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October, 2013

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Available at: https://works.bepress.com/t_keith_fogg/27/

What Is a Return–The Long Slow Fight in the Bankruptcy Courts

By T. Keith Fogg

Keith Fogg examines what constitutes a return within the context of a bankruptcy for purposes of allowing a taxpayer to discharge the tax debt.

A decision just came out in the Middle District of Alabama highlighting the issue of "what is a return" that bankruptcy courts have wrestled with for almost 15 years.[1] In *Perry*, the court determined that a taxpayer has not filed a return for purposes of excepting a liability from discharge in bankruptcy. The court examined all three theories now floating around on this issue and decided that Mr. Perry met none of the three theories that might have allowed him to discharge this tax debt.

Bankruptcy Code (BC) section 523(a)(1)(B)(i) provides that an individual debtor who fails to file a tax return cannot discharge the taxes owed for a period in which the individual did not file a tax return. That may have seemed simple enough in 1978 when the Bankruptcy Code was adopted, but it has become increasingly complicated over the past 35 years. An amendment to the Bankruptcy Code in 2005 seeking to "fix" the problem has only increased the complexity.[2]

The facts in the *Perry* case resemble the facts in most cases of this type. Mr. Perry did not file tax returns for 1997, 1999, 2001 and 2003. The opinion does not say if he had some type of tax filing phobia in odd years. As it often does, the IRS "assisted" Mr. Perry by preparing substitute returns for him.[3] Mr. Perry did not petition the Tax Court after receiving notices of deficiency for the years at issue. The IRS assessed the taxes. Collection of the taxes began, and notices of federal tax liens were filed causing even more notices to go to Mr. Perry.

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After ignoring the issue for many years for reasons that are not explained, Mr. Perry filed Forms 1040 with the IRS for each of the years between October 19, 2007, and January 3, 2008. The IRS treated these forms as requests for abatement because they reported substantially less tax liabilities than determined by the IRS. The IRS did abate his taxes to the lower amounts reflected on the Forms 1040. This fact pattern holds true in most of these cases and in almost all of the exceptions to discharge cases involving what is a return.

After the IRS abated some taxes, he still owed taxes for each of the years. After filing these Forms 1040, Mr. Perry waited two years before filing his chapter 7 bankruptcy petition. He sought a determination from the bankruptcy court that the Forms 1040 he filed satisfied the definition of a return in BC 523(a)(1)(B).

The first one of these type cases, *W.C. Hindenlang*, appeared in 1999.[4] Mr. Hindenlang, who had a factual situation similar to Mr. Perry, filed Forms 1040 and waited two years before filing for bankruptcy. This technique and the requirement to wait two years results from BC 523(a)(1)(B)(ii), which excepts from discharge returns filed late within two years of the date of the bankruptcy petition.[5] So, bankruptcy lawyers developed the technique of filing Forms 1040 for their clients who had not previously filed returns and waiting two years before filing a bankruptcy petition in order to avoid the problem of (B)(ii).

For some reason, Mr. Hindenlang filed Forms 1040 that precisely matched the income and tax numbers on the substitute for returns that the IRS had previously prepared and assessed, making it clear that the only reason he filed the Forms 1040 was his desire to obtain a discharge of the taxes for those years. He exhibited no

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desire to provide additional information about his tax situation even though the substitute returns have a very high probability of not properly reporting a taxpayer's income. The Sixth Circuit agreed with the Government's argument that the Forms 1040 that Mr. Hindenlang submitted did not meet the *Beard* test for what is a return because they did not "represent an honest and reasonable attempt to satisfy the requirements of the tax law."[6] In fact, for tax law purposes, the Forms 1040 submitted by Mr. Hindenlang really served no purpose.

Having won the *Hindenlang* argument, the IRS then adopted a position that Forms 1040 filed after an assessment based upon a substitute for return that the taxpayer did not cooperate in completing would not be treated as returns for purposes of determining discharge. It had success in three additional circuit-level decisions and failure in one.[7] Prior to 2005, the discussion focused on the four-part *Beard* test. The focus has changed slightly since 2005 when Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), amending BC 523(a) to add a hanging paragraph that defines a "return" as follows:

> 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 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.

