

The Bankruptcy Code's Return Policy: Another Hanging Paragraph Hangs Consumers Out to Dry

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I. Introduction

In this article, we will discuss the implications of the “hanging paragraph” of section 523(a) on the dischargeability of late-filed tax returns and will examine recent cases on this topic including: *In re Fahey*, 779 F.3d 1 (1st Cir. 2015), *In re Mallo*, 774 F.3d 1313 (10th Cir. 2014), *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), *In re Martin*, 542 B.R. 479 (B.A.P. 9th Cir. 2015), and *In re Justice*, No. 15-10273, 2016 WL 1237766 (11th Cir. Mar. 30, 2016).

II. Late-Filed Tax Returns and the Hanging Paragraph

Section 523 of the Bankruptcy Code provides certain exceptions to discharge. With respect to tax debt, § 523(a) states:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

...
(B) with respect to which a return, or equivalent report or notice, if required—

(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition;

11 U.S.C. § 523(a).

Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), courts looked to the test articulated in *Beard v. Comm’r*, 82 T.C. 766, 777–78 (1984), to determine what qualified as a return. *In re Nilsen*, 542 B.R. 640, 644 (Bankr. D. Mass. 2015).³ Under the *Beard* test in order to qualify as a “return”: “(1) it must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to

³ At the time of this writing, *In re Nilsen* is on appeal to the United States District Court for the District of Massachusetts. In *Nilsen*, the Bankruptcy Court for the District of Massachusetts, rejected an argument that a late-filed return could be “equivalent report or notice” under § 523(a)(1)(B). 542 B.R. at 647 (“The Debtor filed Form 1040s and Form 1s is late. He did not file something akin to or equivalent to those documents. He filed actual returns, not something different. It appears to this Court that the Debtor is attempting to rename the tax forms as equivalent reports to evade the holding in *In re Fahey*.”)

allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law.” 542 B.R. at 644. As part of BAPCPA, a definition of “return” was added as a “hanging paragraph” to § 523:

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.

11 U.S.C.A. § 523(a)(*).⁴ Courts are divided on whether the hanging paragraph makes tax debt associated with all late-filed tax returns non-dischargeable. The Court of Appeals for the First Circuit, the Court of Appeals for the Fifth Circuit, and the Court of Appeals for the Tenth Circuit have found that late-filed returns are not “returns” within the meaning of the hanging paragraph.⁵ *See In re Fahey*, 779 F.3d 1; *In re Mallo*, 774 F.3d 1313; *In re McCoy*, 666 F.3d 924. The Court of Appeals for the Eleventh Circuit and the Bankruptcy Appellate Panel for the Ninth Circuit have rejected that strict approach and continue to use versions of the *Beard* test. *See In re Martin*, 542 B.R. 479; *In re Justice*, No. 15-10273, 2016 WL 1237766.

A. First Circuit

In *Fahey*, the Court of Appeals for the First Circuit found that a return filed after the due date is “a return not filed as required, i.e. a return that does not satisfy the ‘applicable filing

⁴ The legislative history of BAPCPA provides no guidance on the intent behind the addition of the first sentence of the hanging paragraph. With respect to the second sentence, the House Report states: “Section 714 of the Act amends section 523(a) of the Bankruptcy Code to provide that a return prepared pursuant to section 6020(a) of the Internal Revenue Code, or similar State or local law, constitutes filing a return (and the debt can be discharged), but that a return filed on behalf of a taxpayer pursuant to section 6020(b) of the Internal Revenue Code, or similar State or local law, does not constitute filing a return (and the debt cannot be discharged).” H.R. REP. 109-31(I), 103, 2005 U.S.C.A.N. 88, 167.

⁵ At the time of this writing, a case on this issue is pending in the Court of Appeals for the Third Circuit on appeal from the United States District Court for the Eastern District of Pennsylvania. *See In re Giacchi*, 2015 WL 5737357 (E.D. Pa. Sept. 30, 2015). In the underlying case, the United States District Court for the Eastern District of Pennsylvania affirmed the bankruptcy court’s decision that late-filed post-assessment tax documents do not qualify as “returns” under the hanging paragraph of § 523(a). *Id.* at *5–6.

requirements.” 779 F. 3d at 5. In that case, the debtors filed their Massachusetts income tax returns late and failed to pay all taxes, interest, and penalties that were due to the Massachusetts Department of Revenue.⁶ The Court of Appeals for the First Circuit found that under the hanging paragraph, in order for a document to be “return,” it must “satisfy the requirements of applicable nonbankruptcy law (including applicable filing requirements).” *Id.* at 4. Timely filing is a “filing requirement” under Massachusetts law. *Id.* Accordingly, a return filed after the due date does not satisfy the applicable filing requirements and is a return not filed as required. *Id.* at 5.

