 49503

I. **What is Entireties Property**?

A. Common Law Roots

> A species of common-law concurrent ownership, tenancy by the entireties, developed as part of the English feudal system of land tenures. The exigencies of feudalism demanded that the functions of ownership be vested in males, presumably capable of bearing arms in war. Women were lightly regarded legally, and especially married women-whose very identities, in most respects, were considered merged and lost in the personalities of their husbands. For purposes of property and of contract, the married woman was under a complete legal blackout termed coverture. **Man and wife were one and the one was male.**

Phipps, *Tenancy by the Entireties* 25, Temp. L.Q. at 24 (1951) (emphasis added).

> Like joint tenants, tenants by the entirety enjoy the right of survivorship. Also like a joint tenancy, unilateral alienation of a spouse's interest in entireties property is typically not possible without severance. Unlike joint tenancies, however, tenancies by the entirety cannot easily be severed unilaterally. 4 *Thompson* § 33.08(b). Typically, severance requires the consent of both spouses. *id.,* § 33.08(a), or the ending of the marriage in divorce, *id.,* 33.08(d). At common law, all of the other rights associated with the entireties property belonged to the husband: as the head of the household, he could control the use of the property and the exclusion of others from it and enjoy all of the income produced from it. *Id.,* § 33.05. The husband's control of the property was so extensive that, despite the rules on alienation, the common law eventually provided that he could unilaterally alienate entireties property without severance subject only to the wife's survivorship interest. *Orth*, *supra,* at 40-41.

U.S v. Craft, 535 U.S. 274, 280-81, 122 S. Ct. 1414, 1421 (2002).

B. Conceptual Changes

Michigan courts have long recognized that the married women's property laws as enacted in Michigan abolished the common law fiction of a single marital entity:

> Now, however, and since the adoption of the constitution of 1850, and the act relative to the property of married women, already referred to, husband and wife no longer constitute a single person in contemplation of law. The wife may take, hold, and dispose of her separate property as though she were unmarried, and all rights and

> disabilities of either party growing out of the old doctrine of unity of person, have disappeared with the doctrine itself, which, being directly repugnant to both the letter and the spirit of these enactments, no longer exists.

Fisher v. Provin, 25 Mich. 347, 349 (1872).

How the concept of entireties property has changed over time is illustrated in Mich. Comp. Laws Ann. § 557.101. That section states:

> In all cases where husband and wife own any interest in land as tenants by the entirety, such tenancy by the entirety may be terminated by a conveyance from either one to the other of his or her interest in the land so held.

Mich. Comp. Laws Ann. § 557.101 (West 1988).

The notion of one spouse conveying to the other his or her interest in the entireties estate would have been unimaginable under the common law. After all, "man and wife were one and the one was male." Indeed, it is only because Michigan now recognizes the separate interests of both the husband and the wife in the entireties estate that this section became necessary.

C. The Modern Entireties Estate

The modern conception of entireties property is more akin to a joint tenancy in which both parties control the alienation of the fee interest and both parties have an indestructible right of survivorship. *See, e.g., Morgan v. Cincinnati Insurance Co.,* 411 Mich. 267, 307 N.W.2d 53 (1981) (Fitzgerald, concurring opinion).

> With the passage of the Married Women's Property Acts in the late 19th century granting women distinct rights with respect to marital property, most States either abolished the tenancy by the entirety or altered it significantly. 7 Powell § 52.01[2]. Michigan's version of the estate is typical of the modern tenancy by the entirety. Following Blackstone, Michigan characterizes its tenancy by the entirety as creating no individual rights whatsoever: "It is well settled under the law of this State that one tenant by the entirety has no interest separable from that of the other . . . . Each is vested with an entire title." *Long v. Earle*, 277 Mich. 505, 517, 269 N.W. 577, 581 (1936).

> And yet, in Michigan, each tenant by the entirety possesses the right of survivorship. Mich. Comp. Laws Ann. § 554.872(g) (West Supp. 1997), recodified at § 700.2901(2)(g) (West Supp. Pamphlet 2001). Each spouse-the wife as well as the husband-may also use the property, exclude third parties from it, and receive an equal share of the income produced by it. *See* § 557.71 (West 1988). Neither spouse may unilaterally alienate or encumber the property, *Long v. Earle, supra*, at 517, 269 N.W., at 581; *Rogers v. Rogers*, 136 Mich.App. 125, 134, 356 N.W.2d 288, 292 (1984), although this may be accomplished with mutual consent, *Eadus v. Hunter*, 249 Mich. 190, 228 N.W. 782 (1930). Divorce ends the tenancy by the entirety, generally giving each spouse an equal interest in the property as a tenant in common, unless the divorce decree specifies otherwise. Mich. Comp. Laws Ann. § 552.102 (West 1988).

Craft, 535 U.S. at 281-82, 122 S. Ct. at 1422.

II. **Property and the Bankruptcy Estate**

A. Sections 541(a) and (c)(1)

Section 541(a) creates, upon the commencement of the case, an estate (1) that is a separate, legally recognized entity, and (2) that becomes the immediate owner of any and all interests that the debtor owned in property as of the commencement of his case.

> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
> (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable **interests of the debtor** in property as of the commencement of the case.

11 U.S.C. 541(a)(1) (emphasis added).

However, Section 541(a) is only declaratory. That is, Section 541(a) merely states what is to constitute the estate's property. It is Section 541(c) that actually accomplishes the transfer of all of these interests to the newly created estate.

> (c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any

> provision in an agreement, transfer instrument, or applicable nonbankruptcy law--

11 U.S.C. 541(c).

B. The Cardozo Metaphor

> A common idiom describes property as a "bundle of sticks"-a collection of individual rights which, in certain combinations, constitute property. See B. Cardozo, *Paradoxes of Legal Science* 129 (1928) (reprint 2000).

