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#19**LATE-FILED RETURNS: Clarify the Bankruptcy Law Relating to Obtaining a Discharge****PROBLEM**

Taxpayers who face financial hardship and seek a bankruptcy discharge of their tax liabilities face uncertainty as to whether they will be able to obtain a discharge of these liabilities if they do not file their tax returns timely. This lack of clarity is due to conflicting judicial interpretations of a provision of § 523(a) of the Bankruptcy Code, which sets forth exceptions to the bankruptcy discharge in certain cases.<sup>1</sup> Section 523(a)(1)(B)(i) creates an exception for a tax debt for which the debtor had not filed returns, and § 523(a)(1)(B)(ii) creates an exception for a tax debt for which the debtor had filed the return after the due date and within two years of the bankruptcy case. At least before 2005, a tax would be dischargeable when the debtor filed the return late more than two years before the bankruptcy case was filed. As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),<sup>2</sup> Congress amended § 523(a) and added a paragraph at the end of this section, sometimes referred to as the “Hanging Paragraph.” This addition provides “the term ‘return’ means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements).”<sup>3</sup>

Some courts, including two circuit courts of appeals, have taken the approach that the language defining a return as one that satisfies “applicable filing requirements” means that unless a return is filed by the appropriate due date, the tax liability is not eligible for discharge.<sup>4</sup> This means an individual taxpayer who files a tax return late—even one day late—could never discharge the tax in bankruptcy. This rule can apply even where the IRS has determined the late filing was due to reasonable cause or a natural disaster, or because the taxpayer was in combat status. Other courts do not interpret the “applicable filing requirements” language as requiring a timely filed return.

Although the IRS currently takes the position that an untimely filed return does not bar a bankruptcy discharge, this stance can change at any time.<sup>5</sup> Also, despite the IRS’s current position, given the split in legal interpretation, it is possible that some courts could ignore the IRS position. In addition, the uncertainty in the bankruptcy law may have an adverse impact on taxpayers with state tax liabilities. As a result, otherwise compliant taxpayers who file late returns may not be able to obtain the fresh start intended by the Bankruptcy Code, or achieve finality in resolving their tax liabilities at the time of the discharge. This may undermine the taxpayers’ *right to a fair and just tax system* and *right to finality*.

1 The Bankruptcy Code is contained in Title 11 of the United States Code. 11 U.S.C. § 523(a)(1)(B) and (C) sets forth exceptions to a bankruptcy discharge for certain tax debts when the debtor is an individual. See 11 U.S.C. §§ 727(b), 1141(d)(2), and 1328(a)(2). Unless otherwise noted, all code references are to provisions in the Bankruptcy Code contained in Title 11 of the United States Code.

2 Pub. L. No. 109-8, § 714, 119 Stat. 23, 128 (2005).

3 The Hanging Paragraph also provides that the term return includes a return prepared pursuant to Internal Revenue Code (IRC) § 6020(a) 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 IRC § 6020(b) or a similar state or local law. These two IRC provisions will be discussed below.

4 See, e.g., *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), cert. denied, 133 S. Ct. 192 (2012); *In re Mallo*, 2014 WL 7360130 (10th Cir. Dec. 29, 2014), aff’g 498 B.R. 268 (D. Colo. 2013); *In re Creekmore*, 401 B.R. 748 (Bankr. N.D. Miss. 2008). See also *In re Payne*, 431 F.3d 1055, 1060 (7th Cir. 2005) (Judge Easterbrook dissenting) (after the BAPCPA, tax liability on a late-filed return is nondischargeable).

5 Chief Counsel Notice 2010-16, 2010 WL 3617597 and Chief Counsel Advisory 201044008 (Nov. 5, 2010), 2010 WL 4384171.

## EXAMPLE

Due to a severe medical condition, a taxpayer with an excellent compliance history files her federal and state tax returns one day after their deadlines. Because of her financial circumstances, she cannot meet her tax obligations timely. Over the next several years, her condition worsens and due to financial hardship, she files a bankruptcy petition seeking a discharge of her tax and other liabilities. Because she filed returns one day late, the taxpayer cannot be certain if her tax liabilities will be discharged, thereby undermining her fresh start.

