THE BANKRUPTCY DISCHARGE WAR, PART I:
DISCHARGING SFR ASSESSMENTS IN BANKRUPTCY AFTER BAPCPA

Back in the 90s, it was pretty easy to deal with tax liabilities in bankruptcy. Dan Pilla, Mac MacPherson, Morgan King and other notable practitioners carefully read the Bankruptcy Code and gave us a road map to guide us through income tax discharge.

- Original due date of the return plus extensions is more than three years ago;
- The tax has been assessed for more than 240 days; and
- A late-filed tax return has to be on file for at least 2 years.

Substitute for Return ("SFR") assessments[1] have never been dischargeable in bankruptcy. So how did we get SFR assessments discharged? Simple. The taxpayer files an actual signed return for the SFR years–taxpayer could even use the same numbers IRS used on the SFR—wait two years, file a chapter 7 bankruptcy and discharge the liability.

Beginning in the late 90s, IRS became concerned about the ease with which skilled bankruptcy lawyers were discharging millions of dollars in SFR assessments. IRS seemed powerless to stop it. However, when faced with this kind of situation IRS never remains idle for long. They seek relief through the courts or through legislation or both. To combat the SFR discharge issue, IRS did both.

The Litigation Solution

The first battleground in IRS's war against SFR discharge was in the federal courts. IRS's weapon was a novel theory claiming that SFR replacement returns signed under penalty of perjury and filed by the taxpayer at least two years before the bankruptcy, couldn't be discharged because they weren't valid returns. In support of its theory, IRS used the definition of a return developed by the United States Tax Court in *Beard v. Commissioner*, 82 T.C. 766 (1984); *aff'd*, 793 F.2d 139 (6th Cir. 1986). The four-part "Beard Test", which has been accepted by nearly every federal court in the country, states that in order for a document to qualify as a return:

1. It must purport to be a return;
2. It must be signed under penalty of perjury;
3. It must contain sufficient information to allow the tax to be calculated; and
4. It must represent an honest and reasonable attempt to satisfy the requirements of the tax law.

One of the first cases to test this theory was *Hindenlang v. United States (In re Hindenlang)*, 205 B.R. 874 (Bkr. S.D. Ohio 1997); *aff'd*, *United States v. Hindenlang*, 214 B.R. 847 (S.D. Ohio

[1] A substitute for return (SFR) is a return that IRS prepares and files for the taxpayer. The SFR includes all of the taxpayer's income that was reported to IRS on W-2s, 1099s, K-1s, etc. The tax assessed on the SFR is usually much higher than the tax that would have been shown on the return the taxpayer failed to file, because the SFR does not allow deductions for dependents, mortgage interest, gambling losses, ordinary and necessary business expenses of a self-employed taxpayer, etc.

1997). As with many novel theories, the first test was a failure. The debtor won in the bankruptcy court and won in the District Court appeal. But, if at first you don't succeed . . .

Undaunted by failure in both the bankruptcy court and the district court, IRS appealed *Hindenlang* to the Sixth Circuit Court of Appeals. On appeal, the Sixth Circuit reversed both the bankruptcy court and the district court. The opinion was a stunning rebuke for bankruptcy practitioners:

> We hold as a matter of law that a Form 1040 is not a return if it no longer serves any tax purpose or has any effect under the Internal Revenue Code. A purported return filed too late to have any effect at all under the Internal Revenue Code cannot constitute "an honest and reasonable attempt to satisfy the requirements of the tax law." Once the government shows that a Form 1040 submitted after an assessment can serve no purpose under the tax law, the government has met its burden.

My bankruptcy colleagues and I tried to brush off the *Hindenlang* decision by calling it an aberration. It wasn't. The *Hindenlang* holding—SFR assessments can never be discharged in bankruptcy—became the rule in nearly every jurisdiction.

Buoyed by its victory in *Hindenlang*, IRS pushed the ruling at every opportunity. If IRS lost in the bankruptcy court, IRS appealed to district court. If it lost in district court, it appealed to the Circuit Court of Appeals. Never underestimate IRS. They are dogged, single-minded and they play to win–always.

