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Expert Analysis

# Discharging Tax Debts in Bankruptcy: When Is a Return not a Return?

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Even well-intentioned people run into financial difficulty. Unfortunately, falling behind on one's taxes often leads to a downward spiral, and it is not uncommon for a taxpayer who cannot pay her tax obligations to decide not to file a return. Not only does such a failure to file expose the taxpayer to additional penalties and criminal liability, but it may have devastating ramifications if she subsequently files for bankruptcy.

Under Section 523(a) of the Bankruptcy Code, unpaid taxes are not dischargeable if they arise from an untimely return that was filed within two years of the filing of a bankruptcy petition.[1] Historically, this provision left open the possibility that unpaid taxes could be discharged when arising from a late return that was filed more than two years before a petition. In 2005, however, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), Congress appended a "hanging paragraph" to Section 523(a). This provision precludes the discharge of tax obligations reflected on returns that, among other things, fail to satisfy "applicable filing requirements."[2]

Last month, the U.S. Court of Appeals for the First Circuit analyzed the hanging paragraph in *In re Fahey*,[3] and joined the Fifth and Tenth Circuits[4] in concluding that filing deadlines are "filing requirements," and thus that the tax liabilities on an untimely return are not subject to discharge. Although the courts of appeals so far have been unanimous in concluding that late-filed returns are not "returns" under the hanging paragraph, this interpretation will have a harsh impact on debtors. For example, in one of the cases giving rise to *Fahey*, the debtor filed a late return five years before his bankruptcy petition.[5]

While it is likely that the $36,000 in taxes reflected on that return would have been discharged under the pre-BAPCPA law, under the approach adopted in *Fahey*, the debtor was unable to obtain a discharge because his late-filed return was not considered a "return" for purposes of Section 523(a). As Judge O. Rogeriee Thompson noted in her dissent in *Fahey*, this interpretation leads to the "draconian" result that a debt arising from a tax return filed one day late would not be dischargeable in bankruptcy.

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### Background

In a Chapter 7 bankruptcy proceeding, Section 727 of the Bankruptcy Code provides that a debtor meeting certain qualifications is entitled to a discharge of all debts arising before the order of relief, except as provided in Section 523.[6] Section 523(a)(1)(B), in turn, provides that tax debts may not be discharged when a return with respect to such debts was not filed, or was filed after the date on which it was last due *and* after two years before the petition filing date.[7] This provision operates to prevent the discharge of tax debts where a return was not filed or where, perhaps anticipating the inevitability of bankruptcy, a debtor files a late return shortly before seeking bankruptcy protection.[8]

> The First, Fifth and Tenth circuits have all interpreted Section 523(a)(*) in a manner that excludes virtually all late-filed tax returns from dischargeability in bankruptcy.

While debts from late-filed returns filed more than two years before the bankruptcy petition date would seem to be dischargeable under Section 523, even before the BAPCPA, courts had limited the availability of relief by defining the term "return" by reference to a four-factor test established by the U.S. Tax Court in *Beard v. Commissioner*.[9]

Under the Beard test, a "return" for purposes of Section 523 must satisfy four requirements: "(1) it must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law."[10] As the First Circuit majority noted in *Fahey*, many courts applying the Beard test had determined that returns filed after an involuntary assessment were not "returns" for purposes of Section 523, since they served no tax purpose and therefore did not qualify as "honest and reasonable attempt[s] to satisfy the requirements of the tax law."[11]

Congress was therefore not acting on a blank slate when it adopted what courts have referred to as the hanging paragraph and cited as Section 523(a)(*), which provides that for purposes of Section 523(a), a "return" means "a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)." The hanging paragraph adds that a "return" for purposes of Section 523(a) includes a "return" prepared pursuant to Internal Revenue Code Section 6020(a) (i.e., a substitute return prepared by the IRS based on information provided voluntarily and signed by the taxpayer), but not one prepared under Section 6020(b) (i.e., based on information available to the IRS and not signed by the taxpayer).

At issue in *Fahey* was whether Congress intended to provide a new definition of "return," or rather intended largely to codify the Beard test. While the majority in *Fahey* viewed Congress' language as clear, the dissent disagreed and found support for a debtor-friendly approach in the legislative history and policy considerations.