## RECOMMENDATION

To address conflicting judicial interpretations as to whether the “applicable filing requirements” language in § 523(a) of the Bankruptcy Code imposes a timely filing requirement, the National Taxpayer Advocate recommends that Congress clarify this language to provide that a late-filed tax return may be considered a return for purposes of obtaining a bankruptcy discharge.<sup>6</sup>

## PRESENT LAW

Section 523(a) of the Bankruptcy Code contains many exceptions to the discharge of an individual’s liabilities in bankruptcy.<sup>7</sup> Section 523(a)(1) lists three exceptions to the discharge of tax liabilities:

- An exception to discharge based on the type of tax, date of tax assessment, and the age of the tax debt;<sup>8</sup>
- An exception to discharge in cases where a taxpayer did not file a return<sup>9</sup> or filed a late return within two years of filing a bankruptcy petition;<sup>10</sup> and
- An exception to discharge in the case where a bankruptcy debtor made a fraudulent or willful attempt to evade or defeat taxes for which a discharge is being sought.<sup>11</sup>

In 2005, Congress enacted the BAPCPA, adding an unnumbered “Hanging Paragraph”<sup>12</sup> to the end of § 523. It reads:

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.

The Hanging Paragraph, which defines what constitutes a return for purposes of a bankruptcy discharge, has caused confusion for the courts. Several courts of appeal dealt with the issue before Congress

6 The American Bar Association Section of Taxation proposed to Congress a substantially similar amendment to § 523(a) in a submission dated July 29, 2014.

7 Section 523(a) references the discharge provisions contained in 11 U.S.C. §§ 727, 1141, 1228(a), 1228(b), and 1328(b). 11 U.S.C. § 1328(a)(2) also references section 523(a)(1)(B).

8 See 11 U.S.C. § 523(a)(1)(A) (referencing 11 U.S.C. §§ 507(a)(3) and 507(a)(8)).

9 See 11 U.S.C. § 523(a)(1)(B)(i).

10 See 11 U.S.C. § 523(a)(1)(B)(ii).

11 See 11 U.S.C. § 523(a)(1)(C).

12 The term comes from the fact this paragraph is unnumbered and stands alone at the end of § 523(a). See *In re McCoy*, 666 F.3d 924, 926 n.3 (5th Cir. 2012), *cert. denied*, 133 S. Ct. 192 (2012).

added the paragraph.<sup>13</sup> However, with the change in law in 2005, courts had to interpret the Hanging Paragraph’s definition of the term “return” for bankruptcy law purposes—namely that, to be considered a return, the tax filing must satisfy the requirements of applicable nonbankruptcy law—including applicable filing requirements. If a taxpayer files a document that does not qualify as a return under the Hanging Paragraph, it will be considered a non-filed return under § 523(a)(1)(B)(i), and any tax reported will be excepted from discharge.

Some courts have interpreted the phrase “applicable filing requirements” in the Hanging Paragraph to impose a rule requiring the taxpayer to have met the filing due date. This would apply even where the IRS had found reasonable cause for the failure to file a return and thus did not impose a late filing penalty on the taxpayer.<sup>14</sup> Therefore, under a strict reading of this provision, a taxpayer who files even one day late will be denied a discharge for taxes due on the return. This rule can be referred to as the “One-Day-Late Rule.”

For example, in *In re Creekmore*,<sup>15</sup> a bankruptcy court held that any late-filed return can never qualify as a return for the purpose of obtaining a bankruptcy discharge,<sup>16</sup> unless it was prepared pursuant to IRC § 6020(a). Under IRC § 6020(a), if a taxpayer fails to file a return, the IRS may prepare a return with information disclosed by the taxpayer and signed by the taxpayer. This is a cooperative process between the taxpayer and the IRS.<sup>17</sup> The *Creekmore* court noted that this reading of the Hanging Paragraph led to a harsh outcome for the taxpayer, but stated that taxpayers could avoid this problem by taking advantage of the “safe-harbor” found in IRC § 6020(a).