Craft, 535 U.S. at 278, 122 S. Ct. at 1420.

C. *Butner*

An important axiom of bankruptcy law is that state law controls the estate's rights in an interest acquired from the debtor unless the Bankruptcy Code itself modifies that right.

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interest [i.e., property interest created under state law] should be analyzed differently simply because an interested party is involved in the bankruptcy proceeding.

Butner v. U.S., 440 U.S. 48, 55, 99 S. Ct. 914, 918 (1979).

Another way of stating the same rule is that the estate has no greater right in the interest acquired than did the debtor himself unless the Code creates that additional right.

III. The Entireties Interest and the Bankruptcy Estate

A. The Entireties Bundle of Sticks

Craft provides this description of the rights, or "sticks," that comprise Michigan's version of the modern entireties estate:

> According to Michigan law, respondent's husband had, among other rights, the following rights with respect to the entireties property: the right to use the property, the right to exclude third parties from it, the right to a share of income produced from it, the right of survivorship, the right to become a tenant in common with equal shares upon divorce, the right to sell the property with the respondent's consent

> and to receive half the proceeds from such a sale, the right to place an encumbrance on the property with the respondent's consent, and the right to block respondent from selling or encumbering the property unilaterally.

Craft, 535 U.S. at 282, 122 S. Ct. at 1422.

B. The Bankruptcy Estate

The Bankruptcy Code, unlike the former Act, clearly includes the debtor's interest in entireties property as property of the estate. *Liberty State Bank and Trust v. Grosslight (In re Grosslight)*, 757 F.2d 773, 775-76 (6th Cir. 1985). However, it is only the debtor's undivided interest that becomes part of the bankruptcy estate. The non-filing spouse's interest remains outside of the bankruptcy estate, just as would the undivided interest of a non-filing tenant in common remain outside of the other tenant's bankruptcy estate. H.R. REP. NO. 95-595 at 367-68 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963 and S. REP. NO. 95-989 at 95-989 at 85 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787.

C. Severance?

Assume that A and B, who are married, own Blackacre as tenants by the entirety and that A, but not B, files for Chapter 7 relief. Under this hypothetical:

– Only A's entireties interest in Blackacre would become part of his bankruptcy estate. B's entireties interest would continue to be held by her separate and apart from A's bankruptcy estate.

– B, then, would no longer be a co-tenant with A; rather, she would now be a co-tenant with A's bankruptcy estate. But, under Michigan law, only a husband and wife can hold property as tenants by the entirety.

– Does not *Butner* then mandate a severance of A's and B's entireties estate unless the Bankruptcy Code itself operates to preserve the tenancy during the bankruptcy estate's administration of A's interest?

Indeed, were A and B to have both filed for Chapter 7 relief, two separate bankruptcy estates would have been created, thereby leaving neither A or B as a co-tenant of Blackacre. Rather, each would have been replaced by an incorporeal entity incapable of being married.

D. Code Treatment of the Undivided Entireties Interest

1. Sale of the Debtor's Undivided Interest

Section 363(b)(1) provides that "the trustee, after notice and a hearing, may use, sell or lease . . . property of the estate . . . ." Given that the debtor's undivided interest in the entireties property now becomes property of the estate, it follows that the trustee should also be able to sell that interest. Granted, selling an undivided interest in property would be difficult. That is why Congress enabled the trustee to sell other co-tenants' interests as well under Section 363(h). Nonetheless, the Section 363(b) sale of only the debtor's interest in entireties property is certainly conceivable.

It would seem, then, that a severance of the entireties estate must occur should the trustee ever sell the filing spouse's undivided interest. That is, whoever purchased the interest could not continue as a tenant by the entirety with the non-filing spouse because they would lack the unity of marriage.

QUERY: Does the severance occur when the Section 363(b) sale is consummated or did the severance occur at the inception of the case when the estate itself became B's co-tenant? And, if the answer is the latter, what Code provision preserved the entireties relationship between A's bankruptcy estate and B up to the point A's bankruptcy trustee ultimately disposed of the bankruptcy estate's undivided interest in Blackacre?

2. Sale of the Non-Filing Spouse's Undivided Interest

A common misconception is that the bankruptcy trustee's ability to sell both the debtor's and the non-filing spouse's interests in entireties property is accomplished solely through Section 363(h). *See, e.g.*, *In re Grosslight*, 757 F.2d at 776 ("If not specifically exempted, the debtor's interest in the entireties property may be sold pursuant to 11 U.S.C. § 363(h) - (j)."). However, a careful reading of that subsection reveals that it is only the non-filing spouse's interest that is sold pursuant to that subsection. The estate's own interest in the entireties property (i.e., the debtor's bundle of sticks) is still sold under the separate authority given the trustee under subsection (b).

> [T]he trustee may sell **BOTH** the estate's interest, **under subsection (b) or (c) of this section**, **AND** the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety . . . .

11 U.S.C. 363(h) (emphasis added).

Subsection (h), then, is, in conjunction with subsections (i) and (j), the Bankruptcy Code's version of a partition statute. That is, these subsections permit A's bankruptcy trustee to sell not only the estate's own undivided interest in a co-tenancy, including a tenancy by the entireties, but also the other tenant's interest. Moreover, the power granted to A's bankruptcy trustee by these subsections begs even more the question of whether the entireties estate ever survived the commencement of the case. In other words (1) not only has A's bankruptcy filing caused B, the non-filing spouse, to now be in a co-tenancy with a total stranger, but (2) this new co-tenant's rights in Blackacre are markedly different then those of a tenant by the entirety – to wit, A's bankruptcy trustee can now unilaterally dispose of the estate's own undivided interest in Blackacre without B's consent and A's trustee can even dispose of B's undivided interest without her consent.

