Developing Areas in the Treatment of Tax Debts in Bankruptcy after 2010

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Current Areas of Controversy

1. **Late-filed returns;**
2. **Late-filed returns filed after some assessment action by IRS or state; and**
3. **Amended returns.**

Possible future controversy: Equitable tolling.

Late Filed Returns

BAPCPA added the following flush paragraph to BC 523(a):

> 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.

Although the IRS has taken a taxpayer-friendly position in CC Notice 2010-16, that a late-filed return can still be a "return" for purposes of BC 523(a), as amended in 2005 by BAPCPA, there is a harsher rule that has now spread to three circuits (1st, 5th, and 10th).

Late Filed Returns

"The One Day Late Rule"

In *McCoy v. Mississippi State Tax Comm'n (In re McCoy)*, 666 F.3d 924 (5th Cir.), cert. denied, 133 S. Ct. 192 (2012), the 5th Circuit became the first to adopt a "one day late rule."

Mrs. McCoy filed her 1998 and 1999 Mississippi state returns late. In 2007, she filed chapter 7 and a discharge order was entered in 2008. Mrs. McCoy filed an AP against the Mississippi State Tax Commission ("MSTC") seeking a declaration that her 1998 and 1999 state income tax liabilities had been discharged. The MSTC moved to dismiss her complaint, arguing that under the new language added to BC 523 by BAPCPA, Mrs. McCoy's late-filed returns were not "returns" because they did not "satisfy the requirements of applicable nonbankruptcy law (including applicable filing requirements." The MSTC argued that *timeliness* was an "applicable filing requirement." Jerks. But *smart* jerks nonetheless.

Late Filed Returns

McCoy argued in favor of the *Beard* Test, as applied in *United States v. Hindenlang*, 164 F.3d 1029, 1033 (6th Cir. 1999), cert. denied, 528 U.S. 810 (1999).

But the 5th Circuit clerks apparently read *Hindenlang* and found the portion of the 6th Circuit's opinion where it explained that its holding did not "not address the issue of the definition of return for purposes of BC 523(a)(1)(B) when a TP seeks to discharge state, municipal, or other tax liability."

The 5th Circuit noted that the change to BC 523(a) was motivated by a desire to curb an increase in consumer bankruptcy filings and less impressed with McCoy's reliance on decades of bankruptcy practice that exceptions to discharge are to be construed narrowly. See *Boyce v. Greenway*, 71 F.3d 1177, 1180 n.8 (5th Cir. 1996), *citing Citizen Bank & Trust Co. v. Case*, 937 F.2d 1014, 1024 (5th Cir. 1991).

Late Filed Returns

In the end, the 5th Circuit held that Miss. Code Ann. §27-7-41 provides the "applicable filing requirements" for Mississippi income tax returns.

That Mississippi law includes a requirement that Mrs. McCoy filed her 1998 return by 4/15/99 and her 1999 return by 4/15/00.

McCoy's failure to file the returns by those dates was a failure of her returns to satisfy the requirements of applicable nonbankruptcy law.

Therefore, the resulting debts were not dischargeable under BC 523(a).

In particularly hilarious dicta, the 5th Circuit noted that this was not a major change in pre-Code practice, and that such a reading was required by the "plain language" of BC 523(a)'s new flush paragraph.

Late Filed Returns

The *McCoy* Rule: Unless a return is filed under a safe harbor provision similar to IRC 6020(a), a state income tax return that is filed late under the applicable nonbankruptcy state law is not a "return" for bankruptcy discharge purposes under BC 523(a).

The metastasization and expansion of the One Day Late Rule:

The 10th Circuit jumped on board in with the 5th Circuit when it decided *Mallo v. Internal Revenue Service (In re Mallo)*, 774 F.3d at 1321 (10th Cir. 2014).

- IRC 6072 provision that income tax returns "shall be filed on or before" is a classic example of an "applicable filing requirement."
- Note that *Mallo* concerned itself with FEDERAL income tax debts, not state income tax debts, whereas *McCoy* dealt with state income tax debts and distinguished itself from *Hindenlang* on that basis.

