OPINION POINT

Dischargeability of Income Tax Liability in Bankruptcy: The Late-Filed Tax Returns Conundrum Continues*

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Taxes and death are often categorized as some of life's certainties, but sometimes a taxpayer can discharge older income tax liabilities in bankruptcy. The rules and requirements for discharging taxes can be confusing. Adding to these complications, the circuits appear to be splitting on how to interpret a fundamental issue: whether taxes associated with a late-filed tax return may be discharged in bankruptcy. In some jurisdictions, if a tax return is filed even one day late, the associated taxes can *never* be discharged in bankruptcy. In others, the timeliness of a return is irrelevant, so long as the return was filed in good faith. Because of the disparate rulings of several courts, this issue will undoubtedly make its way to the U.S. Supreme Court.

This article refers to both bankruptcy and tax provisions. References to Title 11 of the United States Code in this article are to provisions in the Bankruptcy Code. References to section 6020 are to the Internal Revenue Code.

Dischargeability of Tax Liabilities

There are three key requirements for discharging tax obligations: the three-year rule, the 240-day rule, and the two-year rule. The three-year rule, under 11 U.S.C. section 507(a)(8)(A)(i), provides that the tax at issue must be at least three years old. This three-year period is calculated from the most recent date the tax return was due for the tax year, including any filed extensions (*e.g.*, on April 16, 2014, taxes filed on April, 15, 2011, meet the three-year rule). The 240-day rule, under 11 U.S.C. section 507(a)(8)(A)(ii), states that the tax in question must have been assessed more than 240 days before the bankruptcy petition was filed. Finally, under the two-year rule, pursuant to 11 U.S.C. section 523(a)(1)(B)(ii), the tax return must have been filed at least two years prior to the petition date.

The most recent controversial developments involve the interpretation of the two-year rule. That rule had always been interpreted to permit the discharge of taxes if (1) a debtor had filed a tax return, even if late; (2) the tax return had been on file for at least two years when the bankruptcy petition was filed; and (3) all of the other bankruptcy discharge rules are met (*e.g.*, no fraud, no evasion, etc.).

Beginning in 2008, the *status quo* was thrown into disarray. Courts have struggled with interpreting the hanging paragraph that follows subsection (19) of 11 U.S.C. section 523(a), generally referred to as "§ 523(a)(*)," and the meaning of the terms "applicable nonbankruptcy law" and "applicable filing requirements." Section 523(a)(*), added as part of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) amendments to the Bankruptcy Code, directly affects the two-year rule. It states: "For purposes of this subsection, the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law." Properly framed, the question is: because under nonbankruptcy law, a return is supposed to be filed timely, does a return that is filed even one day late meet the "applicable filing requirement" under nonbankruptcy law such that associated taxes are dischargeable?

Prior to 2005, the issue under the two-year rule focused on what document had to be filed to constitute a return under nonbankruptcy tax law. Thus, if a taxpayer filed something other than the official form (*i.e.*, Form 1040), could the tax be discharged? This raised the corollary, and much litigated question, of: if a taxpayer filed a return *after* the Service assessed a tax, could the tax be discharged?

Litigation addressed whether non-official forms, or government-prepared or filed returns, were "returns" for purposes of obtaining a discharge. Courts applied *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986), to determine if a purported return met the requirements. "Under the *Beard* Test, a document submitted to the IRS by a taxpayer qualifies as a return if it (1) purports to be a return; (2) is executed under penalty of perjury; (3) contains sufficient data to calculate

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the tax liability; and (4) represents an honest and reasonable attempt to satisfy the requirements of the tax law." *In re Martin*, 508 B.R. 717 (Bankr. E.D. Cal. 2014). The fourth element was the most important: if the taxpayer tried, in good faith, to file a return, the taxing authority should accept it without regard to timeliness.

BAPCPA supposedly clarified this issue, making it explicit that a Service-prepared return that was signed by a taxpayer *was* dischargeable, but a Service-filed return was not dischargeable. *See* I.R.C. § 6020(a) & (b); 11 U.S.C. § 523(a)(1)(B). Under certain provisions of the Internal Revenue Code, if a taxpayer does not file a return, the Service is allowed to prepare a return based on information it has and request that the taxpayer adopt it. If this return is then signed, the Service will accept it as a taxpayer-filed return. 11 U.S.C. section 523(a)(*) specifically permits discharge of taxes associated with "6020(a) returns."

However, ambiguities in both the tax law and the BAPCPA changes to 11 U.S.C. section 523(a)(*) have fueled a furious debate over whether the BAPCPA amendments prohibit discharge of *any* late-filed returns. The cases discussed below have addressed this issue, although with differing outcomes.