3. Exemption of the Undivided Interest

(a) Generally

Unlike the former Bankruptcy Act, the Bankruptcy Code contemplates all of the debtor's interests in property becoming the estate's property, with the debtor then selecting from whatever has become the estate's property those interests he would like to claim as exempt.

> Notwithstanding Section 541 of this title, an individual debtor may exempt **from** property of the estate . . .

11 U.S.C. § 522(b)(1) (emphasis added).

Consequently, if it is only A's undivided interest in Blackacre that became property of his bankruptcy estate, it is only that same undivided interest in property that A may exempt under Section 522(b)(1).

(b) Federal Exemptions

If A were to elect the federal exemption scheme and if he were also to successfully claim the estate's undivided interest in Blackacre as exempt under Section 522(d)(1), that interest would at some point be returned to A. But if the entireties estate was severed upon the commencement of A's case, does it necessarily follow that A and B will resume holding as tenants by the entirety once A's interest is returned to him? After all, A might like the idea of being able to sell his interest without B's consent, especially when A could now rely upon Section522(c) to protect the exempted interest from all of his creditors, both joint and individual.

(c) Section 522(b)(3)(B) Exemption

A would have also had the opportunity to exempt the estate's undivided interest in Blackacre under the state exemption scheme, for those exemptions include any:

> . . . interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety

> . . . to the extent that such interest as a tenant by the entirety . . . is exempt from process under applicable nonbankruptcy law . . . .

11 U.S.C. § 522(b)(3)(B).

But even here the Code speaks of the debtor's interest in the entireties property as having existed only prior to the commencement of the debtor's case. Moreover, the interest referenced in this subsection is only the debtor's undivided interest. There is no reference to the non-filing spouse's interest.

Consider again A and B and their tenancy by the entirety in Blackacre. But this time suppose that A has two creditors, with Creditor 1 having only a claim against him but Creditor 2 also having a claim against B, his non-filing spouse. In other words, Blackacre would have been exempt from process by Creditor 1 under Michigan law had A not filed for bankruptcy relief but Blackacre would have been subject to execution by Creditor 2 because it was fortunate enough to have a joint claim against both A and B. Therefore, A would not be able to exempt his bankruptcy estate's undivided interest in Blackacre to the extent of Creditor 2's claim against it. Rather, that portion of A's undivided interest would remain the property of only his estate. Moreover, the non-exempt portion would be available to all of his creditors, not just the creditors who had held a joint claim against both A and B. And, finally, B would have to still cope with A's creditors who also had claims against her unless she too had sought bankruptcy relief.

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TAX REFUNDS AND THE NON-FILING SPOUSE

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Tax Refunds and the Non-filing Spouse

Most spouses file joint income tax returns. How is a tax refund treated when one spouse files for bankruptcy protection and the other does not? Who owns the tax refund? Is it property of the estate? The facts of particular cases give rise to other questions such as when the right to receive a refund accrues, and how the spouses' respective interests are calculated.

1. Property of the estate. It is well established that a debtor's right to receive a tax refund is property of the bankruptcy estate. As noted by the Court in *In re OBrien*, 443 BR 117 (W.D. Mich. 2011), the seminal decision on the issue was made in *Segal v. Rochelle,* 382 U.S. 375, 86 S.Ct. 511, 15 L.Ed.2d 428 (1966). The Supreme Court held that a postpetition tax refund resulting from a loss-carryback from a prior year was property of the bankruptcy estate. The loss-carryback refund claim was "sufficiently rooted in the pre-bankruptcy past" to be regarded as property of the estate. In *Kokoszka v. Belford,* 417 U.S. 642, 94 S.Ct. 2431, 41 L.Ed.2d 374 (1974), the Supreme Court again concluded that a tax refund based upon a debtor's prepetition earnings was "sufficiently rooted in the prebankruptcy past" to be included in property of the estate.

The enactment of the Bankruptcy Code in 1978 did not alter the principle established by *Segal* and *Kokoszka,* which were both decided under the old Bankruptcy Act. *Doan v. Hudgins (In re Doan)*, 672 F.2d 831 (11th Cir. 1982). See also *Benn v. Cole (In re Benn),* 491 F.3d 811 (8th Cir.2007) (debtor's anticipated tax refund, to the extent it was attributable to events occurring prior to the filing of the bankruptcy petition, was included in the bankruptcy estate) and *Barowsky v. Serelson (In re Barowsky),* 946 F.2d 1516 (10th Cir.1991) ("the pre-petition portion of the refund essentially represents excessive tax withholding which would have been other assets of the bankruptcy estate if the excessive withholdings had not been made").

As noted by the Court in *In re Meyers*, 616 F.3d 626, 628 (7th Cir. 2010), determining what is property of the estate is normally a relatively simple matter of whether the asset was acquired prior to or subsequent to the bankruptcy filing. However, tax refunds received post-petition are often attributable to overpayment of taxes prior to the filing, and are therefore part of the estate. In *Meyers*, the Court utilized the "pro rata by days" method of allocating what portion of the refund is prepetition property of the estate. A percentage is calculated based upon the date of the filing of the bankruptcy petition; for example, that if the petition is filed on day 251 of the year, then 69% of the refund (251/365) is property of the bankruptcy estate. The Court noted that this method of calculation may not be appropriate in all circumstances, such as where income varies widely from season to season, although it was appropriate in this case, where the debtor earned a steady income.

