The Intersection of Tax and Bankruptcy: The McCoy Rule

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I. Background and Introduction

A debtor in bankruptcy is permitted to discharge personal income tax liability but only if a valid tax return is filed for the tax year in which the subject liability was assessed.¹ Early judicial determinations concerning the validity of a tax return are nearly a century old.² These initial determinations focused on good faith and an honest attempt to comply with the tax laws (hereinafter “good faith”).³ If a fact based investigation satisfied the court that the taxpayer acted in good faith, then the document in question was deemed a valid tax return for all purposes under the law⁴, including discharge in bankruptcy. More recent bankruptcy cases have relied upon those early judicial decisions and have restated the good faith requirement.⁵ So, for almost a century the judicial standard for determining the sufficiency of a document as a tax return has always included an investigation into the actions and motive of the taxpayer to confirm good faith.

A. Sudden Retreat From Good Faith

Beginning in 2008, a handful of opinions held that the good faith requirement had been eradicated because of amendments to 11 U.S.C. 523 codified in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”)⁶ and based on a passing interpretation of those amendments in a statement of dicta in a dissenting opinion rendered by Judge Easterbrook of the 7th Circuit Court of Appeals⁷. Cases decided under this line of reasoning find that any tax return filed after an applicable deadline for filing, regardless of the taxpayer’s good faith, can never constitute a valid

³ Germantown, 309 U.S. at 309; Zellerbach, 293 U.S. at 180.
⁴ Id. (In these early cases the question was whether or not a document filed by the taxpayer was substantially a return so as to trigger the start of the statute of limitations on assessment.)
⁵ United States v. Hindenlang (In Re Hindenlang), 164 F.3d 1029 (6th Cir. 1999); Beard v. Commissioner, 82 T.C. 766 (1984), aff’d, 793 F. 2d 139 (6th Cir. 1986).
⁷ United States v. Payne (In Re Payne), 431 F. 3d 1055, 1060 (7th Cir. 2005).
tax return for purposes of discharge in bankruptcy.\(^8\) For the first time good faith was ignored completely as a factor and the timeliness of a filed return was wholly dispositive.

Isolated to the narrow instance of discharge in bankruptcy these decisions do not seem to pose an incredible affront to tax law. But, the issue is that the Bankruptcy Code does not define “tax return” and relies upon tax law to provide that guidance.\(^9\) In addition, the Internal Revenue Code itself does not set out a specific definition of a tax return.\(^10\) The definition of tax return, for all purposes including discharge in bankruptcy, is and always has been judicially constructed; as previously stated, the well-established definition is made up of common judicial wisdom nearly a century old and includes a good faith requirement. So, this recent break from tradition does present a direct coup, a pointed uprising based on what many consider to be an ill-founded reading of the BAPCPA amendments, a petulant fire ignited by a passing statement in Judge Eastbrook’s dissenting opinion.\(^11\)

B. Effect of McCoy

For almost seven years after the enactment of the BAPCPA amendments these rogue opinions were confined to the bankruptcy courts. Then, in U.S. v. McCoy, 666 F.3d 924, the 5th Circuit United States Court of Appeals affirmed the decision of the prior bankruptcy and district courts denying the discharge of the taxpayer’s prepetition income tax debt based on the amendments. The Court decided in favor of the State of Mississippi who argued that, based on the BAPCPA amendments, a late filed tax return, regardless of the taxpayer’s good faith, can never constitute a valid tax return for purposes of discharge in bankruptcy under 11 U.S.C. 727.\(^12\) In agreeing with the State of Mississippi and the lower courts, the 5th Circuit Court of Appeals granted an elevated precedential status to the rogue opinions, a new height previously unreached.

As of now the McCoy ruling is undisturbed and currently presents the final judicial position on the matter in the 5th Circuit. The decision has also had a measureable effect at the bankruptcy court level. As of today the number of examinable bankruptcy court decisions split the issue – half reject McCoy and employ the pre-BAPCPA good faith test while the other half expressly adopt McCoy.\(^13\) Additionally, some of the post

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\(^9\) See Hindenlang, 164 F.3d at 1033.

\(^10\) 26 U.S.C. § 6011(a); United States v. Hatton (In Re Hatton), 220 F.3d 1057 (9th Cir. 2000).

\(^11\) Payne, 431 F.3d at 1060.

\(^12\) McCoy, 666 F.3d at 924.

McCoy bankruptcy court decisions have relied on the decision to expand the case’s reasoning to federal tax returns. Finally, one 4th Circuit District Court had the opportunity to specifically reject McCoy but did not. The stage may be set for unrest among the Circuits and a possible Supreme Court review.