After *Hindenlang*, IRS won on this issue in many bankruptcy courts (eg., *In re Ehrig*, 308 B.R. 542 (Bkr. N.D. OK 2004)) and in at least three other Circuit Courts of Appeals. See, *United States v. Hatton*, 220 F. 3d 1057 (9th Cir. 2000); *Moroney v. United States*, 352 F. 3d 902 (4th Cir. 2003); *United States v. Payne*, 431 F. 3d 1035 (7th Cir. 2005). There was also one notable loss for IRS among its string of victories. See, *Colsen v. United States*, 446 F. 3d 836 (8th Cir. 2008).

The Legislative Solution

As stated earlier, IRS is not content to just win in court. Courts can reverse themselves, and sometimes, as in *Colsen*, courts don't rule in favor of IRS's position. But IRS knows what every good lobbyist knows: The only way to assure victory in perpetuity is to change the rules with legislation. That's exactly what IRS has done. I contend that under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Congress has settled the argument whether SFR Assessments are dischargeable in bankruptcy. They're not.

In BAPCPA, the Bankruptcy Code was substantially amended. IRS advocated a change that put to rest any argument about discharging SFR assessments. The amendment is a dangling paragraph inserted after 11 U.S.C. §523(a)(19) (usually labeled "523(*)"), and it provides:

> For purposes of this subsection, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law (***including applicable filing requirements***). Emphasis added.

Clearly this amendment to the Bankruptcy Code is meant to prevent discharge of SFR assessments by filing an actual return, waiting two years and filing bankruptcy. But new Bankruptcy Code §523(*) applies only to returns filed after an SFR assessment. It cannot apply to all late-filed returns as one court has held (See, *In re Creekmore*, 401 B.R. 748 (Bkr. N.D. MS 2008)), because the long-standing provision allowing discharge of taxes on late-filed returns filed more than two years before bankruptcy still exists. See, 11 U.S.C. §523(a)(1)(B)(ii).[2] In his dissent in *United States v. Payne*, 431 F. 3d 1035, 1060 (7th Cir. 2005) Judge Easterbrook made the following comment:

> After [BAPCPA], an untimely return cannot lead to a discharge–recall the new language refers to applicable non-bankruptcy law (including applicable filing requirements).

The issue in *Payne* was whether the SFR assessment could be discharged by filing an actual signed return more than two years before bankruptcy. Even though his statement, taken out of context, is far too broad, Judge Easterbrook was obviously saying that after BAPCPA, the question whether SFR assessments are dischargeable is dead. Reluctantly, I agree with Judge Easterbrook.

IRS Chief Counsel Memo

To solidify its victory in the bankruptcy discharge war, IRS published a Chief Counsel Memo (CCM-2010-016) stating its post-BAPCPA bankruptcy litigation position. I have read and reread this CCM. At first I thought "this can't be right." That was wishful thinking. The CCM is a well-reasoned statement of the issue, and its conclusion—SFR assessments are no longer dischargeable in bankruptcy–is correct.

Conclusion

Despite the best efforts of all who fought the bankruptcy discharge war, our side has lost an important issue. After BAPCPA, SFR assessments are no longer dischargeable in bankruptcy. It is still advisable to file actual returns after the SFRs are assessed because the taxpayers signed return will usually reduce the tax liability substantially. But the question whether the SFRs can later be discharged is decided. They cannot.

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[2] When I wrote this article in 2011, it was my firmly held opinion that as long as the taxpayer filed his/her own return **BEFORE** IRS assessed tax on the SFR, **AND** the taxpayer's return was filed more than 2 years before the taxpayer filed bankruptcy, the tax would be dischargeable. IRS expressed the same opinion in CCM-2010-16, see above text. Unfortunately, 3 Federal Circuit Courts disagreed with this opinion. These three courts have held that under 523(*) the tax assessment on a late filed return—whether it's a day late or 10 years late—cannot be discharged in bankruptcy, EVER!