2. To what extent is a tax refund property of the estate when one spouse does not file for bankruptcy protection? The calculation must be taken a step further when tax refunds are owed pursuant to joint tax returns, yet only one of the spouses is in bankruptcy. The issue becomes even more difficult where one spouse is the main or sole income earner. Three approaches to this issue were summarized by the Court in *In re Carlson*, 394 B.R. 491 8th Cir.BAP (Minn.) 2008. The first approach, acknowledged by the *Carlson* court as the majority approach, allocates a joint tax refund between the spouses in proportion to their respective tax withholdings. Similarly, the second approach would divide a refund according to the income generated by each spouse. The third approach would split the refund equally between the spouses, regardless of the source of the income or tax withholding. A common ground among the three approaches is that property rights are determined in accordance with state law.

a. Allocation based upon respective tax withholdings. In *In re Kleinfeldt*, 287 B.R. 291(10th Cir. BAP Wyo. 2002), the non-debtor spouse had no income and no tax withholdings. The Court found that the filing of a joint tax return does not create equal property interests for each spouse in any resulting refund; instead, each spouse has a separate interest in any overpayment based upon their contribution to the overpaid tax. Accordingly, even though a refund is payable to both the debtor and the non-debtor spouse, the refund was entirely the debtor's property and consequently was property of the estate.

Other courts utilizing the approach adopted by *Kleinfeldt* include *In re Edwards*, 400 B.R. 345 (D.Conn. 2008) (finding the majority approach is appropriate and attributing to the debtor only the amount of the joint tax refund that reflects the withholdings she contributed); *In re Lyall,* 191 B.R. 78 (E.D.Va.1996) (the majority of courts have held tax refunds should be allocated between spouses proportionally in accordance with tax withholdings); *In re WDH Howell*, 294 B.R. 613 (D.N.J. 2003) (non-debtor wife does not possess an interest in tax refund where parties filed joint return and wife earned no income); *In re Levine,* 50 B.R. 587 (S.D. Fla.1985) (trustee is presumed to be entitled to an amount proportionate to the amount withheld from the debtor's paycheck).

b. Allocation based upon income generated by each spouse. This approach was utilized in *In re Verill*, 17 B.R. 652 (Md 1982). The Court found there is a presumption, absent proof to the contrary, that a formula prorating the tax return as of the date of the filing is both fair and equitable, and a further presumption that prorating a tax refund between spouses' estates based upon each spouse's annual earnings is fair and equitable. The court adopted the Trustee's allocation, based upon the bankrupt spouse earning 79.4% of the spouses' joint income, and his voluntary petition being filed on the 326th day of the year. Thus, 79.4% of 326/365 of the total income tax refund of $1,160.23 was allocated to the estate, equaling $822.79.

Although the Income Rule is frequently noted as one of three approaches to the tax refund issue, there are few reported cases utilizing the approach, and at least one court has noted that the approach "appears to have been abandoned". *In re Garbett*, 410 B.R. 80 (E.D.Tenn. 2009).

c. Allocation based on equal division of refund. This approach is also known as the "50/50 refund rule" and is discussed by the Court in *In re Trickett*, 391 B.R. 657 (D.Mass. 2008). The Court first applied the pro rata by days method to determine what amount is potentially property of the estate, then went on to further adjust the estate's interest based on the allocation between the debtor and the non-filing spouse. The Court noted that the question of the extent of a debtor's interest in property is one of state law. In adopting the "50/50 refund rule" the court relied on *In re Barrow*, 306. B.R. 28 (W.D.N.Y. 2004), quoting:

> "I disagree with those courts that allocate refunds in proportion either to income or amount of withholdings. The reality of the Internal Revenue Code is that the total tax is not necessarily linked to income, while the overpayment is not necessarily linked exclusively to income or withholdings. For many taxpayers, a significant portion of the refund is attributable not to these factors, but to any number of credits, such as the child tax credits or credits for education or for child and dependent care expenses. In many ways, the tax consequences of a joint filing exhibit no proportionality to respective levels of withholding and income. Joint tax filers may claim an exemption for each spouse, thereby effectively allowing them to use the exemption to offset income of the spouse with higher earnings. Similarly, the losses or deductions of one spouse may favorably impact their joint taxable income. For many married couples, a joint filing permits use of a more favorable tax table. The results are most dramatically indicated when one spouse earns the entire family income. In that instance, because a spouse without income has joined in signing the tax return, the family may pay significantly less tax, as compared to the tax that would have accrued to a married person filing separately but with identical income and withholdings. It is simply inaccurate to say that the greater refund is attributable only to the income and withholdings of the employed spouse." *Barrow*, 306 B.R. at 30-31.

Courts have held that the ownership analysis should be made on a case-by-case basis. In the matter of *In re Garbett*, 410 B.R. 80 (E.D.Tenn. 2009), a joint bankruptcy filing, the Court noted the primary difference between those courts which adopted the withholding approach and those adopting the 50/50 Refund Rule is the applicable underlying state law. Looking to Tennessee law with respect to marital property, the Court imposed the rebuttable presumption that each spouse had an equal interest in the tax refund, and allowed each debtor to claim an exemption in 50% of the refund. In *Garbett*, the joint tax return included combined incomes, earned income credit, child tax credit, joint losses, joint capital gains, and taxes on a joint IRA distribution. Given this level of intermingling of the debtors' incomes and deductions, the trustee had not successfully rebutted the presumption of joint ownership.

In *In re Aldrich*, 250 B.R 907 (W.D. Tenn 2000), the court held that the non-filing spouse, a homemaker who did not produce income but made a substantial contribution to the family, may be entitled to have a property interest in a joint tax refund check, notwithstanding that all the taxable income was generated by the debtor. The court directed that one-half of the tax refund check would be allocated to the debtor-husband's bankruptcy estate for administration and distribution to creditors after his allowed exemptions, and the other half would be allocated to the non-filing spouse, stating that "the totality of the particular facts and circumstances existing here create an equal ownership in the joint tax refund check."