The critical backlash and uproarious commentary regarding the McCoy decision was immediate and is plentiful. Even the IRS disagrees with McCoy. Most of the arguments against McCoy cite judicial statutory construction rules and a lack of supporting legislative history as the primary reasons to overturn. Some bluntly state that McCoy does not comport with common sense. These are all valid points but McCoy’s biggest flaw is its break from the well-established good faith requirement. This article will briefly discuss the genesis and the current adaptation of the good faith requirement. This article will continue with the critical trend by breaking McCoy’s reasoning into smaller parts and refuting some of the more doubtful propositions. Finally, this article will discuss why equity should be the guiding factor in discharge determinations – it encompasses good faith, it is flexible and it upholds the spirit of the Bankruptcy Code and the Internal Revenue Code.

II. GOOD FAITH AND THE DEFINITION OF “TAX RETURN” FOR PURPOSES OF DISCHARGE IN BANKRUPTCY

Generally, a debtor in bankruptcy can discharge pre-petition personal income tax liabilities. But, there are two sets of limitations: the first is a fairly straightforward, date driven passage of time limitation requiring the liability producing tax return to have been due for longer than three years before the date of petition, to have been filed for longer than 2 years before the date of the petition and requiring the liability to have been assessed for longer than 240 days before the date of the petition. The second limitation concerns the validity of the filed tax return and may prevent discharge of a tax liability even if the liability meets the date driven tests. Courts that have denied discharge of a liability that meets the date driven test have denied based on 11 U.S.C. 523 (a)(1)(B)(i) stating that the filed tax return was never legally filed because the filed tax return was not valid – so, even when a tax return is actually filed if the courts decide

16 Martin, 500 B.R. at 7.
17 Id.
18 Id.
the tax return was not valid the tax return is considered not legally filed so the debt is then not dischargeable based on 11 U.S.C. 523 (a)(1)(B)(i).

To determine the validity of a tax return the bankruptcy courts must define the term tax return. The Bankruptcy Code does not define tax return so the courts look to tax law for that definition. The Internal Revenue Code does not define tax return so prior case law is the only guide. The modern emanation of all case law concerning the validity of a tax return is the “Beard Test”. The Beard Test is rooted in Zellerbach and Germantown – the early judicial determinations mentioned above. Zellerbach and Germantown state that a tax return must be filed in good faith to be valid. In Zellerbach and Germantown the Supreme Court determined that a tax return made “in good faith” that “evinces an honest and genuine endeavor to satisfy the [tax] law” is a valid tax return for all purposes under the law. The more modern Beard Test combines and specifies the requirements from Zellerbach and Germantown. The beard Test states that a valid tax return must: (1) purport to be a tax 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.

So, if a tax return meets all date driven requirements and it meets the Beard Test it is dischargeable under 11 U.S.C. §727. Cases where the filed return meets the date driven test but is nonetheless denied as an invalid return are decided against the debtor on the basis of a lack of good faith. More specifically, because the court determines that under applicable tax law the filed return was not filed in good faith no return was ever legally filed. If no return is legally filed the debt is non-dischargeable under 11 U.S.C. 523 (a)(1)(B)(i). For a tax liability to be dischargeable it must meet the date driven test and it must be filed in good faith. To determine if a tax return is valid and filed in good faith the bankruptcy courts look to the well-established tax case law rooted in Zellerbach and Germantown as described and encapsulated in the Beard Test.

III. MccoY CASE

The McCoy case is the focus of all the criticism and commentary because the decision was made by the 5th Circuit Court of Appeals – its reach was broad enough to grab the attention of the legal community at large and it binds all lower courts in the circuit. But, McCoy was preceded by many bankruptcy court decisions that disregarded the good faith test. All the preceding bankruptcy court decisions and eventually McCoy read the BAPCPA amendments as statutorily requiring timely filing of a tax return as a

21 Beard, 82 T.C. at 777.
22 Germantown, 309 U.S. at 309.
23 Zellerbach, 293 U.S. at 180.
24 Beard, 82 T.C. at 777.
prerequisite to discharge under 11 U.S.C. 727. So, based on that reading of the statutory amendments the bankruptcy courts and the 5th Circuit Court of Appeals denied discharge relief to multiple debtors based solely on the fact that the returns giving rise to the income tax liabilities were filed after the date they were due.\textsuperscript{25}

The date of filing, up to that point, had never been dispositive of the dischargeability issue\textsuperscript{26}. In fact, given the express language of date driven test\textsuperscript{27} discussed in the prior section it was (and, still is) clear that as long as the filing fell within the date driven test parameters it did not matter when the return was filed.\textsuperscript{28} So, failure to file a timely return is not mentioned by the statute and has nothing to do with the date driven inquiry. The Beard Test also was not directly concerned with late filed returns.\textsuperscript{29} Late filing may have had some bearing on good faith but the fact that a return was filed late did not mean the return could not meet the Beard Test.\textsuperscript{30} Overall, if the return met the date driven test and was filed in good faith the liability on the return was dischargeable.

