THE BANKRUPTCY DISCHARGE WAR, PART II: THE FIFTH CIRCUIT COURT OF APPEALS REWRITES THE BANKRUPTCY CODE

Linda Trenett McCoy hadn't filed her Mississippi income tax returns for 1993 through 2000. By September of 2002, the Mississippi State Tax Commission ("MSTC") had made no-file assessments (MSTC's version of IRS's SFR) for 1993 through 1997 and for the year 2000. However, MSTC had not assessed tax against McCoy for 1998 or 1999. On September 11, 2002, McCoy filed her 1998 and 1999 Mississippi income tax returns. MSTC immediately assessed the tax shown due on McCoy's 1998 and 1999 returns.

McCoy filed bankruptcy in Mississippi on September 25, 2007. She listed all of the tax debts owed to MSTC on her bankruptcy schedules and received her discharge in January 2008. A few months after January 2008, MSTC attempted to collect tax from McCoy, including the tax she owed for 1998 and 1999. In December 2008, McCoy reopened her bankruptcy case and filed an adversary proceeding against MSTC asking the bankruptcy court to determine that the 1998 and 1999 tax debts were discharged in her bankruptcy and could no longer be collected by MSTC.

MSTC filed a motion to dismiss McCoy's adversary complaint claiming that under Bankruptcy Code §523(*) (an unnumbered "hanging" paragraph), a late-filed return is not a return for bankruptcy purposes. The Mississippi bankruptcy court sustained MSTC's motion and dismissed McCoy's discharge action (strike one). McCoy appealed to the United States District Court. The District Court affirmed the bankruptcy court (strike two). McCoy then appealed to the Fifth Circuit Court of Appeals. In a stunning decision published on January 4, 2012, the Court of Appeals affirmed the Bankruptcy Court and the District Court (strike three).

The Court of Appeals' decision is stunning because it completely ignores and, in effect, repeals Bankruptcy Code §523(a)(1)(B)(ii), usually referred to as the "two-year rule". The two-year rule allows discharge of taxes on late filed returns as long as the return has been on file for at least two years when the bankruptcy case is filed and all of the other bankruptcy discharge rules are met (ie. 3-year rule, 240-day rule, no fraud, no evasion, etc). Bankruptcy Code §523(a)(1)(B)(ii) states that taxes will not be discharged if the tax return:

> 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***.

The two-year rule is somewhat confusing because it is stated in the negative. Stated in the positive, the two-year rule simply means that the tax won't be discharged unless the return has been on file for at least two years when the bankruptcy petition is filed. McCoy clearly met the two-year rule. No question about it.

The two-year rule has been law for nearly fifty years and even has the blessing of the IRS, but the Fifth Circuit Court of Appeals has just repealed it. The repeal was accomplished by construing the definition of "return" passed in the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"). BAPCPA defines a "return" for purposes of bankruptcy discharge in §523(*) as follows:

> For purposes of [§523(a)], 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.

Most bankruptcy practitioners and even IRS's Chief Counsel believed that §523(*) meant that only SFR assessments made under IRC §6020(b) were no longer dischargeable after BAPCPA. No one (except maybe MSTC) contemplated that §523(*) was meant to ban discharge on all late-filed returns. In Chief Counsel Notice CC-2010-016, IRS summarized its position on this issue by stating:

> Section 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, the return was due, and after two years before the date of the filing of the petition in bankruptcy. The *Creekmore* (a 2008 Mississippi bankruptcy court decision) reading would limit the application of section 523(a)(1)(B)(ii) to cases in which the Service prepares a return for the taxpayer's signature under section 6020(a) of the Internal Revenue Code. By presuming that Congress intended to limit section 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 Service prepares a return for the taxpayer's signature under section 6020(a), the *Creekmore* reading also contradicts a special rule for interpreting the Bankruptcy Code. As the Supreme Court stated in *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992), "This 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 section 6020(a) is illusory. Taxpayers have no right to demand that the Service prepare a return for them under that provision. We, therefore, conclude that section 523(a) in its totality does not create the rule that every late-filed return is not a return for dischargeability purposes.

In a recent email (King's TaxGram), bankruptcy discharge expert and author Morgan King stated the Congressional intent issue a lot more succinctly than IRS Counsel:

> Had Congress, in enacting BAPCPA, intended that a late-filed tax return always resulted in non-dischargeability of the liability, it could have made it perfectly clear by deleting subsections (i) and (ii) of §523(a)(1)(B), and inserting simply:
>
> WAS FILED LATE.

The Chief Counsel Notice was part of the record in *McCoy*. The Fifth Circuit Court of Appeals even referred to the Notice in the *McCoy* opinion. Nonetheless, the Court completely ignored the two-year rule and held in *McCoy* that a late-filed return (whether one day late or ten years late) cannot constitute a return for bankruptcy discharge unless the return is a 6020(a) return. I have been a tax attorney for 35 years, and I have ***never*** seen a 6020(a) return.

The effect of this ruling on bankruptcy/tax practice is staggering. By misapplying a parenthetical phrase of four words, the Fifth Circuit Court, which has jurisdiction over Louisiana, Mississippi and Texas, has effectively ended bankruptcy discharge as we have known it for nearly 50 years. If this ruling spreads to other Circuits—and I predict that IRS will do an about face in its bankruptcy litigation position and start pushing this ruling—the bankruptcy discharge business will be severely curtailed and only available for a select few.[1]

When I first read *Hindenlang*, I thought there couldn't be a worse blow to my business. I was wrong. *McCoy* is worse.

[1] I misjudged the IRS when I wrote this. IRS is not following the *McCoy* decision, nor is it following the two later Circuit Court decisions, *Mallo* and *Fahey* (see my third article in this series), which agreed with the *McCoy* decision. The IRS position is undoubtedly correct, because I'm certain that IRS personnel drafted §523(*).