Code Sec. 6020(a) provides:

> If any person shall fail to make a return required by this title or by regulations prescribed thereunder, but shall consent to disclose all information necessary for the preparation thereof, then, and in that case, the Secretary may prepare such return, which, being signed by such person, may be received by the Secretary as the return of such person.

While the provision in the hanging paragraph holds out some hope for taxpayers who go through the Code Sec. 6020(a) return procedure, this process generates very few returns.[8]

Code Sec. 6020(b) describes situations in which the taxpayer submits no return, provides no information or fraudulent information, and refuses to sign a return after the IRS prepares it, requiring the IRS to send a notice of deficiency based on the best information it can collect independently.[9] Usually, these returns are based upon the wage and income transcripts that third parties have reported to the IRS, but occasionally they result from independent fact gathering. Because the taxpayer has not consented, the IRS does not make elections for the taxpayer such as joint return filing status or itemized deductions, *etc.,* that might reduce the tax liability. Usually, these returns overstate the liability because the IRS does not (cannot) make elections that might reduce the taxes; however, these returns might understate the liability because the IRS is unaware of income sources not reported to it by third parties.

All of the above decisions interpreting the "what is a return" issue for purposes of discharge, were decided under pre-BAPCPA law, *i.e.,* prior to the adoption of the hanging paragraph. In his *Payne* dissent, Judge Easterbrook wrote that, after the 2005 legislation, "an untimely return cannot lead to discharge" because of the applicable filing requirements language added by BAPCPA.

In looking at the new legislation, the Fifth Circuit, in *McCoy v. Miss. State Tax Comm'n,*[10] agreed with Judge Easterbrook. The first case to adopt Judge Easterbrook's reasoning was *Creekmore.*[11] To date, the Fifth Circuit is the only circuit court that has interpreted the hanging paragraph. It concluded that the first sentence of that paragraph provides "a clear definition of 'return' for both state and federal taxes."[12] In the view of the Fifth Circuit, the language in the statute requiring that the return must satisfy the requirements of applicable nonbankruptcy law includes the laws requiring timely filing of returns. A late-filed return, even one filed one day late, cannot satisfy the hanging paragraph definition of a return. Therefore, a late return is never a return for purposes of BC 523(a)(1)(B) unless it meets the narrow requirements of Code Sec. 6020(a). Other courts have criticized this *per se* rule, in part, because it seems to read the two-year rule contained in BC 523(a)(1)(B)(ii) out of the Code.[13]

The IRS does not agree with the *McCoy* decision and has issued a notice explaining its view.[14] The Chief Counsel Notice takes the position:

> Read as a whole, section 523(a) does not provide that every tax for which a return was filed late is nondischargeable. If the parenthetical "(including applicable filing requirements)" in the unnumbered paragraph created the rule that no late-filed

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> return could qualify as a return, the provision in the same paragraph that returns made pursuant to section 6020(b) are not returns for discharge purposes would be entirely superfluous because a section 6020(b) return is always prepared after the due date. It is a cardinal principle of statutory construction that a statute should be construed so that no clause, sentence or word is rendered superfluous. Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998) (refusing to read one provision of the Bankruptcy Code to render another superfluous).

In addition to finding that the interpretation in *McCoy* cannot be reconciled with the balance of the hanging paragraph, the Notice goes on to point out that it cannot be justified with the basic provision creating the exception from discharge.[15] The Notice concludes with a return to the basic position of the IRS under *Hindenlang*. Under that position, a taxpayer can file a late return and obtain a discharge by waiting two years after the filing of the late return (and waiting whatever time period is necessary to also meet BC 523(a)(1)(A)). The IRS does not view the hanging paragraph as creating a problem for individuals who file late prior to the completion by the IRS of return for the taxpayer and the assessment of that return. For those individuals who allow, or cause, the IRS to go to the trouble of preparing the taxpayer's return, the Notice falls back to the basic position of the IRS in the *Hindenlang* cases: that a return filed after the IRS makes a return and assesses the liability reporting additional tax has meaning with respect to the additional tax but not the amount already assessed.

As will be discussed further below, the Notice contained language that may not have been fully appreciated when it first came out because the Notice did not flush out its meaning. It stated "The assessed portion of the tax was a debt for a tax that was legally enforceable by lien or levy before any return was filed. In the case of a debtor who files a Form 1040 after assessment reporting no more tax than was previously assessed, no portion of the tax would be a dischargeable debt." This language now forms the basis for a third argument different from both *Hindenlang* and *McCoy*.