The amendments cited by the denying courts, including the Fifth Circuit Court of Appeals in McCoy, add an unnumbered paragraph to 11 U.S.C. 523 (a)(19) which, for the first time, statutorily addressed the concept of return. The text reads:

For purposes of this subsection [subsection (a) of 11 U.S.C. 523] , 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.\textsuperscript{31}

The denying courts took particular interest in the parenthetical language: “including applicable filing requirements”. Driven by this language and Judge Eastbrook’s judicial interpretation of this language in his dissent from\textsuperscript{}\textsuperscript{32} the courts concluded that

\begin{footnotes}
\item[25]\textsuperscript{25} Segnitz, 2013 WL 2897048; Shinn, 2012 WL 986752; Hernandez, 2012 WL 78668; McCoy, 666 F.3d 924.
\item[26]\textsuperscript{26} See Colsen v. United States (In Re Colsen), 446 F.3d 836, 840 (8th Cir.2006).
\item[27]\textsuperscript{27} 11 U.S.C. § 523(a)(1).
\item[28]\textsuperscript{28} See generally 11 U.S.C. § 523(a)(1), and Colsen, 446 F.3d at 836.
\item[29]\textsuperscript{29} See generally Colsen, 446 F.3d 836; Payne, 431 F.3d 1055; Moroney v. United States (In Re Moroney), 352 F.3d 902 (4th Cir. 2003); United States v. Hatton (In Re Hatton), 200 F.3d 1057 (9th Cir. 2000); Hindenlang, 164 F.3d 1029; and Beard, 82 T.C. 766.
\item[30]\textsuperscript{30} See generally, Id.
\item[31]\textsuperscript{31} 11 U.S.C. § 523(a).
\item[32]\textsuperscript{32} Payne, 431 F.3d at 1060 (“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).”
\end{footnotes}
“applicable filing requirements” included compliance with filing deadlines and return due dates. The result was an impetuous trend denying relief to debtors with late filed returns culminating in McCoy which now binds the 5th Circuit.

IV. PROBLEMS WITH MCCOY

The preceding bankruptcy courts and McCoy are surprisingly short sighted and present an abrupt, unsupportable break from tradition. The BAPCPA amendments are not specific enough and the legislative history is not developed enough to read the radical McCoy intent into the statutory amendments as the courts have done. Given the statutory subsection as a whole, including references, and given the rich history of judicial constructions of the term “return” the correct and more provident reading of the parenthetical language must interpret “applicable filing requirements” as referring back to the Beard Test.

A. Statutory Issues

The BAPCPA amendments did not change the date driven test. The date driven test has never been met or failed based on timely or untimely filing. To read “all applicable filing requirements” as meaning that all returns giving rise to liabilities must be timely filed to be eligible for discharge renders the date driven test mostly ineffective and superfluous. Imagine, if every liability subject to discharge was based on a timely filed return there would be no need for the filing portion of the test (must be filed for two years prior to the petition). And, to the extent that the return was never audited and additional tax assessed the 240 day assessment requirement would not be needed as it would always be met by a timely return. The reason being that if a return is timely filed and three years have passed since its due date we know it’s been filed for at least two years (unless there is fraud) and we know the balance has been assessed for at least 240 days (unless the return is audited and the IRS assesses additional tax). So, overwhelmingly, the denying courts’ reading of the amendment renders the date driven test ineffective and superfluous.

Also, such a reading absolutely conflicts with 11 U.S.C. (a)(1)(B)(ii) which states that late filed returns are dischargeable as long as they were filed more than two years prior to the petition date.

33 See McCoy, 666 F. 3d at 924; Cannon, 451 B.R. at 204; Links, 2009 WL 2966162; and Creekmore, 401 B.R. at 748.
And, a final point regarding the parenthetical language: 11 U.S.C. 523 (a)(1)(B)(i) is rendered superfluous by the denying courts’ reading of the amendment. 11 U.S.C. 523 (a)(1)(B)(i) states that if a return is not filed the liability is not dischargeable. This language is superfluous if the BAPCPA amendment parenthetical language is read to mean that liability from late filed returns can never be discharged. If the parenthetical language is read to exclude late filed returns from the prospect of discharge then there is no grey area requiring the guidance from 11 U.S.C. 523 (a)(1)(B)(i). Under the reasoning from McCoy and the prior denying courts a return is either filed timely and subject to discharge or it is not filed timely and not subject to discharge. Once the return is late you are barred from discharge. So, if the parenthetical language is read to exclude late filed returns from discharge there is no need to state that liabilities from unfiled returns are not dischargeable.