Creekmore

The manner of how the two-year rule was implemented stood unchallenged until *Creekmore v. Internal Revenue Service*, 401 B.R. 748 (Bankr. N.D. Miss. 2008). In *Creekmore*, the Service continued collection efforts post-discharge. Michael Creekmore, the debtor, filed an adversary proceeding in bankruptcy court against the Service, seeking a determination of the dischargeability of tax debts he owed to the Service. The issue in this case centered on whether he filed tax returns, timely or otherwise, in 1994 and 1995.

Because Creekmore had not filed his tax returns for 1994 and 1995, the court said the Service had filed SFRs "pursuant to" section 6020(b) on his behalf in 1997 and 1998. After each 6020(b) return was filed, Creekmore subsequently filed Form 1040s, after which the Service reduced his tax liabilities based on these signed returns. Thus, the dischargeability issue was whether a taxpayer who files a return *after* a Service assessment can discharge the associated taxes. The Service has long taken the position that such taxes are non-dischargeable because the post-assessment return was not filed in good faith. *Contrast In re Colsen*, 446 F.3d 836, 840 (8th Cir. 2006) (allowing discharge of all taxes when taxpayer filed a post-assessment return) *with In re Hindenlang*, 164 F.3d 1029, 1034 (6th Cir. 1999) (disallowing discharge).

The court in *Creekmore* relied on *In re Payne*, 431 F.3d 1055 (7th Cir. 2005), and *Hindenlang* to hold that a post-assessment return was not a "return" for purposes of satisfying the two-year rule. However, the court went on to hold that under 11 U.S.C. section 523(a)(*), a late-filed return did not comply with the "applicable filing requirements" of nonbankruptcy law and could never be discharged. *Creekmore*, 401 B.R. at 452. This is the position Judge Easterbrook took in his dissent in *Payne*: post-BAPCPA, returns must be timely filed for taxes to be dischargeable. "After the 2005 legislation, an untimely return cannot lead to a discharge—recall that the new language refers to 'applicable nonbankruptcy law (including applicable filing requirements).'" 431 F.3d at 1060.

Creekmore further reasoned that post-BAPCA, 11 U.S.C. section 523(a)(*) provides a "safe harbor" under section 6020(a), which applies to late returns the Service prepares, but the taxpayer signs. The *Creekmore* court held that no taxes associated with late returns can be discharged unless the return is a section 6020(a) return.

The logic of *Creekmore* is troubling. The court did not need to reach the 11 U.S.C. section 523(a)(*) issue. It could have decided the case more narrowly, applying *Payne* and *Hindenlang*. Fortunately for taxpayers, following *Creekmore*, the Service has decided that it will not claim that a late-filed return cannot *per se* satisfy the two-year rule. Chief Counsel Notice, CC–2010–016, 2010 WL 3617597 (Sept. 10, 2010) (the Chief Counsel Notice). Of course, the Service will continue to take the position that if no tax return was filed by the taxpayer, and the Service issues an assessment, any later filed return that reduces the tax liability is not filed in good faith and is not a "return" under *Beard. But see In re Martin*, 508 B.R. 717 (Bankr. E.D. Cal. 2014) (permitting discharge of taxes based on a return filed after a deficiency assessment).

McCoy

McCoy v. Mississippi State Tax Commission, 666 F.3d 924 (5th Cir. 2012), involves a taxpayer who failed to file state income tax returns. Linda McCoy, the debtor, had not filed her state tax returns in Mississippi for 1993 through 2000. The Mississippi State Tax Commission (MSTC) had made no-file assessments by September 2002 for McCoy for 1993 through 1997 and for 2000, but not for 1998 and 1999. According to the court, "no-file assessments" in Mississippi are the equivalent of 6020(b) returns, and are not considered "returns" under applicable nonbankruptcy law. On September 11, 2002, McCoy filed her 1998 and 1999 Mississippi income tax returns, and the MSTC assessed the tax due on her 1998 and 1999 returns immediately.

McCoy filed for bankruptcy in Mississippi in 2007, listing all tax debts owed to the MSTC. After she received her discharge in January 2008, the MSTC attempted to collect the taxes McCoy had owed before filing for bankruptcy. McCoy filed an adversary proceeding against the MSTC seeking a determination that her taxes were

discharged in her bankruptcy, including those taxes for 1998 and 1999 (for which she filed late, but self-filed, returns). Accordingly, unlike *Creekmore*, *McCoy* properly raised the issue concerning the meaning of "applicable filing requirements" under 11 U.S.C. section 523(a)(*).

The MSTC moved to dismiss McCoy's case, claiming that a late-filed tax return cannot be a return for the purposes of 11 U.S.C. section 523(a)(*) under Mississippi law, and that, consequently, McCoy's income taxes were nondischargeable. The Mississippi bankruptcy court agreed with the MSTC, dismissing McCoy's adversary proceeding, while the district court affirmed the bankruptcy court's dismissal.