Addressing the arguments made in the dissenting opinion, the court reasoned that since the hanging paragraph carves out an exception for one type of late return—those prepared under Internal Revenue Code section 6020(a)—the “two-year” provision of § 523(a)(1)(B)(ii) is not superfluous. *Id.* at 6. As such, “a late tax return, if prepared in compliance with section 6020(a) and filed within two years of the bankruptcy petition, is still a return (and the tax due thus dischargeable), notwithstanding its failure to meet the otherwise ‘applicable filing requirement’ of a mandatory deadline.” *Id.* Returns prepared under section 6020(a) of the Internal Revenue Code are those that are prepared and processed by the Internal Revenue Service for non-filing taxpayers.⁷ Although this exception “may only apply in a small minority of cases,” the court

⁶ The opinion in relates to four separate chapter 7 cases that were appealed to the First Circuit Court of Appeals on the same issue. See *Perkins v. Mass. Dep’t of Revenue*, 507 B.R. 45 (D. Mass. 2014); *In re Gonzalez*, 506 B.R. 317 (B.A.P. 1st Cir. 2014); *In re Brown*, B.A.P. No. MW 13–027, 2014 WL 1815393 (B.A.P. 1st Cir. Apr. 3, 2014).

⁷ Section 6020 of the Internal Revenue Code states:

a) Preparation of return by Secretary.--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.

b) Execution of return by Secretary.--

(1) Authority of Secretary to execute return.--If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed

found that the “two-year provision still has a role to play if the hanging paragraph’s plain meaning controls.” *Id.*

In the dissent, Judge Thompson found several flaws in the majority’s logic. *Id.* at 12 (Thompson, J., dissenting). First, as late-filed returns will still be accepted by the Commonwealth under Massachusetts law and incur only a small penalty which can be waived, the dissent did not understand how the court could “conclude that a late-filed return never satisfies the requirements of Massachusetts tax law if the Commonwealth not only accepts the return, but is even willing to waive the already relatively conservative penalty for filing it late.” *Id.* at 13. Additionally, the dissent found that majority’s reading rendered § 523(a)(1)(B)(ii) superfluous. *Id.* The dissent found the outcome under the majority’s reasoning absurd:

the scofflaw who sits on his hands at tax time, doesn’t bother to file a return, and then, after getting caught cooperates with the authorities and lets the government file the substitute return for him, would be the only late filer who would be allowed to discharge his tax debt. The person who files his return one day late—which the state then accepts—would not be permitted to discharge, regardless of the reason for tardiness.

Id. at 15. Rather, the dissent interpreted subsection (ii) and its two year provision as creating a specific exception that deals with late filers. *Id.* at 13.

B. Fifth and Tenth Circuits

The Court of Appeals for the Fifth Circuit and the Court of Appeals for the Tenth Circuit have also adopted the strict interpretation. In *McCoy*, the Fifth Circuit Court of Appeals determined that a debtor’s failure to comply with a Mississippi law stating that returns “shall be

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.

(2) Status of returns.--Any return so made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes.

filed on or before April 15th” meant that the returns did not satisfy applicable filing requirements under the definition in the hanging paragraph. 666 F. 3d at 932.

In that case, the debtor filed a post-discharge adversary proceeding against the Mississippi State Tax Commission seeking a declaration that her pre-petition state income tax debts were discharged. *Id.* at 925. The Mississippi tax code provides that “if the return is filed on the basis of a calendar year, it shall be filed on or before April 15th of each year.” *Id.* at 928 (quoting Miss. Code. Ann. § 27-7-41). Taking the plain meaning approach, as the debtor submitted her tax filings after April 15th, the court found that the filings did not satisfy applicable nonbankruptcy law and were not “returns” for the purposes of § 523(a). *Id.*

Addressing the exemption for returns prepared under § 6020 of the Internal Revenue Code, the court reasoned that:

[the] second sentence in § 523(a)(*) carves out a narrow exception to the definition of “return” for § 6020(a) returns, while explaining that § 6020(b) returns, in contrast, do not qualify as returns for discharge purposes. Such a reading conforms with the plain language of the text and leaves no portion of § 523(a)(*) superfluous.

