

## Is a Tax Refund Exempt in Bankruptcy?

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### Overview

The U.S. legal system has a long history of allowing debtors to hold specified items of property exempt from creditors (unless the exemption is waived). This, in effect, gives debtors a “head start” in becoming reestablished after suffering economic reverses. But, how extensive is the list of exempt property, and does it include federal and state refunds.

The ability (or not) to treat tax refunds as exempt from creditors in bankruptcy – it’s the topic of today’s post.

### Bankruptcy Exemptions – The Basics

Typically, one of the largest and most important exemptions is for the homestead. Initially even the exempt property is included in the debtor's estate in bankruptcy, but the exempt assets are soon returned to the debtor. Only nonexempt property is used to pay the creditors.

Each of the 50 states has developed a unique list of exemptions available to debtors. 18 states and the District of Columbia allow debtors to choose between their state exemptions or the federal exemptions. The remaining states have chosen to “opt-out” of the federal exemptions. Under the 2005 Bankruptcy Act, to be able to utilize a state’s exemptions, a debtor must have resided in the state for 730 days preceding the bankruptcy filing. If the debtor did not reside in any one state for 730 days immediately preceding filing, then the debtor may use the exemptions of a state in which the debtor resided for at least 180 days immediately preceding filing. If those requirements cannot be met, the debtor must use the federal exemptions.

### Tax Refunds as Exempt Property – The *Moreno* Case

Each state’s statutory list of exempt assets in bankruptcy will determine the outcome of whether tax refunds are exempt. But, a recent case involving the state of Washington’s exemption list is instructive on how other states might approach the matter.

**Facts of *Moreno*.** In *In re Moreno, No. 20-42855-BDL, 2021 Bankr. LEXIS 1262 (Bankr. W.D. Wash. May 11, 2021)*, the debtor filed Chapter 7 (liquidation) bankruptcy in late 2020. The debtor then filed her 2020 federal income tax return on January 28, 2021, and later received a tax refund of \$10,631.00. That refund was made up of \$572 of withheld taxes; \$2,800 of a “Recovery Rebate Credit” (RRC); \$1,079 of an Additional Child Tax Credit (ACTC); and \$5,500 of an Earned Income Tax Credit (EITC). The bankruptcy trustee sought to include almost all of the debtor’s tax refund in the bankruptcy estate, excluding only 0.3 percent of the total amount (\$31.89) based on the debtor’s Chapter 7 filing being December 30, 2020 (i.e., only one day of 2020 fell after the date the debtor filed bankruptcy).

**Timing of filing.** The debtor claimed that the tax refund arose post-petition because she filed the return post-petition. Consequently, the debtor claimed, the tax refund was not property of the bankruptcy estate. The court disagreed, noting that under [11 U.S.C. §541\(a\)\(1\)](#), the bankruptcy estate includes all legal or equitable interests of the debtor in property as of the date the case commences. Based on that, the court determined that the debtor had obtained an interest in the tax refund as she earned income throughout 2020. Thus, the tax refund for the prepetition portion of the tax year were rooted in her prepetition earnings



and were property of the bankruptcy estate regardless of the fact that she had to file a return to receive the refund.

**RRC.** The debtor used the state's list of exemptions and the trustee conceded that certain portions of the debtor's prorated tax refund were exempt. Specifically, the trustee did not dispute the debtor's right to retain the full RRC in the amount of \$2,800. [11 U.S.C. §541\(b\)\(11\)](#), enacted December 27, 2020, specifically excluded the RRC from the debtor's bankruptcy estate.

**Withheld taxes.** The debtor filed an amended Schedule C on which she claimed that \$572 of her 2020 refund attributable to withheld tax was exempt under state law. The trustee disagreed and the debtor failed to explain how state law applied to withheld taxes. However, the trustee conceded that amount was exempt as personal property (up to a dollar limitation). *Rev. Code Wash. §6.15.010(1)(d)(ii)*. This same part of the state exemption statute, the trustee concluded, entitled the debtor to an additional exemption of \$2,630, the balance allowable as exempt personal property after allowing the debtor to exempt \$370 in cash and checking accounts.

**ACTC and EITC.** As for the part of the refund attributable to the ACTC and the EITC, the debtor claimed that it was exempt under *Rev. Code Wash. §6.15.010(1)(d)(iv)* as any past-due, current or future child support "that is paid or owed to the debtor" or as "public assistance" under [Rev. Code Wash. §74.04.280](#) and 74.04.005. The trustee claimed that the ACTC was encompassed by the remaining "catch-all" exemption for personal property of *Rev. Code Wash. §6.15.010(1)(d)(ii)*. However, the court noted that if the catch-all provision didn't apply to the ACTC, it could be applied to the debtor's other debts to the benefit of the debtor. Thus, the court needed to determine whether both the ACTC and the EITC were exempt under state law.

The Court first concluded that neither the ACTC nor the EITC portions of the tax refund constituted "child support" under RCW § 6.15.010(1)(d)(iv). Instead, the court determined that the plain meaning of "child support" refers to payments legally required of parents. That was not the case with neither the ACTC nor the EITC. The court likewise concluded that the credits were not "public assistance" as defined by [Rev. Code Wash. §§ 74.04.280](#) and 74.04.005. Based on state law, the court noted, the credits would have to be "public aid to persons in need thereof for any cause, including...federal aid assistance." *Rev. Code Wash. §74.04.005(11)*. The court determined that the credits, under this statute, could only possibly be exempt as "federal aid assistance" which is defined under *Rev. Code Wash. § 74.04.005(8)* to include "[T]he specific categories of assistance for which provision is made in any federal law existing or hereafter passed by which payments are made from the federal government to the state in aid or in respect to payment by the state for public assistance rendered to any category of needy persons for which provision for federal funds or aid may from time to time be made, or a federally administered needs-based program."

The court determined that the state definition of "federal aid and assistance" applied to assistance in the form of monetary payments from the federal government to needy persons, but did not describe federal tax credits. Instead, tax credits are paid by the federal government directly to taxpayers. However, the court also noted that the statutory definition also included "federal aid assistance" and any "federally administered needs-based program." As such, it was possible that the credits could be exempt as "assistance" from a "federally administered needs-based program." On this point, the court noted that there was no statutory language nor legislative history associated with the credits indicating that they were part of a federally administered needs-based program. In addition, there was no caselaw on point that provided any light on the subject. However, disagreeing with the trustee's objection to the categorization of any federal tax credit as a federally administered needs-based program, the court relied on court opinions from other states construing similarly worded state statutes to conclude that both the ACTC and the EITC were "federally administered needs-based programs" exempt from bankruptcy under [Rev. Code Wash. §74.04.280](#). See [In](#)



[re Farnsworth, 558 B.R. 375 \(Bankr. D. Idaho 2016\)](#); [In re Hardy, 787 F.3d 1189 \(8th Cir. 2015\)](#); [In re Hatch, 519 B.R. 783 \(Bankr. S.D. Iowa 2014\)](#); [In re Tomczyk, 295 B.R. 894 \(Bankr. D. Minn. 2003\)](#).

## Conclusion

The *Moreno* case, even though it involved the particular language of one state's exemption statute, provides good insight as to how bankruptcy courts in other states would analyze the issue of whether federal tax credits (and other tax benefits) are exempt from a debtor's bankruptcy estate.

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