This background sets the scene for the court's decision in *Perry*, which tests the facts in that case against the three competing lines of reasoning: (1) the tax on any late-filed return is nondischargeable (*McCoy*); (2) for the tax to be dischargeable, the taxpayer's return must be filed before the IRS prepares a return for the taxpayer and makes an assessment (*Hindenlang* and the Chief Counsel Notice, but possibly with a *Beard* overlay that keeps the *per se* rule from applying); and (3) taxes assessed based on the IRS preparation of the return prior to the taxpayer filing a return are *per se* nondischargeable because they are a debt for a tax legally enforceable before the filing of a return (*Smythe* and the final sentence from the Chief Counsel Notice).

Applying *Perry*'s facts to the legal position on discharge espoused in *McCoy* takes little effort. Mr. Perry did not file the returns for the four years at issue by the due date of those returns. Therefore, under the rationale in *McCoy*, the exception to discharge under BC 523(a)(1)(B)(ii) applies, and he still owes the taxes for these years after the granting of the chapter 7 discharge.

Applying *Hindenlang* reaches the same result. The IRS prepared returns and assessed the liabilities for these periods. Perry filed Forms 1040 after the assessment of the liabilities. The IRS treated the Forms 1040 as request for abatement and reduced his outstanding liability to the amount shown on the returns. The exception to discharge applies to the amount of tax remaining, and he still owes the taxes for these years after the granting of the chapter 7 discharge. The result for Perry provides no surprises and is consistent with almost all cases decided since the *Hindenlang* decision in 1999.

The slight twist in *Perry* comes from the court's description of the position of the IRS, which departs from the *Hindenlang* analysis. The court says that the "Internal Revenue Service relies on *Smythe v. United States (In re Smythe)*, Bk. No. 11-04077, Adv. No. 11-04077, 2012 WL 843435 (Bankr. W.D. Wash. Mar. 12, 2012)." The IRS argued that the "tax debts [were] nondischargeable because the debts [were] base[d] on the I.R.S. assessments and not on the Debtor' Forms 1040, so that the assessments [were] tax debts for which no returns were filed or given under 523(a)(1)(B)(i)." This position, which the IRS may have signaled in the last sentence of CC Notice 2010-16, first appears in case law in the *Wogoman* case. *Perry* adopts the description of the issue from *Wogoman*.

The court finds that Mr. Perry fails under this argument as well. It stated that:

> When the I.R.S. made tax assessments against the Debtors, the Debtors' tax obligations became

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enforceable and the I.R.S. could pursue its claims; therefore, the assessments created "debts[s]" as defined in the Bankruptcy Code. Although the Debtors subsequently filed Forms 1040, the tax debts had already been established by the I.R.S. assessments. The tax debts, therefore, are debts "for which no return was filed," and are nondischargeable under 523(a)(1)(B)(i).[16]

This position seems make the assessment date a significant event in determining "what is a return." For purposes of filing a claim in bankruptcy, the assessment date does not have meaning. The IRS can file a claim whether or not it has assessed the liability. Mixing the assessment date with the return filing date or making it a part of the equation for "what is a return" stretches concepts to get to a result that is clean and provides the *per se* rule the IRS seeks. Because the bankruptcy concept of debt does not link with the act of assessment, the argument may stretch the statute too far to get to this result. Ken Weil, debtor's counsel in the *Smythe* case and a member of the Tax Advisory Panel to the Bankruptcy Commission created by the 1994 Bankruptcy Act, argued against this connection.[17]

The *Smythe* argument provides the IRS a cleaner path to victory than the straight *Hindenlang* argument because it avoids the problem that it encountered in *Colson* of having a bankruptcy court apply the *Beard* test to determine that the Forms 1040 filed after the 6020(b) assessment represent a genuine attempt to file a return. Stay tuned. The "what is a return" question keeps getting more and more interesting.

Endnotes

1 *D.Z. Perry,* DC-AL, No. 3:12-cv-00913 (Oct. 30, 2013).

2 In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) adding a hanging paragraph to the end of BC 523(a). That paragraph provides:

> 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.