The next issue is that returns filed under 6020 (b) have never been considered returns for purposes of discharge in bankruptcy. The restatement of the exclusion in the final sentence of the unnumbered paragraph only makes sense as a modifier of the preceding language. If the preceding language is read to mean that all liabilities based on unfiled returns are nondischargeable then the 6020 (b) language is superfluous. The modified amendment paragraph must mean something else – “applicable filing requirements” must mean that the return has to meet the Beard Test. When read with that meaning the entire statute is still in harmony and the 6020 (b) exclusion makes sense as a codification of the case law up to that point. So, reading “applicable filing requirements” as meaning that all late filed returns are nondischargeable renders the 6020 (b) portion of the final sentence of the amendment paragraph irreconcilable and superfluous.

B. Unsupportable Break from Good Faith

Again, the foregoing points are all arguments based on statutory construction and indirectly based on a lack of legislative history to support the denying courts’ reading of the amendment language. These arguments are not unique to this article and have been proffered against McCoy by other commentators and bankruptcy courts alike.

The bigger issue is the radical break from the near century of good faith based judicial tradition and what it has meant across the country and it what it could mean moving forward. The reasoning in the post BAPCPA bankruptcy court cases denying relief to debtors drives a hard line based on the statute language; they cite the BAPCPA

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36 See generally Colsen, 446 F.3d 836; Payne, 431 F.3d 1055; Moroney, 352 F.3d 902; Hatton, 200 F.3d 1057; Hindenlang, 164 F.3d 1029; and Beard, 82 T.C. 766.
37 See Rhodes v. United States (In Re Rhodes), No. 11-42890-PWB (Bankr. N.D. Georgia filed May 6, 2013); Martin, 500 B.R. 1; Brown, 489 B.R. 1; and Pitts, 497 B.R. 73.
38 Id.
amendment as the sole reason for their holdings and deny debtor relief because the liabilities are based on late filed returns. Good faith, even nuanced good faith persuasion, makes up no part of the decisions; the reasoning is clear and based solely on the BAPCPA amendments. So, no extended discussion regarding the break is needed. But, the current effect of the break from tradition and the possible legacy of these rulings should be explored. Ultimately, McCoy and the post BAPCPA bankruptcy court decisions that preceded it are fundamentally flawed because they work against the spirit of bankruptcy. Even prior to the BAPCPA amendments the good faith standard imposed undue restrictions on discharge so McCoy and the prior cases are a large step in the wrong direction. What is needed is a liberalization of even the good faith standard to a more relaxed equity standard – a stark contrast to the statute driven, technical inquiry that McCoy represents. Both of these points are visited below.

V. The Limits To Discharge Have Always Been Overbroad

From a good faith perspective McCoy, the debtor, should have been granted discharge. But McCoy is emblematic of the post BAPCPA decisions that do not consider surrounding facts and circumstances. McCoy filed the delinquent state tax returns in good faith. In all prior relief denying cases in the bankruptcy courts the Internal Revenue Service had exercised its power under 26 U.S.C. 6020 (b) and made unilateral assessments against the debtors. These prior debtors filed their own returns only after IRS assessment. McCoy filed the returns before the state filed on her behalf. McCoy’s case for good faith under the Beard Test is much stronger than any debtor who had previously sought discharge relief post BAPCPA amendments. She voluntarily subjected herself to assessment and collection and waited for years to meet the date driven test. Failure to take into account good faith completely bypasses these facts, facts that reveal that discharge of McCoy’s state tax debts would have been harmonious with the anti-abuse spirit of the bankruptcy code and the amendments.

Even prior to the BAPCPA amendments, under the good faith standard, the tax liability discharge scheme was flawed. The judicial interpretation and limitations on discharge judicially based on 11 U.S.C. 523 had already gone too far. Automatic denial of discharge to SFR liabilities inhibits the spirit of the bankruptcy law. Not only should the 5th Circuit revisit or isolate the McCoy decision but also bankruptcy courts as a whole should broaden dischargeability to include SFR’s when equitable circumstances warrant such discharge.