The only court of appeals opinion that deals with the Hanging Paragraph after the 2005 change in law is the Fifth Circuit Court of Appeals in *In re McCoy*.<sup>18</sup> *McCoy* dealt with the issue of dischargeability of state tax liabilities. The *McCoy* court held that the first sentence of the Hanging Paragraph provided a “clear definition of ‘return’ for both state and federal taxes.”<sup>19</sup> Therefore, in the view of the Fifth Circuit, the “applicable filing requirements” language in the Hanging Paragraph requires a return be timely filed and a tax liability on a late-filed return, even one day late, cannot be discharged in bankruptcy. Similar to the court in *Creekmore*, the *McCoy* court concluded the only way a taxpayer could avoid this harsh result

13 The most significant (non-bankruptcy) case dealing with what constitutes a return is *Beard v. Comm’r*, 82 T.C. 766 (1984), *aff’d per curiam*, 793 F.2d 139 (6th Cir. 1986). This case set forth a four-part test to determine whether an income tax filing document qualifies as a return. A document is a return under the test if: 1) it contains sufficient data to calculate the tax liability; 2) it purports to be a return; 3) it represents an honest and reasonable attempt to satisfy the requirements of the tax law; and 4) it is executed under penalties of perjury. Five circuit courts of appeal applied the *Beard* test in the bankruptcy context to determine whether the debtor filed a return for discharge purposes. Four of these cases were decided in favor of the IRS. See *In re Hindenlang*, 164 F.3d 1029 (6th Cir. 1999), *cert. denied*, 528 U.S. 810 (1999); *In re Hatton*, 220 F.3d 1057 (9th Cir. 2000); *In re Moroney*, 352 F.3d 902 (4th Cir. 2003); *In re Payne*, 431 F.3d 1055 (7th Cir. 2005). A fifth case, *In re Colson*, 446 F.3d 836 (8th Cir. 2006), resulted in a victory for the taxpayer.

14 See Treas. Reg. § 301.6651-1(c); IRM 20.1.1.3.2 (Nov. 25, 2011).

15 401 B.R. 748 (Bankr. N.D. Miss. 2008).

16 The *Creekmore* court agreed with Judge Easterbrook’s dissent in *In re Payne*, 431 F.3d 1055 (7th Cir. 2005). In *Payne*, a case prior to the change in law, Judge Easterbrook noted that after the change in law, a tax due on a late-filed return is not dischargeable.

17 This is in contrast to IRC § 6020(b), which allows the IRS to prepare a return for a taxpayer who does not file one. This is sometimes referred to as a substitute for return (SFR) and does not involve taxpayer cooperation with the IRS. Under the Hanging Paragraph, a return prepared by the IRS pursuant to IRC § 6020(a) is considered a return for purposes of obtaining a bankruptcy discharge while one prepared pursuant to § 6020(b) is not.

18 666 F.3d 924 (5th Cir. 2012), *cert. denied*, 133 S. Ct. 192 (2012). In a significant recent development, the Tenth Circuit Court of Appeals agreed with the Fifth Circuit’s *McCoy* decision and held that tax debts on late-filed federal returns are not dischargeable in bankruptcy. See *In re Mallo*, 2014 WL 7360130 (10th Cir. Dec. 29, 2014), *aff’g* 498 B.R. 268 (D. Colo. 2013).

19 *In re McCoy*, 666 F.3d at 930.

was to take advantage of a provision similar to that contained in IRC § 6020(a).<sup>20</sup> Thus, under both *Creekmore* and *McCoy*, the One-Day-Late Rule precludes a bankruptcy discharge for tax liabilities on late-filed returns.

Other courts have taken a different approach to interpreting the “applicable filing requirements” language. In determining the definition of a “return” for bankruptcy purposes, these courts look to the substance of what is filed rather than when it is filed.<sup>21</sup> Therefore, a late-filed return could qualify as a return for purposes of obtaining a bankruptcy discharge.