Late Filed Returns

Two more interesting notes about *Mallo*.

1. The 10th Circuit went further than requested by the IRS. The IRS stuck to its published litigating position (CC Notice 2010-016) that not all late-filed returns are excepted from discharge, but the court surged ahead on its own in adopting the One Day Late Rule, with the effect being *neither* litigant in the AP had its position approved by the court.
2. Adoption of the One Day Late Rule was not necessary to decide the case in the Service's favor. In the brief filed by the Solicitor General in opposition to granting cert (brief filed May 2015), the government argues that the "applicable filing requirements" language does not include deadlines to file, that such a reading ignores the "larger statutory context," and that the One Day Late Rule renders the language in the statute dealing with 6020(a) and 6020(b) assessments superfluous. The only cases left would be 6020(a) assessments or state law equivalents, and tax debts stipulated to by the debtor in a nonbankruptcy tribunal, which is a "minute number of cases," according to IRS Chief Counsel.

Late Filed Returns

The One Day Late Rule was also adopted by the 1st Circuit in *Fahey v. Massachusetts Dept. of Revenue (In re Fahey)*, 779 F. 3d 1 (1st Cir. 2015).

Held: Timely filing is a "filing requirement" under Massachusetts law. Therefore, tax assessed pursuant to late-filed Massachusetts income tax returns was not dischargeable in bankruptcy for which petition was filed more than two years after the returns were filed.

Late Filed Returns

Rejection of the One Day Late Rule

There is currently no circuit split for SCOTUS to cure because no other circuits have addressed the issue post-BAPCPA.

The 4th Circuit came close in *Maryland v. Ciotti (In re Ciotti)*, 638 F.3d 276 (4th Cir. 2011), but the issue there was not compliance with "applicable filing requirements," but whether Md. Code Ann. Tax-Gen. §13-409(b) (requiring the filing of an amended Maryland return after federal adjustments) is an "equivalent report or notice," requiring its own 2-year BC 523(a) period.

But the 9th Circuit BAP has spoken ill of the One Day Late Rule in in *Martin v. United States*, BAP No. EC-14-1180-KuKiTa (9th Cir. BAP 2015). *Martin* involves late-filed returns after a completed IRS SFR, so the case was decided against the TP. But the opinion opens with an entertaining and unequivocal rejection of the literal interpretation of the BAPCPA flush paragraph adopted by the 1st, 5th, and 10th Circuits.

Late Filed Returns

Rejection of the One Day Late Rule

There is another case pending in the 9th Circuit right now, *IRS v. Smith (In re Smith)*, 527 B.R. 14 (N.D. Cal. 2014), that may provide the opportunity for the 9th Circuit to create a circuit split that SCOTUS might then take up.

- TP filed a return after the IRS completed a SFR for tax year 2001, but TP's return reported more tax than the IRS assessed under 6020(b).
- TP waited two years from filing that return, filed chapter 7, got a discharge, then filed an AP seeking a declaration that his 2001 liability was discharged.
- The bankruptcy court held that the taxes were discharged but the district court rev'd.
- The case is set for oral argument in May 2016.

Late Returns

Rejection of the One Day Late Rule

There is also some movement in the 3rd Circuit on this issue.

The Bankruptcy Court for the District of New Jersey recently "agreed with those decisions that hold that the timing of the filing is not a factor in determining whether the document meets the definition of a `return'." *In re Davis*, No. 14-26507 (Bankr. D.N.J. Sept. 29, 2015).

Late Returns After SFR

In the three circuits that adopted the One Day Late Rule, this issue is moot. So long as a return is filed late, the debt is not subject to discharge. What the tax authorities do after TP doesn't file their return on time is irrelevant.