The Fifth Circuit affirmed those decisions, thus creating a new precedent for the treatment of late-filed tax returns. The debtor was denied the discharge of her taxes because she had filed her returns late, even though MSTC had not made no-file assessments for the 1998 and 1999 taxes. The Fifth Circuit relied on 11 U.S.C. section 523(a)(*) in its reasoning.

The Fifth Circuit concluded that, since the no-file assessments in Mississippi are essentially the same as the Service's section 6020(b) assessments, McCoy's subsequently filed tax returns for 1998 and 1999 would have been discharged under pre-BAPCPA law. After *McCoy*, any return filed late in the Fifth Circuit, whether it is late by one day or five years, cannot be a return for the purposes of bankruptcy unless the return is filed under section 6020(a) or a state law equivalent. Therefore, any taxes associated with a late-filed state income tax return are nondischargeable in bankruptcy in the Fifth Circuit.

Gonzalez

In direct contradiction to *McCoy*, on March 6, 2014, the Bankruptcy Appellate Panel for the First Circuit (First Circuit BAP) affirmed the bankruptcy court's determination that the debtor's income tax liabilities were dischargeable, even though he had filed late tax returns. *Gonzalez v. Massachusetts Dep't of Revenue*, 506 B.R. 317 (1st Cir. BAP 2014).

The debtor, Anthony Gonzalez, filed tax returns in February 2005 for each of the tax years from 1999 through 2002. In July 2005, he filed returns for 2003 and 2004. All of the returns were late, but the Massachusetts Commissioner of Revenue had not assessed any taxes before they were filed. Almost five years later, on April 19, 2010, Gonzalez filed for bankruptcy, listing debts to the Massachusetts Department of Revenue (MDOR) for 1999–2004. He received his discharge in September 2010, and commenced an adversary proceeding in November 2011, seeking the same determination that Creekmore and McCoy had sought—that his pre-petition income tax liabilities were discharged.

In response, the MDOR relied on the same theory that worked for the MSTC in *McCoy*: Gonzalez's late-filed state income tax returns could not qualify as returns for tax purposes because they did not comply with Massachusetts's applicable filing requirements. Fortunately for Gonzalez, the First Circuit BAP disagreed with the MDOR since even the MDOR admitted that a late-filed return was treated as a "return" under Massachusetts law.

The First Circuit BAP, also engaging in a statutory "plain reading," disagreed with the Fifth Circuit and did not find any timeliness requirement in the applicable nonbankruptcy law referenced in 11 U.S.C. section 523(a)(*). Further, the court held that (1) as a policy matter, exceptions to discharge are strictly construed in favor of a debtor, and (2) under the two-year rule in the Bankruptcy Code, it is undisputed that late tax returns are eligible for a discharge. The court ultimately concluded that if a late-filed return is *not* a "return" for purposes of §523(a)(*), such an interpretation of the Bankruptcy Code would render 11 U.S.C. section 523(a)(1)(B)(ii) superfluous, which would not have been what Congress intended by amending section 523(a)(*). *Gonzalez*, 506 B.R. at 322 ("If all late-filed returns except § 6020(a) returns are not returns there is no need to state that § 6020(b) returns are not returns."). Thus, *Gonzalez* accepts *Beard*; the issue remains whether a filing by the taxpayer is a good faith attempt to comply with the tax laws.

Further confusing the state of affairs, in *Perkins v. Massachusetts Dep't of Revenue*, 507 B.R. 45, 54 (D. Mass. 2014), decided one day after *Gonzalez*, a Massachusetts district court followed *McCoy*, holding that "the law is straightforward, and does not allow one to read out timeliness issues from the applicable filing requirements." The First Circuit BAP has since reaffirmed its decision in *Gonzalez*. *In re Pendergast*, 2014 WL 1800838 (B.A.P. 1st Cir. May 2, 2014) (late filed returns dischargeable, but returns filed after MDOR assessments not dischargeable). Thus, even within the First Circuit, courts are in conflict.

Conclusion

McCoy and *Gonzalez* have focused the issue of whether a late-filed return is a "return" for purposes of the two-year rule, and whether timely filing of a return is an "applicable filing requirement" for purposes of 11 U.S.C. section 523(a)(*). The authors suggest that for the reasons stated in *Gonzalez* and the Chief Counsel Notice, *McCoy's* "one-day late" rule is contrary to the plain meaning of the two-year rule and not required by section 523(a)(*). This issue will, eventually, require Supreme Court intervention because the Service and state taxing authorities are interpreting the two-year rule in opposing ways that are leading to confusing and conflicting results. ■