3 Assistance in this context does not mean that the IRS and Mr. Perry worked together. Rather, it means that the IRS gathered up the data it had about each of the tax years, prepared the returns based on that data, sent him letters giving him a chance to agree, and then sent him notices of deficiency setting forth the taxes it determined were due for those years.

4 *W.C. Hindenlang,* CA-6, 99-1 USTC ¶50,214, 164 F3d 1029, *cert. denied*, 528 US 810 (1999).

5 The technique took on added importance after the 2005 amendments. Prior to 2005, individuals with unfiled returns, late returns or returns prepared by the IRS could avoid the issue of "what is a return" by going into chapter 13. A debtor in chapter 13 received a superdischarge—so named because it discharged almost all pre-confirmation debts. That changed in 2005 when Congress amended BC 1328 to reflect back to BC 523 for certain debts including those involving unfiled returns. With this change, all individual debts face the problem caused by failing to file a return.

6 *R.D. Beard,* 82 TC 766, Dec. 41,237 (1984), *aff'd per curium*, CA-6, 86-2 USTC ¶9496, 793 F2d 139. In *Beard*, the Tax Court set forth a four-part test for determining which documents satisfied the requirements of a return: (1) purports to be a return; (2) executed by the debtor under penalty of perjury; (3) contains sufficient data to allow calculation of the tax; and (4) represents an honest and reasonable attempt to satisfy the requirements of the tax law. The test created in *Beard* has gained universal acceptance even though its application in the context of determining whether a document meets the test in the bankruptcy context arising in *Perry* does not provide a neat fit. Perhaps for this reason, the IRS, as discussed below, appears to have adopted a new argument moving away from the "what is a return" question.

7 *See M.J. Moroney*, CA-4, 2004-1 USTC ¶50,141, 352 F3d 902; *J.H. Payne*, CA-7, 2006-1 USTC ¶50,106, 431 F3d 1055. The Seventh Circuit reached the same result as *Hindenlang* and *Moroney* but did not go so far as to adopt a *per se* rule. The IRS wanted a *per se* rule here similar to the one it obtained on fraudulent returns with the Supreme Court's opinion in *E. Badaracco, Sr.*, SCt, 84-1 USTC ¶9150, 464 US 386, 104 SCt 756. Without a *per se* rule, the IRS finds itself in a tough spot because applying the *Beard* test to all of the cases with these circumstances running through its bankruptcy units presents a significant administrative challenge. The inability to achieve a *per se* rule through litigation or legislation may have driven the IRS to the new argument discussed below; and *J.H. Hatton*, CA-9, 2000-2 USTC ¶50,651, 220 F3d 1057. While the IRS won *Hatton*, this case presents slightly different facts, which are less favorable to the taxpayer. Mr. Hatton never filed the subsequent Form 1040 after the IRS calculated his liability and made the assessment. Instead, he argued that his subsequent installment agreement should count to allow him to discharge the taxes. *Contra Colson,* CA-8, 446 F3d 836 (2006) (The lone circuit-level IRS loss on this issue. The Eighth Circuit declined to follow the other precedent because of its view that an accurate calculation of the taxes submitted under penalty of perjury met the *Beard* test. The IRS decided against filing a petition for certiorari even though it had a circuit split and an issue of some administrative importance. This suggests some dissention within the Government on the correctness of the position.)

8 *See generally M.J. Wogoman*, BAP-10, 2012-2 USTC ¶50,437, 475 BR 239, 249 (noting that the IRS has "commented that it prepares a return for the taxpayer's signature under 6020(a) in only a minute number of cases").

9 Code Sec. 6020(b)(1) states: "If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise."

10 *McCoy v. Miss. State Tax Comm'n,* CA-5, 666 F3d 924, *cert. denied*, 113 SCt 192 (2012).

11 *Creekmore,* 401 BR 748 (Bankr. N.D. Miss. 2008) (The bankruptcy court agreed with Judge Easterbrook's dissent and concluded

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that any late-filed return can never qualify as a return for dischargeability purposes, unless it was prepared pursuant to Code Sec. 6020(a). The bankruptcy court in *Creekmore* acknowledged that its reading of the unnumbered paragraph was harsh, but stated that debtors could avoid the problem by taking advantage of the "safe-harbor" of Code Sec. 6020(a) by having the IRS prepare their returns). *See also Pendergast v. Mass. Dept. of Revenue (In re Pendergast)*, 494 BR 8 (Bankr. D. Mass. 2013).