### A Plain Language Approach

The First Circuit majority in *Fahey* defined the question before them as whether timely filing was a "filing requirement" under Massachusetts law.[12] The court determined that because Massachusetts law provides that returns "shall be made" by a certain date, the due date was a "filing requirement" under the plain language of Section 523(a)(*) such that a late-filed return was not a "return" for purposes of Section 523(a).[13]

The holding in *Fahey* parallels a 2014 decision by the U.S. Court of Appeals for the Tenth Circuit finding that the Internal Revenue Code's filing deadlines are "filing requirements"[14] and a 2012 decision by the U.S. Court of Appeals for the Fifth Circuit making the same finding with respect to tax deadlines imposed by the State of Mississippi.[15] The majority in *Fahey* acknowledged that there may be some ambiguity with

respect to what constitutes a "filing requirement," questioning whether an instruction that the return not be stapled could be deemed a "filing requirement." The court, however, described such a scenario as existing "at the margins," and concluded that filing deadlines were unambiguously "filing requirements" for purposes of Section 523(a)(*).[16]

In response to the debtors' contention that Section 523(a)(1)(B) plainly contemplates that some late-filed returns filed more than two years prior to a bankruptcy filing would qualify as "returns," the majority pointed out that Section 523(a)(*) provides an exception for returns prepared pursuant to Internal Revenue Code Section 6020(a), or similar state or local law. The majority recognized that the exception would apply in only a small minority of cases, but found that it nevertheless gave the two-year provision of Section 523(a)(1)(B) a "role to play."[17]

The majority acknowledged that excluding late-filed returns from the definition of "return" rendered unnecessary the clause of the hanging paragraph addressing returns prepared pursuant to Internal Revenue Code 6020(b), since such returns could never comply with "applicable filing requirements."[18] Nevertheless, the majority was not concerned with the redundancy, which it attributed to a "belt and suspenders" approach by Congress intending to make clear that it did not intend the exception created for returns prepared by the IRS under 6020(a) to apply to returns prepared under Section 6020(b).[19]

In dissent, Judge Thompson argued that the hanging paragraph is ambiguous as to whether timing requirements count as "applicable filing requirements," and that it could reasonably be interpreted as providing that a "return" that is accepted by the relevant taxing authority meets the "applicable filing requirements."[20] This interpretation would protect a debtor who filed an untimely return more than two years before the bankruptcy petition so long as the return was accepted by the relevant taxing authority. In this regard, Judge Thompson pointed out that Massachusetts state law provides that late returns would still be accepted by the state, albeit with a 1 percent penalty that could be waived under certain circumstances. In light of this leeway, she further concluded that timely filing was not a necessary requirement of a "return" under Massachusetts law.[21]

Noting that Congress had not removed the two-year provision set forth in Section 523(a)(1)(B) when enacting the hanging paragraph, Judge Thompson concluded that it did not make sense to leave that two-year provision intact if Congress intended to penalize all late filers.[22] Thompson further argued that the majority's interpretation limiting the two-year rule to returns prepared pursuant to Internal Revenue Code Section 6020(a) would lead to the absurd result of allowing a taxpayer who failed to file a return but eventually cooperated with the IRS in preparing one for him to obtain a discharge, while penalizing a taxpayer who filed a return one day late that was accepted by the taxing authority.[23]

### Legislative Intent and Policy

Parties arguing both for and against the exclusion of late returns from the definition of a "return" in the hanging paragraph can find support in the legislative history. As the majority in *Fahey* noted, the BAPCPA was enacted in response to a "recent escalation of consumer bankruptcy filings" and associated losses, and in light of "opportunistic personal filings and abuse."[24] The majority further noted that Congress had historically excepted tax debts from the general dischargeability rule, reflecting its judgment that taxes are one area where the creditors' interest in recovery outweighs the debtors' interest in a "fresh start."[25]

On the other hand, as Judge Thompson notes in her dissent, the hanging paragraph was enacted amid confusion in the courts over whether debts arising from returns prepared after an assessment could be discharged. Perhaps, then, the hanging paragraph was only meant to clarify that debts arising from substitute returns prepared pursuant to Section 6020(a) and similar state and local provisions could still be dischargeable.[26]

> The First Circuit determined that because Massachusetts law provides that returns "shall be made" by a certain date, the due date was a "filing requirement" under the plain language of Section 523(a)(*) such that a late-filed return was not a "return" for purposes of Section 523(a).

