

Dischargeability of Certain Taxes in Lieu of the IRS' Having Filed a Substitute for Return – Where We Stand Now

At various junctures Titles 11 and 26 of the United States Code intersect with one another and require the attorney to closely examine and plan their debtor-client's affairs to avoid the potential gridlock that may arise, thus facilitating a smooth transition between both bodies of law. Of particular concern are cases where the IRS has prepared a "return" under the authority of section 6020 of the Internal Revenue Code¹ and a client is contemplating (or has already filed) for Chapter 7 discharge or for a Chapter 13 plan.

Background

Although the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") amended the Bankruptcy Code to clarify what would constitute a "return" for purposes of the dischargeability provisions,² many questions were still left unanswered. This article is a follow up to our previous article "Discharge of Unfiled Taxes under the Bankruptcy Abuse Prevention and Protection Act of 2005 (BAPCPA). No More "Super" Discharge? 2006, Vol XXIV No. 5 p. 10. In our previous article we discussed the major BAPCPA changes affecting the discharge of income tax debt. Since this publication we have analyzed many cases where the IRS filed substitute returns for the taxpayer and thus forever blocked a discharge. Most recently, we have even observed this problem in chapter 13 cases in which a substitute return was filed for old years.³

This article will focus primarily on this issue and the definition of a return with specific reference to chapter 7 cases and then will conclude with some options for dealing with this problem.

¹ 26 U.S.C. § 6020. Essentially, this section of the Internal Revenue Code contemplates two situations where the Secretary, instead of the debtor, files a return ("Substitute for Return" or "SFR") for the debtor. If a debtor fails to make a return but agrees to disclose all information necessary for preparing the return, the IRS may prepare the return and it will be treated as the debtor's return (so long as it is signed by the debtor), and the debtor will be held legally accountable for its accuracy as if he or she had prepared it. *See* IRC § 6020(a); Treas. Reg. § 301.6020-1(a)(2). If a debtor fails to file a timely return (taking into account any filing extensions) or files a false, fraudulent or frivolous return, the IRS may prepare a return based on its own information. *See* IRC § 6020(b). To satisfy the second situation, the IRS' SFR must be a single or collection of documents, signed by an appropriate IRS representative, identify the debtor by name and by taxpayer identification number, contain sufficient information from which to compute the debtor's tax liability, and purport to be a return. *See* Treas. Reg. § 301.6020-1(b).

² *See* Pub. L. 109-8 § 714(2), 119 Stat. 23 (April 20, 2005).

³ For instance, consider a situation where a Debtor filed some old returns, but was late on others and the IRS filed a SFR for these years. The Debtor also has some credit card debt, medical bills and other miscellaneous debt. In addition, the Debtor owes taxes for the most recent 3 years. The Debtor has no assets and is on a limited budget where there is enough to fund a reasonable distribution to unsecured creditors and pay off priority taxes in full. Under this scenario, the Debtor can have the chapter 13 plan confirmed and complete the 5 year payments and still owe a substantial amount of taxes which equals the amount of the old SFR years that is not paid for under the plan.

Rules for determining if taxes are unsecured

Priority taxes are nondischargeable in Chapter 7 cases.⁴ This Article deals exclusively with non-priority taxes, however, the determination of whether or not certain taxes constitute priority claims is not always readily apparent. Thus, the following summary is generally indicative of whether a tax debt cannot be discharged because it is a priority claim. A priority tax is defined as “a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition (the ‘Petition Date’)” and that also meets one of the three following tests: (1) was assessed for a taxable year ending on or before the Petition Date and the return, with any extensions thereto,⁵ was due less than three years before the Petition Date; (2) was assessed within 240 days of the Petition Date; or (3) was assessed after the Petition Date, and the statute of limitations on assessment has not run as of the Petition Date.⁶

Exceptions to discharge

Assuming a tax has been determined non-priority, it may nonetheless be nondischargeable if either “a return, or equivalent report or notice” was not filed or given or it was filed or given after the [ultimate due date] and within the two years preceding the date of the bankruptcy filing.”⁷ In some cases, the determination of whether the debtor has actually filed a “return” will be clear, in other cases not so much so.

What is a “return”?

Prior to BAPCPA, what constituted a “return” for purposes of 523(a) discharge led to significant litigation.⁸ Post-BAPCPA, however, this was clarified, at least to some extent, under an amended version of section 523(a). This amended section provides an expansive definition of a “return” in the flush language at the end of the provision. For purposes of 523(a), a “return” means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements) and includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code ... 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)...or a similar State or local law.⁹

⁴ 11 U.S.C. § 523(a)(1)(A). *See also* 11 U.S.C. § 507(a) (Priority taxes, or “allowed unsecured claims of governmental units”, include income taxes and are ranked eighth among the priority ordering).

⁵ This test contemplates any extensions to the due date. Ordinarily, this will occur if a Form 4868 (“Automatic Extension to File Federal Income Tax Return”) has been filed and the due date has automatically been extended by six months. *See* 26 U.S.C. § 6081 (providing authority for the Form’s automatic extension).

⁶ *See* 11 U.S.C. § 507(a)(8)(A)(i-iii).

⁷ 11 U.S.C. § 523(a)(1)(B) (emphasis supplied).

⁸ Particularly prevalent among the disputes was whether a special definition of a “return,” for Bankruptcy Code purposes, or the federal tax common law definition of a return was appropriate. Causing further confusion was the fact that the nowhere within the Internal Revenue Code is the term “return” defined.