VI. DISCHARGE OF TAX LIABILITY SCHEME SHOULD BE BROADENED AND EQUITY SHOULD BE THE GUIDE

39 Pursuant to 27-7-53, Mississippi could have also filed a substitute return.
Before the misinterpretation of BAPCPA amendments by McCoy and prior cases denying discharge to late filed returns the courts routinely denied discharge of SFR liabilities based on 11 U.S.C. 523 (a)(1)(B)(i). The courts reasoned that an SFR was not a filed return at all so the liability was not dischargeable. From a practitioner’s standpoint I can tell you that an SFR is every bit as genuine as a filed tax return from an IRS perspective. The filing of an SFR starts the collection process which results in correspondence, investigation, liens, levies and possible criminal prosecution. The waiting period to file bankruptcy in order to meet the date driven test to discharge SFR liability can be a hellish duration without proper representation.

The Internal Revenue Code itself supports the dischargeability of SFR returns. 26 U.S.C. 6020 (b)(2) states plainly that SFR’s are tax returns for all intents and purposes. Also, from a procedural standpoint SFR’s are not a barrier to any other type of relief such as offers in compromise and installment agreements. You can replace SFR’s with actual tax returns and the liability will be reduced in accord with the taxpayer filed return. Penalties and interest will be abated to comport with the taxpayer’s actual liability. An SFR assessment is not a rigid event in the tax law, it is subject to change or elimination. The bankruptcy courts’ position on SFR’s as insurmountable and ultimately nondischargeable under 11 U.S.C. 523 (a)(1)(B)(i) does not comport with equity, tax law and other procedural practicalities that provide a flexible scheme of relief and recognize the severe consequences of an SFR assessment. In fact, the judicial handling of SFR’s in bankruptcy is decidedly inflexible. It does not comport with the spirit of bankruptcy. The date driven test ensures good faith or at least a purgatorial waiting period in which the delinquent taxpayer in under the fire of the IRS collection process. The consequences of the SFR assessment are every bit as economically palpable as an original tax return – the debtor’s fresh start must include these extremely pressing liabilities if equity allows. SFR’s should be eligible for discharge in the proper circumstances.

Beyond SFR’s the courts have routinely denied discharge relief to liabilities based on taxpayer filed returns that were filed after an SFR assessment. Using the same bankruptcy statute section the courts reason that because an assessment had already

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40 See Germantown, 309 U.S. at 309; Zellerbach, 293 U.S. at 180; Hindenlang, 164 F.3d at 1029; and Beard, 82 T.C. at 766.
41 Id.
42 I.R.M. 5.1.11.
43 I.R.M. 5.12.
44 I.R.M. 5.11
45 I.R.M. 9.1.3.3.
47 I.R.M. 1.2.12.1.2.
been made any post SFR filing cannot be made in good faith as it could never “evince[] an honest and genuine endeavor to satisfy the [tax] law”.\textsuperscript{48} Some courts have disagreed with that proposition\textsuperscript{49} but generally denial is the result. So now, not only can you not discharge an SFR liability but generally, under good faith, you cannot replace the SFR and discharge the liability under the replacement return even after you have met the date driven test. So, once the IRS files an SFR you are essentially barred from bankruptcy relief on that liability. This does not comport with the spirit of bankruptcy.

To the utmost inequitable extreme, now, in the 5\textsuperscript{th} Circuit, under McCoy, even if there is no SFR and you merely file late you cannot discharge the liability despite meeting the date driven test and despite the meeting the Beard Test. This newest prohibition on late filed returns under McCoy, as discussed throughout this article, is completely unsupportable. It is also extremely inequitable. As flexible as the IRS is with SFR’s it is even more flexible with late returns. For example, reasonable cause can eliminate all penalties for late filing and payment. Reasonable cause provisions benefit troops overseas, extremely ill taxpayer’s, victims of natural disaster and a wide array of other taxpayers experiencing any type of hardship that is not preventable by ordinary prudence.\textsuperscript{50}

\textbf{VII. CONCLUSION}

This practitioner believes that McCoy must be isolated or overturned. The previous good faith based Beard Test should be liberalized to an equity standard. If discharge of tax liabilities is equitable given the facts and circumstances of the case the tax liability, regardless of its source, should be discharged. Grounded in equity, judicial decisions based on facts and not on hard, fast limitations can be a more effective guard against abuse of the system.

\textsuperscript{48} Hindenlang, 164 F.3d at 1034–35; Beard, 82 T.C. at 777; Zellerbach, 293 U.S. at 180.
\textsuperscript{49} See generally Colsen, 446 F.3d 836.
\textsuperscript{50} I.R.M. 12.1.12.1.2(2).