The underpinnings of the "50/50 refund rule" were explained by the Court in *In re Innis*, 331 B.R. 784 (Bankr. C.D. Ill. 2005), as well as the practical reasons supporting its adoption. The concept of marriage as a shared partnership should be included within the court's "decisional framework". Where a right to an income tax refund accrues during the parties' marriage, the refund is marital property without regard to whose income generated the refund. Furthermore, the court gave consideration to the fact that joint liability is imposed on the spouses for any tax deficiency that results

from a jointly filed tax return, so it follows that there should be a presumption of equal ownership of a tax refund. "If a debtor's spouse can suffer the burdens of filing a joint return, he or she should get the attendant benefits as well." The *Innis* court adopted the 50/50 rule but disagreed with the rebuttable presumption established by the courts in *Barrow* and *Aldrich*, in which courts may look to the financial histories and the particular circumstances of the spouses. Instead, the *Innis* court opined that ownership of a tax refund by spouses is 50/50, and there need be no inquiry beyond the fact that the parties voluntarily elected to file a joint return. The only evidence which could be introduced to rebut the 50/50 presumption would be a pre-existing domestic relations court order, or an enforceable, written, prepetition contract between the spouses designating a particular degree of ownership.

In a New York case involving joint debtors, the Court concluded that 50/50 ownership was appropriate. In *In re Glenn*, 430 B.R. 56 (N.D.N.Y. 2010), the court adopted the reasoning of *Trickett, Garbett* and *Innis*, as well as the rationale set forth by the court in *Innis* in limiting the rebuttal inquiry to domestic relations court orders or enforceable contracts.

d. Calculation based on IRS procedures. A variation of the first approach as advocated in *In re Kleinfeldt*, has arisen. Rather than calculate the allocation based strictly upon respective tax withholdings, some courts have undertaken complex calculations. In the matter of *In re Crowson*, 431 B.R. 484 (10th Cir. BAP 2010), the bankruptcy court applied *Kleinfeldt* in holding that the joint tax refund consisting solely of debtor's wage withholdings was property of the debtor's bankruptcy estate. However, on appeal, the BAP distinguished *Kleinfeldt*, finding that the refund in the *Crowson* matter arose not only from the debtor's withholding, but also from three tax credits that generated refundable overpayments: the earned income credit, the child tax credit, and the recovery rebate credit. The court then looked to the IRS's procedures for allocating joint refunds in instances where a portion of the joint refund is offset against one debtor's separate tax or support liability.

The analysis undertaken by the court in *Crowson* includes calculations of what tax liability would have been incurred if each spouse hypothetically filed as "married filing separately" and of what each spouse's hypothetical separate earned income and additional child tax credits would have been. The Court acknowledged that the calculations are cumbersome and that it may not be appropriate to undertake them in all cases. However, the simpler *Kleinfeldt* method of allocation based only upon actual withholdings was viewed as detrimental to the non-filing spouse, who should be permitted to benefit from the tax credits to which he contributed.

Recently, the Montana Bankruptcy Court acknowledged that all three methods of calculation have suffered criticism, and was ultimately persuaded by the view of the *Crowson* Court. Recognizing that tax refunds do not stem exclusively from income or withholdings, the Court sought to calculate the total contributions of each spouse based upon rulings arising from the Internal Revenue Code and Rules. *In re Palmer*, 2011 WL 890690 (D. Montana).

The Internal Revenue Code, at Section 6402(a) (26 U.S.C. § 6402(a)) provides that the IRS may credit an overpayment to the person who made the overpayment. Under IRS rules, filing a joint income tax return does not create new property interests for the husband or the wife in each other's income tax overpayment; each retains a separate interest. In the non-bankruptcy case of *United States of America v. MacPhail,* 2005 WL 2206681, at 3 (6th Cir. Ohio), the Sixth Circuit Court of Appeals addressed the issue of allocating a refund between spouses who had filed a joint return. The court held that the refund at issue was to be disbursed in proportion to the amount each party paid in taxes.

The IRS allows trustees to divert debtors' tax refunds to the bankruptcy estate. According to the IRS application form, the first step is to determine what proportion of the total refund is property of the bankruptcy estate based upon the calendar year. Then, that amount is multiplied by the percentage of the federal income taxes withheld from the petitioning spouse to determine the amount of the tax refund that is property of the estate, and the balance is refunded to the non-debtor spouse. The IRS also points out that allocation may be different in, for instance, community property states.

3. Tax Refunds in Community Property States. In community property states there is a presumption that all property is marital property, including any tax refunds. There are ten community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. In these states, as a general rule, the tax rules treat income as if each spouse earned half of it.

In the non-bankruptcy case of *U.S. v. Elam*, 112 F.3d 1036 (9th Cir.1997), Mrs. Elam sought one half of an overpayment issued to her and her ex-husband for a tax year during which they were married. The court held that California's community property laws create a presumption that the overpayment was community property owned equally by husband and wife. However, the presumption was rebuttable, and since there was a prenuptial agreement in place providing that the husband's income was his separate property, the court remanded the matter for findings on whether the agreement rebutted the presumption.

In *In re Barnes*, 14 B.R. 788 (N.D.Tex.1981), a joint bankruptcy filing, the Court analyzed ownership rights in a tax refund based on Texas's community property laws. All of the income was earned by Mrs. Barnes; however, personal earnings and tax refunds are community property. Therefore, not only was Mr. Barnes able to exempt the refund, he was not limited to claiming only one-half, and could claim the entire refund as exempt under 11 USC 522(d)(5).

4. Conclusion. There are multiple approaches to determining how the non-filing spouse is impacted by a tax refund. Practitioners should be aware of the property laws of their states, the different methods employed by Courts, and the arguments made by non-filing spouses that they are entitled to one half of the refund irrespective of the non-filing spouse's income or withholding taxes.

