

How Should I Spend My Tax Refund Prior to Bankruptcy?

If you are contemplating filing for Chapter 7 bankruptcy and expect a tax refund, you need to be careful how you spend your refund money. Paying the wrong person, or buying the wrong things before your case is filed, can cause huge problems in your case.

It's My Money. I can Spend it as I Wish . . . Right?

Not so fast. When you file for Chapter 7 Bankruptcy, all of your assets must be disclosed to the Chapter 7 Trustee, an appointee of the Department of Justice who is charged with marshaling your non-exempt property and selling it. The proceeds are then used to pay your debts. A portion of the sale proceeds goes into the trustee's pocket for his time and trouble.

One of the assets trustees always look for during tax season is your beloved tax refund. Trustees like this asset because there is nothing to liquidate. Unlike real estate, which takes time to sell, a tax refund is quick hard cash that goes immediately to your creditors. So if you've decided to ruin the trustee's payday by spending your tax refund before your case is filed, you had better have a good answer as to how you spent the money before your case is heard.

“I Rented a Party Boat for My 40th Birthday Party.”

While hiring a party boat may seem like a good idea at the time, spending your tax refund on frivolous items won't make the trustee happy. Think about it — you are asking the Court to release you from your debts. If you choose to buy a big screen T.V. or install a new in-ground swimming pool with a heated cabana and tiki bar, the trustee could move to dismiss your case for bad faith. He or she will rightfully ask why you didn't use the money to pay some of your bills. And that's when the fun starts — motions to dismiss, extra court appearances, and oh yeah . . . more legal fees. Wasn't that tiki bar worth it?

“I Fixed My Car, Paid Some Bills, and Bought Clothes for the Kids.”

The trustee will typically not question your use of refund money for necessary living expenses such as food, clothing, medical care and home repair. As long as you can generally account for how the money was spent, the trustee will quickly move on to the next question and you will be in the clear. Although trustees can be tough, most of them are pragmatic and understanding, and realize that filing for bankruptcy does not mean you have to deprive yourself of the life's basic necessities.

Don't Repay Relatives Before Bankruptcy

One thing not to do before filing for bankruptcy is to use your refund to repay debts owed to family or business partners. It's probably not a good idea to repay close friends either. If any such payments are made within one year of filing your case, the trustee can demand they return the money. The recaptured money would then be distributed evenly among all of your creditors.

Needless to say, getting your family, friends or business partners involved in your personal bankruptcy proceeding is a nightmare scenario that can destroy relationships. It sounds strange, but you should show your love and respect for mom and dad by not repaying them before filing bankruptcy. Once your case is filed and closed, you can voluntarily repay anyone you want, including your nearest and dearest.

Spending your tax refund wisely before filing Chapter 7 bankruptcy is a critical first step to a smooth case. Before you give in to temptation, take some time to think about the possible consequences of your spending choices. If at all in doubt, seek the advice of a qualified bankruptcy attorney in your area.