The Service's position on this remains clear and unchanged since the issuance of CC Notice 2010-016: If a SFR is prepared, a SNOD issued, no Tax Court petition filed, and the SFR is completed and assessed, the resulting tax is rendered nondischargeable.

Late Returns After SFR

There continues to be movement on this issue.

In *Briggs v. United States*, 511 B.R. 707 (Bankr. N.D.Ga. 2014), the bankruptcy court denied the Service's MSJ in an AP filed by the debtor seeking a determination of dischargeability with regard to their 2002 federal income taxes. The Service completed a SFR for 2002, TP later filed a return, waited two years, then filed bankruptcy in 2013.

The bankruptcy court held that the BAPCPA language added to 523(a) does not invoke the timeliness requirements when determining whether a document purporting to be a return is a "return" for purposes of BC 523. Rather, the court applied the *Beard* Test, and found that the Service did not present any evidence to show that the debtor's 2002 post-assessment return was not an honest and reasonable attempt to comply with the tax laws. The Service's MSJ was denied.

Late Returns After SFR

In *Briggs*, the bankruptcy court later held that the post-assessment return complied with the *Beard* requirements and that the 2002 liability was subject to discharge.

The Service entered an appeal in July 2015 to the N.D. Ga. That appeal has been stayed pending a decision in the 11th Circuit case of *Justice v. United States*, Case No. 15-10273, which presents identical issues. On 3/30/16, the 11th Circuit opined that "applicable nonbankruptcy law" refers to the *Beard* Test, but ruled in accord with *Moroney* that returns filed after completed SFRs fail the fourth prong of *Beard*.

Amended Returns

The IRS has not pursued the argument that an amended "return" should get its own 2-year clock under BC 523(a).

The most likely explanation for this is that the statutory underpinnings for federal amended returns is murky at best.

But, many states have statutory provisions that require TPs to file amended returns in various circumstances. Savvy state tax agencies are using such statutes, in conjunction with the BAPCPA-added language in BC 523(a), to argue that a new 2-year BC 523(a) period applies to state amended returns.

Amended Returns

Md. Code Ann. §13-409(b) requires the filing of a "report of federal adjustment" within 90 days of the IRS making adjustments.

This state statute was at issue in *Ciotti v. Maryland (In re Ciotti)*, 638 F.3d 276 (4th Cir. 2011).

- TPs were audited by the IRS, resulting in a deficiency being assessed.
- TPs did NOT file the required Maryland amended return within the 90-day period required by §13-409(b).
- Maryland (as they often do) got wind of the IRS adjustment and made an additional assessment in the absence of an amended Maryland return.
- TPs filed bankruptcy and Maryland objected to the discharge of the Maryland deficiency.

Amended Returns

The 4th Circuit's holdings in *Ciotti*:

1. The Maryland report of federal adjustments was an "equivalent report or notice," within the new flush language added to BC 523(a) by BAPCPA.
2. The Maryland report was required by Maryland statute.
3. TPs failure to file the required report before Maryland made the adjustment rendered the Maryland assessment nondischargeable.

Amended Returns

C*iotti* is working its way through the 4th Circuit. It has recently been adopted by the Virginia Department of Taxation.

VA Code §58.1-311 requires a TP to "file an amended return" reporting a "change or correction in federal taxable income within one year after the final determination of such change."

The section also requires a TP that files an amended federal return to file an amended VA return "one year thereafter."

** Note this may be ambiguous – is it one year from when the TP files a federal amended return or one year from when the IRS makes the change? Often the Department requires proof that the IRS has *posted* an amended return before processing the Virginia amended return.

Amended Returns

The VA Dept. of Taxation recently informed us that they would be taking the following positions in future bankruptcy cases:

1. That a new, 2-year BC 523(a) period would be computed to determine dischargeability from the "due date" of the amended VA return required under §58.1-311. Additional VA tax resulting from a federal adjustment is not subject to discharge unless the petition is filed at least two years after the required amended VA return.

2. That adjustments by the Dept. of Taxation in the absence of a required VA amended return will be considered nonfiler assessments, not subject to discharge, *a la Ciotti*.