18th ANNUAL CENTRAL STATES BANKRUPTCY WORKSHOP

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The Non-Filing Spouse Dilemma
Familiar Issues Resurfacing in Record Numbers

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The Dilemma Created by the Non-Party Spouse:
Efforts to Avoid Inclusion in the Bankruptcy Estate

1. Use of Prenuptial Agreements

- In re: Michael v. Frierdich, Sr., 294 F.3d 564 (7th Cir. 2002)
  Transfer of $400,000.00 in stock proceeds within five months of the bankruptcy filing was done with actual intent to defraud under 11 U.S.C. § 548(a)(1)(A).
- U.S. v.. Loftis, 607 F3d 173 (5th Cir. 2010)
  Partition agreements pursuant to which nearly all of husband's assets were placed into his wife's hands were fraudulent transfers.

2. Use of Marital Separation Agreements

- Gray v. Snyder, 704 F.2d 709 (4th Cir. 1983).
  A marital separation agreement executed one year prior to the petition was a sham transaction.

3. Fast-Track Divorces

- In re: Williams, 159 BR 648 (Bank.D.RI 1993); In re Williams, 190 BR 728 (1996 U.S. Dist. Lexis 539)
  Debtor's transfer of assets to ex-wife in quick pre-petition divorce was avoidable fraudulent transfer.
- In re: William J. Beverly, 374 BR 221 (9th Cir. BAP 2007)
  Collusive transfer of assets through use of a marital settlement agreement is an avoidable transfer under the Uniform Fraudulent Transfer Act. Debtor's discharge also denied.

4. Outright Transfers to Non-Party Spouse Prior to Bankruptcy

- In re: Shelton C. Lindsay, 06-36552, (U.S. B.Ct. S.D. NY May 14, 2010)

The transfer of debtor's house, $110,000.00 savings account and stock were recoverable fraudulent transfers as was the payment of tuition to the university, despite debtor's contention that transfers were made for estate planning purposes.

- In re: Richard D. Paschall, 403 BR 366 (B Ct. E.D. Va. 2009)
  The 2005 execution of a post-marital agreement created a debtor/creditor relationship between husband and wife enabling bankruptcy trustee to establish existence of antecedent debt component of a preference.
- In re: Mervyn Phillips, Jr., 379 BR 765 (B Ct. N.D. Ill., E.D. 2007)
  Circumstantial evidence was used to determine whether a transfer was intended to hinder, delay or defraud creditors when debtor and non-party spouse asserted that debtor transferred real estate to his wife because she had originally owned the property in her name only, and she had allowed the debtor to be placed on the title so that he could use the property as collateral in order to borrow money.
- In re: Teleservices Group, Inc., HG 05-00690 (W.Dist.Mi. 2011)
  The defendant's main defense to fraudulent transfers allegations was that it received multi-millions of dollars in transfers from the debtor in good faith. Although Judge Hughes discussed recent case law favoring an objective approach in assessing 548(c)(5) and 550(b)(1), he found that the good faith test was actually a subjective one.

Case Summaries

- Frierdich v. Mottaz, 294 F.3d 864 (7th Cir. 2002)

Frierdich was a director and treasurer of a closely-held corporation. In anticipation of their engagement, Michael Frierdich and Beverly Oswald engaged in premarital financial planning. Michael owned 360 shares of a closely held corporation which were worth approximately $400,000.00. The couple agreed that Michael would transfer his shares to Beverly, and in exchange, she would waive all interest in his estate. (Although the corporation did exist, stock certificates had never been issued).

Beverly never received a stock certificate and no notation was ever made on the stock record book. Nonetheless, language in the parties' January 8, 1998 prenuptial agreement (not a prenuptial agreement, *per se*, but two matching waivers of rights) referenced the ownership of the stock by Beverly.

Some time later, the other officers/stockholders of the corporation sought to repurchase the shares ostensibly transferred to Beverly. The president and managing officer of the corporation were unaware of any transfer or attempted transfer of stock from Frierdich to Beverly. Frierdich signed a sale agreement listing himself as the seller of the stock. Frierdich deposited the $400,000 in sale proceeds into Beverly's account. Involuntary bankruptcy proceedings were instituted against Frierdich shortly thereafter.

The trustee sought to avoid the transfer of the stock proceeds from Frierdich to his spouse under 11 U.S.C. 548(a)(1)(A), which presumed a "transfer" as defined at Section 101(54). Both the bankruptcy court and the district court found for the trustee. On appeal to the Seventh Circuit Court of Appeals, Beverly argued that she received the stock pursuant to the January 8, 1998 prenuptial agreement.

The Seventh Circuit found that the stock was never delivered to Beverly and that delivery was required to effectuate the transfer. In analyzing the delivery of unauthenticated securities under 810 Ill. Comp. Stat. 5/8-301(b)(1), the Seventh Circuit found that delivery occurs when the issuer registers the purchaser as the registered owner or another person either becomes the registered owner on behalf of the purchaser, or acknowledges that it holds for the purchaser. The corporation never registered Beverly as the stock owner, so she was unable to prevail.

Furthermore, since Illinois law requires that a prenuptial agreement be in writing, Beverly's assertion that the transfer occurred by way of the prenuptial agreement was flawed. Nowhere in the writing that purported to be the parties' prenuptial agreement was there a discussion of the stock transfer being connected to the waiver of rights. The Seventh Circuit upheld the rulings of the bankruptcy court and the district court and held that Beverly did not take an interest in the stock until the proceeds were deposited into her account on September 1998, which was five months prior to bankruptcy and well within the reach back period.

- U.S. v. Loftis, 607 F.3d 173 (5th Circuit 2010)

A district court found that a community property partition agreement between a husband and wife in which the wife waived all interest in her husband's future earnings in exchange for her receipt of $2,337,777.16 in assets, to be a fraudulent transfer. The wife appealed to the Fifth Circuit Court of Appeals.

The husband Todd Loftis, in his capacity as corporate president, inflated the costs of tools to Lockheed, which inflated costs were further passed on to the United States government. Todd was notified of an investigation into his misdeeds one month after executing the community property partition

agreement with his wife Lisa. After Todd was found guilty and sentenced to jail time and restitution, the government sought to garnish Todd's property transfers to Lisa under the Federal Debt Collection Procedures Act (the "FDCPA"), 28 U.S.C. §§ 3304(b)(1)(A), and Texas state law.