Thompson and parties arguing against an interpretation excluding late-filed returns from the definition of a "return" for purposes of Section 523(a) have also pointed to the general rule that courts should be "reluctant to accept arguments that would interpret the [Bankruptcy] Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history."[27] Excluding good-faith late-filers from having tax debts discharged in bankruptcy could be viewed as a sufficiently significant change in pre-Code practice that courts should hesitate to assume it was intended by Congress. This rule, however, does not carry weight with those who contend that the hanging paragraph unambiguously incorporates filing deadlines into its "applicable filing requirements" clause.

### An Alternative Approach

If, in fact, Congress did not intend to exclude nearly all late filers from having tax debts discharged in bankruptcy, what, then, did it mean when it enacted the hanging paragraph? Judge Thompson argues that Congress meant to clarify that a "return," no matter who prepared it or when, is only a "return" if it is accepted as such by the relevant taxing authority.[28] Thus, Thompson suggests that the hanging paragraph was intended to preclude taxpayers from filing returns, knowing they would not be accepted by the taxing authority, for the purpose of discharging their tax obligations through bankruptcy. The fact that Congress did not eliminate the two-year waiting period in Section 523(a)(1)(B) further supports the conclusion that debts arising from late-filed returns that are both filed more than two years prior to the filing of a bankruptcy petition and are accepted by the taxing authority should be dischargeable in bankruptcy.

### Conclusion

Although the First, Fifth and Tenth Circuits have all interpreted Section 523(a)(*) in a manner that excludes virtually all late-filed tax returns from dischargeability in bankruptcy, there are compelling reasons to adopt an interpretation of "applicable filing requirements" that captures all returns accepted as such by the relevant taxing authority. In any event, with several courts of appeals yet to weigh in and conflicting authority among lower courts, the issue is likely to be debated for some time to come. In the meantime, practitioners have yet another reason to urge financially strapped taxpayers to file their returns on a timely basis.

1. 11 U.S.C. §523(a)(1)(B)(ii).
2. 11 U.S.C. §523(a)(*).
3. *In re Fahey*, Nos. 14-1328, 14-1350, 14-9002, 14-9003, 2015 WL 677033 (1st Cir. Feb. 18, 2015).
4. See *In re Mallo*, Nos. 13-1464, 13-1488, 2014 WL 7360130, at *6 (10th Cir. Dec. 29, 2014); *In re McCoy*, 666 F.3d 924, 928, 932 (5th Cir. 2012).
5. See *In re Gonzalez*, 506 B.R. 317, 318-19 (B.A.P. 1st Cir. 2014).
6. 11 U.S.C. §727(a)-(b).
7. 11 U.S.C. §523(a)(1)(B) (emphasis added).
8. *Fahey*, 2015 WL 677033, at *2.
9. 82 T.C. 766, 777-78 (1984), aff'd, 793 F.2d 139 (6th Cir. 1986).
10. *United States v. Hindenlang*, 164 F.3d 1029, 1033 (6th Cir. 1999).
11 *Fahey*, 2015 WL 677033, at *2; see *In re Moroney*, 352 F.3d 902, 905-06 (4th Cir. 2003).
12. *Fahey*, 2015 WL 677033, at *2.
13. Id. at *3.
14. *In re Mallo*, 2014 WL 7360130, at *6.
15. *In re McCoy*, 666 F.3d at 928, 932.
16. *Fahey*, 2015 WL 677033, at *3.
17. Id. at *4.
18. Id. at *5.
19. Id.
20. *Fahey*, 2015 WL 677033, at *15 (Thompson, J., dissenting); see also *In re Gonzalez*, 506 B.R. at 328, *In re Martin*, 508 B.R. 717, 729, 736 (Bankr. E.D. Cal. 2014).
21. Id. at *10 (Thompson, J., dissenting).
22. Id.
23. Id. at *11.
24. *Fahey*, 2015 WL 677033, at *7 (citing H. Comm. On the Judiciary, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, H.R. Rep. No. 109-31(I), at 3-5 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 90-92).
25. 2015 WL 677033, at *11.
26. Id. at *13.
27. *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992).
28. *Fahey*,2015 WL 677033 at *15.