Amended Returns

3. **That VA Code §58.1-311 sets a due date for the VA amended return (one year from the federal adjustments becoming final), and that they will argue a new, 3-year BC 507(a)(8)(A)(i) period should apply. Boom.**

Virginia taking *Ciotti*, a decision interpreting state statute in light of the flush paragraph added to BC 523(a) by BAPCPA, and applying its rationale to BC 507. This is new territory, filled with peril.

Amended Returns

Applying *Ciotti* to BC 507:

- The flush paragraph of BC 523(a), with the "return or equivalent report" language on which *Ciotti* hung, was not added to BC 507, only to BC 523. Virginia is assuming that ["return" for purposes of BC 523] = ["return" for purposes of BC 507].
- Prior practice has been consistent that an amended return triggers only a new 240-day period. At least with regard to federal returns, there can be only one "return."
- We have polled notable practitioners in this area. To summarize, we are all still in the "losing our minds" phase. There is no consensus yet, although many appear to agree that *Ciotti* was correctly decided, but applying the rationale to BC 507 would be a stretch. It would give Virginia four years before a liability reported on a timely amended VA return could be discharged in bankruptcy, where it previously was only given 240 days.

Equitable Tolling

"Equitable tolling" is an old doctrine that has been used to get around periods of limitation in order to avoid inequitable results.

Prior to BAPCPA, there were no provisions in BC 507 or BC 523 to toll the three time periods for time the IRS was barred from taking collection action. But in *Young v. United States*, SCOTUS held that the BC 507 periods were tolled for the time a taxpayer was in a previous bankruptcy: "[i]t is hornbook law that limitations periods are `customarily subject to equitable tolling.'" 535 U.S. 43, 49 (2002).

Equitable Tolling

In BAPCPA, Congress sought to incorporate the rule of *Young* into BC 507(a) by providing that the BC 507(a) periods would be extended by the amount of time a TP is in bankruptcy, plus 90 days.

The general consensus among practitioners was that after BAPCPA incorporated the equitable tolling rule into the statutory construct, *Young* was mooted.

However, the IRS has since argued that the pre-BAPCPA concept of equitable tolling is alive and well, and can operate to toll the 2-year period of BC 523(a), extending *Young* beyond its original context of BC 507. See *Putnam v. Internal Revenue Service (In re Putnam)*, [Adversary proceeding No. 12-00273-8-SWH (Bank. E.D.N.C. 2014).

Equitable Tolling

There have been several cases since 2013 involving other aspects of tax law where equitable tolling has been or could have been outcome determinative.

- *Volpicelli* (applying equitable tolling to the 9-month period for bringing a suit for wrongful levy under IRC 6532(a)); see also *Mottahedeh v. United States*.
- *Wong v. Beebe* and *June v. United States* (which could arguably render the the 2-year period for refund suit under IRC 6532(a) subject to equitable tolling).
- *Vintilla v. United States*, 931 F.2d 1444 (11th Cir. 1991) and United States v. Bates, case No. 8:2012cv00833 - Document 78 (M.D. Fla. 2015)

None of the above were bankruptcy cases with equitable tolling applied to extend the BC 507 or BC 523 periods. But they demonstrate that equitable tolling is alive and well in tax cases.

Equitable Tolling

The Service has argued successfully that equitable tolling still operates post-BAPCPA to toll the BC 523 period for the time the IRS is prohibited from seeking to collect federal taxes because of the automatic stay of BC 362. But there is room for possible expansion of this doctrine.

Other than bankruptcy, appeals, and Offers in Compromise (all actions explicitly dealt with in BAPCPA's new additions to BC 507), TPs may take certain actions that prohibit IRS from taking collection action. The IRS recoups time on the Collection Statute of Limitations ("CSOL") for these actions, but they have not been held to extend the BC 507 or BC 523 periods, e.g. installment agreement request, request for Taxpayer Assistance Order.