The Fifth Circuit affirmed that the value of the assets received by Todd, regardless of what was estimated in the agreement, was not reasonably equivalent to assets transferred to Lisa (especially given his pending incarceration). Further, Todd should have reasonably believed he was incurring debts beyond his ability to pay when he defrauded Lockheed and the government. The Court further affirmed that under Texas state law, the government was permitted to garnish Lisa's one-half interest in the couple's community assets jointly or solely managed by Todd.

- Gray v. Snyder, 704 F.2d 709 (1983)

In this early '80's case, Jerald and Irma Snyder entered into a separation agreement after more than 30 years of marriage pursuant to which Jerald transferred to Irma his half interest in the marital home in exchange for her claims for support, alimony, or inheritance. Seven days later, the house was sold and all proceeds went to Irma. Jerald filed a voluntary petition five months after the sale. Jerald and Irma continue to live separately, although no divorce was initiated.

The bankruptcy court found that the conveyance of property from the debtor to his wife, in exchange for the release of the marital rights of support and inheritance, was fraudulent and voidable pursuant to Section 548 of the Bankruptcy Code. This finding was confirmed by the district court and appealed to the Fourth Circuit Court of Appeals.

After discussing some *Northern Pipeline* jurisdictional issues, the Fourth Circuit considered the lower courts' notion that "reasonably equivalent value" excluded future considerations, at least to the extent that they were not actually performed. The Fourth Circuit found that this definition of value was too narrow. Under North Carolina law, the husband owed a continuing duty of support to his wife. The husband owed a presently enforceable legal obligation of support to his wife under state law and her release of that obligation in exchange for the husband's transfer of a one-half interest in real estate would constitute satisfaction of a present or antecedent debt.

Thus, the Fourth Circuit remanded this case to the bankruptcy court to: a) inquire into the validity and enforceability of the separation agreement under North Carolina law; and b) determine whether the release of support rights constituted "reasonably equivalent value" for the husband's transfers.

- In re: Williams, 159 BR 648 (Bank.D.RI 1993); In re: Williams, 190 BR 728 (1996 U.S. Dist. Lexis 539)

  The Bankruptcy Court found that the debtor Lawrence Williams and his wife Diana orchestrated a quick divorce, the transfer and removal of assets and the pre-payment of agreed child support obligations prior to his bankruptcy filing, in an effort to remove the assets from the debtor's bankruptcy estate. The debtor's efforts to transfer substantially all of his personal property on the eve of his bankruptcy filing were intended to hinder, delay and defraud Citibank. While the debtor and Diana argued that her agreement to waive alimony constituted adequate consideration for the transfer of substantially all of the marital assets, the Court analyzed Diana's potential earnings and the likely outcome in divorce court. Given Diana's substantial income and assets, the Court disagreed that Diana's waiver of alimony was adequate consideration for the transfers.

The Court, also finding that Citibank's reliance on the debtor's financial statements was not reasonable, did not find Citibank's debt nondischargeable. Further, the Court did not find a pre-petition transfer to Citibank to be an avoidable preference under 11 U.S.C. 547(b)(5). The Court did, however, deny the debtor his discharge under Section 727(a)(2)(A) and avoided the transfers to Diana pursuant to Sections 544 and 548.

On appeal to the District Court in Rhode Island, the debtor argued that the trial court misapplied the missing-witness inference. Because the inference and the findings of fact were "inextricably intertwined" the court remanded the case to the bankruptcy court for reconsideration. The case was also remanded regarding whether the pre-petition transfer to Citibank was an avoidable preference.

- In re: William J. Beverly, 374 BR 221 (9th Cir. BAP 2007)

The debtor, a lawyer, while planning for a large judgment to be entered against a community debt, executed a marital settlement agreement in his pending divorce action in an effort to strip himself of assets. William transferred his interest in one million dollars worth of non-exempt funds to his wife in exchange for her interest in William's $1.1 million exempt retirement fund. The effect of these transfers was to leave William with only exempt or illiquid assets while his spouse received all non-exempt liquid assets. William's creditors filed an involuntary chapter 7 case.

The lower court found the marital settlement agreement did not embody an "actually fraudulent transfer" under California's UFTA and allowed the transfers as bankruptcy exemption planning. The Ninth Circuit Bankruptcy Appellate Panel reversed the decision, analyzing the transfers with the "badges of fraud" rubric and finding that there was "overwhelming direct

evidence" and corroborating circumstantial evidence of an actual intent to hinder, delay or defraud the debtor's creditors under UFTA.

In its decision, the Ninth Circuit BAP discussed the difficulties in determining the boundary between a legitimate pre-petition conversion of nonexempt property to exempt property (in the nature of "bankruptcy exemption planning") and a fraudulent transfer. According to the court, two things that can cause a debtor to cross that boundary are something other than the mere timing of the transfer and the idea of "too much" or overreaching by the debtor. Citing to a large record of evidence in the bankruptcy court of William's intent to hinder or delay, the court also denied the debtor his discharge under Section 727(a)(2) of the Bankruptcy Code.

- In re: Shelton C. Lindsay, 06-36352, (U.S. B.Ct. S.D.N.Y. May 14, 2010)

  The transfer of debtor's house, $110,000.00 savings account and stock were recoverable fraudulent transfers as was the payment of tuition to the university for the debtor's son, despite debtor's contention that transfers were made for estate planning purposes.

  Having survived a liver transplant (some years prior), the debtor claimed that his transfers to his wife Linda were in the nature of estate planning. The Court did not believe the debtor's efforts to categorize the transfers as estate planning, stating that it could not "overlook the fact that the debtor's most significant asset, his home, was not transferred until twenty-two years after he first fell ill, two years after estate planning commenced, and just one week before he was sued by his business partner."