A significant amount of case law emerged subsequent to the 2005 enactment of the new bankruptcy law that added the Hanging Paragraph. However, the legislative history accompanying the law does not explain or shed light on the congressional intent behind the “applicable filing requirements” language and whether it requires timely filing for a taxpayer to obtain a bankruptcy discharge of tax liabilities.

In 2010, the IRS Office of Chief Counsel issued a Notice regarding its litigating position on the bankruptcy dischargeability of tax liabilities reported on late-filed returns.<sup>22</sup> The Notice first discusses the case law before and after the addition of the Hanging Paragraph, then covers the court’s rationale in the *Creekmore* holding<sup>23</sup> and takes issue with reading a timely filing requirement into the “applicable filing requirements” language in the first sentence of the paragraph. Such a reading would make redundant the second sentence, providing that an IRC § 6020(b) return is not considered a return because this type of return (often referred to by the IRS as a substitute for return) is always prepared after the due date.

In addition, the Notice is critical of the *Creekmore* holding that timely filing of a return is required for a bankruptcy discharge because such a reading would essentially narrow the application of § 523(a)(1)(B)(ii), which excepts from discharge late-filed returns filed within two years of the bankruptcy petition filing (*i.e.*, allowing returns filed outside a two-year timeframe to be dischargeable), to the small number of returns prepared by the IRS under IRC § 6020(a).<sup>24</sup> Finally, the Notice points out that the *Creekmore* court’s “safe harbor” option under IRC § 6020(a) is “illusory,” as taxpayers do not have a right to demand that the IRS prepare a return for them under this provision and the IRS only does so in a “minute number of cases.”<sup>25</sup> The Notice therefore concludes that “section 523(a) in its totality does not create the rule that every late filed return is not a return for dischargeability purposes.”

20 Because *McCoy* dealt with the dischargeability of state tax liabilities, there was no possibility of a safe harbor under IRC § 6020(a). In the court’s view, the taxpayer needed a state law safe harbor provision similar to IRC § 6020 to be able to take advantage of a safe harbor.

21 See, e.g., *In re Gonzalez*, 506 B.R. 317 (1st Cir. B.A.P. 2014); *In re Martin*, 500 B.R. 1 (D. Colo. 2013); *In re Rhodes*, 498 B.R. 357 (Bankr. N.D. Ga. 2013).

22 Chief Counsel Notice 2010-16.

23 The Notice was issued prior to the *McCoy* decision and therefore does not discuss it. However, the Notice is discussed in the *McCoy* opinion.

24 See *In re Martin*, 482 B.R. 635, 639 (Bankr. D. Colo. 2012), *rev’d*, 500 B.R. 1 (D. Colo. 2013).

25 State-law provisions similar to IRC § 6020(a) are probably rare as well. This would call into question the “safe harbor” option recommended by the *McCoy* court.

## REASONS FOR CHANGE

Courts have reached conflicting conclusions as to whether the “applicable filing requirements” language in the Hanging Paragraph imposes a timely tax return filing requirement in order for individual taxpayers to obtain a bankruptcy discharge. Some courts interpret this language to impose a strict One-Day-Late Rule, preventing taxpayers who file a return even a day past the deadline, or who have reasonable cause for late filing, from obtaining a bankruptcy discharge for liabilities reported on the return.<sup>26</sup> Courts, such as *Creekmore* and *McCoy*, have insisted that the only way liabilities on a late-filed return can be discharged is if the return is prepared under IRC § 6020(a) or a similar provision under state or local law. However, as noted in the IRS Chief Counsel Notice, this “safe harbor” does not really exist as taxpayers have no right to demand that the IRS prepare a return for them under this provision and the IRS only rarely does so.<sup>27</sup> This narrow and strict interpretation of 11 U.S.C. § 523(a) may result in harsh outcomes that undermine the “fresh start” rationale behind bankruptcy discharge.<sup>28</sup> However, other courts (and the IRS Office of Chief Counsel) have taken the opposite approach—the “applicable filing requirements” language in the Hanging Paragraph does not require timely filing of a tax return to obtain a discharge.<sup>29</sup>

Forever barring the discharge of tax debts merely because the debtor files a return one date late seems unfair when considering how taxpayers who file late are treated under federal tax law. As noted earlier, while late filers can be subject to penalties, the penalties can be abated. In jurisdictions where tax debts cannot be discharged merely because the return was filed late, the consequences can be more financially severe. In other words, late-filing taxpayers may be punished more severely under bankruptcy law than under tax law.