Id. at 931.

Similarly, the Court of Appeals for the Tenth Circuit found that returns filed late under the Internal Revenue Code are not returns within the meaning of the hanging paragraph. 774 F. 3d at 1321. In *Mallo*, the debtors filed their Form 1040s after the tax had been assessed by the Internal Revenue Service. *Id.* at 1316.

As discussed in *Mallo*, the Internal Revenue Code states that “returns made on the basis of the calendar year shall be filed on or before the 15th day of April following the close of the calendar year” 26 U.S.C. § 6072(a). The court found that the phrase “shall be filed on or before” was a “classic example of something that must be done with respect to filing a tax return and, therefore, is an ‘applicable filing requirement.’” 774 F. 3d at 1321. As such, the court held

that “because applicable filing requirements include filing deadlines, § 523(a)(*) plainly excludes late-filed Form 1040s from the definition of a return.” *Id.*

C. Circuits that Reject the Strict Interpretation

The Eleventh Circuit Court of Appeals and the Bankruptcy Appellate Panel for the Ninth Circuit have rejected the strict approach and continue to use versions of the *Beard* Test to determine what constitutes a “return.”⁸ In *Martin*, chapter 7 debtors brought an adversary proceeding against the Internal Revenue Service seeking a determination that their federal tax debts relating to late-filed tax returns were dischargeable. 542 B.R. 479, 481–82.

In rejecting a strict interpretation, the Bankruptcy Appellate Panel for the Ninth Circuit found “no convincing or persuasive indication that BAPCPA or the hanging paragraph abrogated” the version of the *Beard* test articulated in *In re Hatton (Hatton II)*, 220 F.3d 1057, 1058 (9th Cir. 2000). 542 B.R. at 490 (The *Hatton II* “version of the Beard test provides: ‘(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.’”).

The Bankruptcy Appellate Panel for the Ninth Circuit found that that the literal construction would render § 523(a)(1)(B)(ii) “all but meaningless—reducing the potential application of that provision to a minuscule scope.” *Id.* at 480. The court took further issue with the literal construction:

under the literal construction of the hanging paragraph, a debtor taxpayer who is one month or one day or even one hour late in filing his or her return will have his associated tax debt excepted from discharge, whereas a debtor taxpayer who never bothers to file his or her own return can discharge his or

⁸ The Bankruptcy Court for the District of New Jersey has also rejected the strict interpretation. *In re Maitland*, 531 B.R. 516 (Bk. D.N.J. 2015). The court found that a late-filed tax return can meet the definition of return under § 523(a)(*). *Id.* at 520. The court reasoned that a strict reading would render the other parts of § 523 superfluous, in particular the two year provision. *Id.*

her associated tax debt if the IRS fortuitously prepares a return on that person's behalf.

Id. at 487. Rather than adopt the strict interpretation, the Bankruptcy Appellate Panel for the Ninth Circuit concluded that for the purposes of determining the dischargeability of federal income tax debt, the “return” definition in the hanging paragraph “effectively codified the *Beard* test, except that Congress in the second sentence carved out some specific rules for tax returns prepared by taxing authorities.” *Id.* at 489–90.

In *Justice*, the Court of Appeals for the Eleventh Circuit declined to adopt the strict interpretation's “one-day-late rule.” 2016 WL 1237766, at *3 (“We can assume *arguendo*, although we expressly do not decide, that that one-day-late rule is incorrect”). Rather than establishing a strict rule, the Court of Appeals for the Eleventh Circuit found that the *Beard* test is incorporated into “applicable nonbankruptcy law.” *Id.* In particular, the fourth prong—that there must be an honest and reasonable attempt to satisfy the requirements of the tax law—is relevant where the filing is delinquent. *Id.* at *4–5. In applying the *Beard* test, the court nevertheless found that the debtors' late-filed Form 1040s did not qualify as tax returns, and as such, the tax debts were not dischargeable. *Id.* at *6.

III. Practical Implications

For debtors in the First, Fifth and Tenth Circuits, the rule is clear—tax debt associated with late-filed returns is excepted from discharge (unless the return was prepared pursuant to 6020(a) of the Internal Revenue Code, or similar state or local law). Even though the Internal Revenue Service generally takes the position that a late-filed return does not bar discharge of the underlying debt, most taxing authorities will view the debt as non-dischargeable in those jurisdictions, which places significant leverage in the hands of the taxing authorities when

attempting to deal with tax debt. It is of critical importance that counsel knows what returns have been filed and when.