⁹ 11 U.S.C. § 523(a) (emphasis supplied). Although I.R.C. § 6020(b) states that a return made pursuant to 6020(b) and signed by the Secretary “shall be prima facie good and sufficient for all legal purposes,” Treasury Regulations were promulgated to accommodate for this facial inconsistency between 6020(b) and 523(a). They read, SFRs under 6020(b) “shall be good and sufficient for all legal purposes except insofar as any Federal statute expressly provides otherwise.” T. Reg. § 301.6020-1(b)(3) (emphasis supplied).

SFRs IRC section 6020(b)

Under the current statutory framework, it is apparent that for discharge purposes, substitute for returns (“SFRs”) filed by the IRS under the authority of section 6020(b) can never be returns. Three different bankruptcy courts have held that the language of section 523(a) calls for a definition of a return that embraces the Internal Revenue Code’s filing deadlines for submitting returns.¹⁰ Thus, under this interpretation, if a debtor has filed a return after April 15 of the tax year in question (or six months thereafter if an extension was granted)¹¹ and has not “consent[ed] to disclose all information necessary for the preparation [of a return]” to the IRS or the IRS has already filed a return for the debtor, any resulting tax liability can never qualify for dischargeability. Although a harsh result and a potential disincentive for non-filers to file their returns or late-filers to assist the IRS in the time-consuming task of preparing a return, these same courts have cited the section 6020(a) safe harbor provision as a mitigating element. These holdings necessarily beg the question as to what constitutes “a return prepared pursuant to section 6020(a) of the Internal Revenue Code” that also “satisfies...applicable filing requirements?”¹²

The IRS has provided potential debtors with its litigating position regarding when it will accept certain documents prepared by the IRS, with the debtor’s help, as a 6020(a) return.¹³ For any time on or before September 12, 2005, if a Revenue Agent or Officer has prepared a return from his or her own information and a debtor subsequently executed a Form 870¹⁴, Form 4549¹⁵, or Form 1902¹⁶, based on the IRS official’s return but did not file a formal return, the IRS will not challenge dischargeability.¹⁷ However, any time after September 12, 2005, the IRS has indicated that it will challenge dischargeability unless the four-part test for a return, as initially set forth in *Beard v. Commissioner*,¹⁸ is met. To constitute a 6020(a) return, and therefore be dischargeable, a document must (1) purport to be a return; (2) be executed under penalties of perjury; (3) contain sufficient data to allow calculation of tax; and (4) represent an honest and reasonable attempt to satisfy the requirements of the tax law.¹⁹

¹⁰ See *In re McCoy*, 2009 WL 2835258 at *7-8 (Bankr. S.D. Miss. Aug. 31, 2009); *In re Links*, 2009 WL 2966162 at * 4-5 (Bankr. N.D. Ohio Aug. 21, 2009); *In re Creekmore*, 401 B.R. 748 (Bankr. N.D. Miss. 2008). These three courts have construed the “applicable filing requirements” language to include the Internal Revenue Code’s filing deadlines.

¹¹ See IRC §§ 6072(a), 6081(a).

¹² See 11 U.S.C. § 523(a).

¹³ See Chief Counsel Notice Re: “Litigating Position Regarding the Definition of Returns for Bankruptcy Discharge Purposes”, CCN-CC-2006-002 (Nov. 22, 2005) (adopting Rev. Rul. 2005-59, 2005-37 I.R.B.505 (Sept. 12, 2005)) (“IRS Litigating Position”).

¹⁴ Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment.

¹⁵ Income Tax Examination Changes.

¹⁶ Report of Individual Income Tax Audit Changes

¹⁷ This is mirrored by the guidance the IRS gives to its employees. See Internal Revenue Manual § 5.9.2.9.1.2 (“A Valid Tax Return”) (3/1/2007).

¹⁸ 82 T.C. 766, 777-78 (1984), *aff’d* 793 F.2d 139 (6th Cir. 1986).

¹⁹ *Id.* See also “IRS Litigating Position”, *supra* note 12.

Although the IRS has clearly stated its position on 6020(a) returns, no court has directly evaluated such position's merits. Because, the IRS claims, the abovementioned Forms are not signed under penalty of perjury (i.e., there is no *jurat* clause), they *ipso facto* cannot pass the *Beard* test and thus are nondischargeable. How a particular court will interpret this is yet to be determined.

Options if taxes are non dischargeable

While BAPCPA made progress in clarifying the scope of the definition of a return for purposes of the dischargeability provisions in section 523, it left significant room for flexibility. Although the scope of litigation has been narrowed and there is a clear safe harbor in place for debtors to avail themselves of the fresh start of Chapter 7 discharge, it cannot be emphasized enough that careful planning and structuring is essential, and, as is demonstrated by the IRS' Litigating Position, the difference of even one day can be the lynchpin between dischargeable or perpetual tax debt.

While each client's situation must be evaluated on an *ad hoc* basis, it is important that all options, even non-bankruptcy be considered. If most of a Debtor's tax debt would not be non-dischargeable either under a chapter 7 or chapter 13 plan, prudent advisers should consider filing an offer in compromise, which is an agreement between a taxpayer and the IRS that settles the taxpayer's tax liabilities for less than the full amount owed, which is similar in some parts and different in other from the Means Test.