  Further, the debtor's sale of his vehicles and transfer of the proceeds to his son's college to pay tuition were found to be fraudulent. In the absence of any legal obligation (and dismissing the defendants' argument of a moral

obligation), the Court found that payment of a child's college tuition is not a valid defense to transfers that are presumed fraudulent.

While the Court found constructive intent to defraud under New York state law, the Court also found that the plaintiff failed to show that the debtor's actions in engaging in estate planning and paying his son's college tuition were committed with actual intent to hinder his creditors. The plaintiff trustee did not meet his burden to produce clear and convincing evidence of actual intent. The defendants failed to present proof of solvency sufficient to raise any dispute of material facts and summary judgment was granted.

- In re: Richard D. Paschall, 403 BR 366 (B Ct. E.D. Va. 2009)

The Trustee sought to avoid the transfer of two pieces of real estate held as tenants by the entireties to the ex-wife's trust via quitclaim deeds pursuant to the terms of a post- nuptial agreement. The issues reached the court on cross-motions for summary judgment.

The ex-wife Deborah argued that debtor Richard had no interest in the transferred properties and held bare legal title under Bankruptcy Code Section 541(d). Deborah originally provided the funds for the purchase of both properties. While the marital agreement providing for the transfers between the husband and wife was executed in 2005, it was not recorded. As a result, for purposes of the preference analysis, the transfers were deemed to have occurred on August 23, 2006, the date the quitclaim deeds were executed.

Given the timing of transfers, the court found that the marital agreement was void as against the debtor's judgment creditors and had no effect against the trustee as the hypothetical lien creditor under Section 544. Accordingly, the transfers were presumed to be gifts. The trustee avoided the transfers as preferences pursuant to Section 547(b) and the estate became a one-half

owner in the properties along with Deborah. The trustee also sought to sell the non-debtor's interest pursuant to Section 363(h) of the Bankruptcy Code.

- In re: Mervyn Phillips, Jr., 379 BR 765 (Bk. Ct. N.D. Ill., E,D. 2007)

  In this Northern District of Illinois Judge Squires opinion, the court discussed the transfers from the debtor to and for the benefit of his wife Mercedes and his daughter Madonna. Judge Squires thoroughly discusses and applies the Code, the Illinois Uniform Fraudulent Transfer Act and applicable case law (including the application of the "badges of fraud") in a step-by-step manner.

  Circumstantial evidence was used to determine whether a transfer was intended to hinder, delay or defraud creditors when debtor and non-party spouse asserted that debtor transferred real estate to his wife because she had originally owned the property in her name only, and she had allowed the debtor to be placed on the title so that he could use the property as collateral in order to borrow money. The court used the "badges of fraud" analysis and found that the cumulative effect of the trustee's direct and circumstantial evidence was probative of the debtor's intent to hinder, delay or defraud his creditors. Further, the failure of Madonna to file a pretrial statement and appear at the scheduled pretrial conference resulted in a court order striking all of her pleadings and finding her in default.

  While the trustee was awarded both taxable costs and prejudgment interest on the award from the date of demand, the trustee's request for payment of attorneys' fees was denied for failure to provide specific authority therefor. Lastly, the trustee met his burden to sell the debtor's Burr Ridge real property free and clear of any interest of Mercedes pursuant to Section 363(h) of the Bankruptcy Code.

- In re: Teleservices Group, Inc., HG 05-00690 (W.Dist.Mi. 2011)

  In this pre-BAPCPA case, the trustee sued The Huntington National Bank to recover over $73 million dollars in fraudulent transfers Huntington received either directly from the debtor or indirectly through a related company, Cyberco. Cyberco and the debtor were related companies with a common owner. Huntington provided Cyberco with a business line of credit.

  Prior to its bankruptcy filing, the debtor made large regular transfers to Cyberco. These funds were apparently the proceeds of a fraud that Cyberco and the debtor were running on equipment finance companies. As it turned out, Teleservices was stealing money from finance companies, funneling the money to Cyberco, whose accounts were being swept by Huntington for payment on the line of credit. Huntington's officers had no demonstrable financial reason to be worried about the Cyberco account but were concerned anyway. Despite this and despite the fact that Huntington asked Cyberco to find another banking institution, Huntington continued to provide funds to Cyberco and sweep its account.

  Huntington's main defense to the fraudulent transfers allegation was that it received all of the transfers from the debtor in good faith under both Section 548(c)(5) and Section 550(b)(1). While the court discussed that recent case law favored an objective approach to assessing a transferee's good faith under these code sections, the Western District of Michigan court found that the test was subjective, with the "focus being upon traditional notions of honesty and integrity." The court discussed the "badges of fraud" as they relate to the transferor, but questioned what, if any, duty the transferee has to investigate should some (but not enough) badges come to his attention at a particular point in time. The court must assess not only whether the transferee conducted himself with honesty and integrity regarding the receipt of the transfer in question, but also whether the transferee conducted himself with

honesty and integrity in addressing the receipt of a series of fraudulent transfers as a succession of badges evidencing that intent come to the transferee's attention. It is the duty of the transferee to establish that he acted in good faith. Thus, the court's question as to whether Huntington proceeded with good faith under the facts of the case depended on whether Huntington could convince the court that it was honestly unaware of the debtor's fraud for more than a year notwithstanding its growing suspicions.

While the court believed Huntington when it stated that it never actually knew of the massive fraud the debtor was perpetrating upon its creditors as a result of the transfers to Huntington, the court satisfied itself that at a certain point Huntington was turning a blind eye to certain information. The information, if pursued, would have quickly led Huntington to the conclusion that fraud was being perpetrated. The court found that Huntington failed to establish its good faith regarding the receipt of nine checks from the debtor.

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