[12] *McCoy, supra* note 10, 666 F3d, at 930.

[13] *See Mallo*, DC-CO, 2013 WL 4873057 (2013) and *Wogoman*, *supra* note 8 (The per se rule adopted in *McCoy* creates an extremely harsh result by making the taxes due on a return filed even one day late forever incapable of discharge. The extreme harshness of the application of this rule can be seen in its application with the interplay of returns filed after the statutory due date pursuant to the application of Code Secs. 7508 and 7508A. These sections allow individuals in a combat zone or certain disaster relief areas to file their returns after the statutory due date without fear of late filing penalties. A literal interpretation of the literal interpretation applied in *McCoy* causes soldiers in combat zones or victims of Superstorm Sandy to turn any liabilities on their returns into nondischargable liabilities.)

[14] Office of Chief Counsel Notice 2010-16, CC-2010-016 (Sept. 2, 2010.) *See Brown v. Mass. Dept. of Revenue,* 489 BR 1 (Bankr. D. Mass. 2013)*; Martin*, 482 BR 635 (Bankr. D. Colo. 2012), *rev'd,* DC-CO, 2013 WL 5323350 (2013) (The District Court applied *Beard* and found that the taxpayer flunked the honest and reasonable prong of the *Beard* test. The same judge also reached the same result in *Mallo, supra* note 13); *Rhodes,* No. 11-4074 (Bankr. N.D. Ga. May 6, 2013).

[15] Code Sec. 523(a)(1)(B)(ii) provides that an individual's bankruptcy discharge does not discharge a debt for which a return was filed after the last date, including any extension, that the return was due, and after two years before the date of the filing of the petition in bankruptcy. The *Creekmore* reading would limit the application of Code Sec. 523(a)(1)(B)(ii) to cases in which the IRS prepares a return for the taxpayer's signature under Code Sec. 6020(a). By presuming that Congress intended to limit Code Sec. 523(a)(1)(B)(ii)'s long-standing discharge exception for debts with respect to which a late return was filed more than two years before bankruptcy to the minute number of cases in which the IRS prepares a return for the taxpayer's signature under Code Sec. 6020(a), the *Creekmore* reading also contradicts a special rule for interpreting the Bankruptcy Code. As the Supreme Court stated in *Dewsnup v. Timm*, SCt, 502 US 410, 419 (1992), "[T]his Court has been reluctant to accept arguments that would interpret the 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." Finally, the supposed "safe harbor" of Code Sec. 6020(a) is illusory. Taxpayers have no right to demand that the IRS prepare a return for them under that provision.

[16] *Perry, supra* note 1.

[17] "The Smythes apologize for not pointing out that the *Wogoman* argument was a red herring. *Wogoman v. United States (In re Wogoman),* 2011 W.L. 3652281 (Bankr. D. Colo. 2011). *Wogoman* confuses what is a debt for Bankruptcy Code purposes with what is a debt (the assessment) for Tax Code collection purposes. It is well-established that, under the Bankruptcy Code, the debt arises at the end of the year and not at assessment. *Midland Cent. Appraisal Dist. V. Midland Indus. Serv. Corp. (In re Midland Indus. Serv. Corp.),* 35 F.3d 164 (5th Cir. 1994) (right to payment arose January 1; petition filed January 18; payment due after January 18; held, tax is prepetition), *cert. denied,* 514 U.S. 1016 (1995); *W.Va. Dep't of Tax Rev. v. IRS (In re Columbia Gas Transmission Corp.),* 37 F.3d 982 (3d Cir. 1994) (a tax liability is generally incurred on the date it accrues and not on the assessment date or the pay date), *cert. denied*, 514 U.S. 1082 (1995); and *see*, *In re Stack Steel & Supply Co. 28 B.R. 151* (Bankr. W.D. Wash. 1983) (bankruptcy filing between assessment date and payable date created prepetition obligation), *rev'd on other grounds, United States v. Ledlin (In re Mark Anthony Constr. Inc.),* 886 F.2d 1101 (9th Cir. 1989). This position is further buttressed by 11 USC § 507(a)(8)(A)(iii), which provides priority treatment of not assessed but still assessable taxes." *See* the Reply brief at Docket Entry # 34 of the PACER record for *Smythe*.

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