Similarly, the One-Day-Late rule can have serious repercussions for previously compliant taxpayers who experience financial distress. In the example above, a taxpayer who otherwise meets the bankruptcy law requirements for discharge may not discharge a tax debt because she filed a return one day late.<sup>30</sup> This will hinder her from emerging from her financial predicament and undermine her fresh start.<sup>31</sup> In addition, under certain circumstances, individuals (such as those in disaster areas or military combat zones) may be

26 See, e.g., *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), cert. denied, 133 S. Ct. 192 (2012); *In re Creekmore*, 401 B.R. 748 (Bankr. N.D. Miss. 2008). See also *In re Payne* 431 F.3d 1055, 1060 (7th Cir. 2005) (Judge Easterbrook dissenting) (after the BAPCPA, tax liability on a late-filed return is nondischargeable).

27 While there are regulations under IRC § 6020, they focus on IRC § 6020(b) (including several examples) and only make brief mention of IRC § 6020(a). See Treas. Reg. § 301.6020-1. Similarly, the IRM only makes passing mention of IRC § 6020(a). See, e.g., IRM 4.12.1.8.2 (Oct. 05, 2010). However, there are more frequent and detailed IRM references and descriptions as to the preparation of returns under IRC § 6020(b). See, e.g., IRM 5.1.11.6.7.2 (Apr. 23, 2014).

28 See *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (noting that the bankruptcy law “gives to the honest but unfortunate debtor...a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.”).

29 See, e.g., *In re Gonzalez*, 506 B.R. 317 (1st Cir. B.A.P. 2014) (noting that the definition of return in the Hanging Paragraph appears to be focus on what is filed rather than when it is filed); *In re Martin*, 482 B.R. 635 (Bankr. D. Colo. 2012), rev'd, 500 B.R. 1 (D. Colo. 2013) (both the bankruptcy court and the district court rejected the timeliness requirement; they disagreed as to whether the taxpayer had made an honest and reasonable attempt to comply with the tax law).

30 Because the IRS does not agree with the One-Day-Late Rule, this issue is limited at present to jurisdictions that follow the Fifth Circuit’s holding in *McCoy*. However, it is possible that the IRS will change its litigation position in the future. In a significant recent development, the Tenth Circuit Court of Appeals agreed with the Fifth Circuit’s *McCoy* decision and held that tax debts on late-filed federal returns are not dischargeable in bankruptcy. See *In re Mallo*, 2014 WL 7360130 (10th Cir. Dec. 29, 2014), aff’g 498 B.R. 268 (D. Colo. 2013).

31 As a result, the taxpayer may have to request a currently-not-collectible (CNC) status from the IRS and deal with IRS collection function for an extended period of time, resulting in taxpayer frustration and the use of limited IRS resources to provide relief to a financially distressed taxpayer. See IRM 5.16.1 (Aug. 25, 2014).

permitted to file their returns late with no penalty.<sup>32</sup> However, these returns are still officially late and the taxpayers may not be able to obtain a bankruptcy discharge of tax liabilities in the future.

### EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that Congress clarify the meaning of the Hanging Paragraph language in § 523(a) of the Bankruptcy Code to provide that a late-filed tax return may be considered a return for bankruptcy discharge purposes. This would clear up judicial confusion over the 2005 law and indicate whether the “applicable filing requirements” language in the first sentence of the Hanging Paragraph imposes a timely filing requirement. It would also eliminate disparate treatment of taxpayers under the Bankruptcy Code.

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32 See IRC §§ 7508, 7508A; Rev. Rul. 2007-59, 2007-2 C.B. 582 (providing that special late filing rules for those in military combat zones or disaster areas do not change the filing due date and only waive penalties).