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BY DAVID M. REEDER

Hung up on Unpaid Taxes

Under the Bankruptcy Code's notorious "Hanging Paragraph" most courts have held that taxes for years in which returns were filed late can never be discharged

DURING THE COVID PANDEMIC, various moratoria and the on-again, off-again status of the courts have eased the traditional pressures on cash-strapped individuals and businesses. The one set of actors who are not subject to any moratoria, however, are the federal and state taxing agencies. Their broad-based collection activities continue unabated regardless of COVID.

Unfortunately, and unwisely, many taxpayers believe they are entitled to a breather from tax enforcement, even from the Internal Revenue Service or the Franchise Tax Board. For example, owners of small businesses in financial distress may be tempted to use "IRS financing" by simply not withholding

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from the amounts that the business pays to the owners or making the necessary estimated quarterly tax payments (depending on which is applicable). Instead, the owners may believe that the business will later generate enough funds for the owners to pay their income tax obligation in a lump sum when they file their tax returns.

In doing so, such business owners fool themselves into believing that such IRS financing is a freely available source of cash flow. This may be partly due to the fact that the IRS, unlike suppliers and other trade creditors, might not take immediate action when the business fails to pay its obligations, lulling the business owner into a false sense of security. This is especially the case with sole proprietors and the owners of closely held corporations or limited liability companies that simply withdraw funds from the business and conveniently ignore the pesky tax obligations. Too often, however, the hoped-for growth in business or recovery never materializes and before the business owner knows it, a few months or even years have gone by with the unpaid tax liability being well into the six figures.

Another class of taxpayers that often find themselves in this situation are self-employed individuals, including sole proprietors, and the owners of closely held corporations and limited liability companies (LLCs) and others who are paid Form 1099 income without withholdings. There is a substantial population of these taxpayers.

In contrast, it stands to reason that if the taxpayer's compensation is salary subject to withholdings, then, absent significant errors in withholding amounts, there is little risk that such taxpayers will have substantial unpaid income taxes based on employment/business income. Such taxpayers may nevertheless still have unpaid income taxes from many sources other than employment and/or the operation of a business, including long-term and short-term capital gains, royalties, license fees, and a myriad of other sources.

Some taxpayers may have unpaid income taxes "thrust upon them" through assessments, often following audits. Some may have relied on others, such as business managers, to properly provide for the payment of taxes, only to find out that the manager "managed" their way through the funds without providing for the income tax liabilities. Professional athletes and entertainers are sometimes on the receiving end of such treatment, with disastrous results.

Whether relying on IRS financing or having unpaid income taxes thrust upon them, at some point taxpayers will start receiving IRS notices demanding payment and perhaps even threatening action against the taxpayer. If fortunate, the taxpayer may be able to negotiate an installment agreement with the IRS.

Often this spiral of tax debt increases steadily over time with more failures to make required tax payments, more IRS notices and letters, and more installment agreements until the taxpayer realizes that the payments are increasing faster than the taxpayer's income and the principal balance of the taxes is not going down appreciably while penalties and interest continue to accrue.

At some point the issue becomes what to do with unpaid taxes, penalties, and interest once it is clear the tax debt cannot be serviced. Often this point comes in the face of an IRS bank account levy, which is not limited as to amount or frequency. At that point, harried taxpayers often turn to the bankruptcy system.[1]

Bankruptcy Discharge Test

Is bankruptcy an answer for the crushing burden of unpaid income taxes? The answers are yes, no, and maybe. The good news is that the bankruptcy system does provide for the discharge of some income taxes. These are for the most part unpaid taxes that could be described as "old."

In general, to determine whether unpaid income taxes are dischargeable in bankruptcy, each tax year must be analyzed using three separate tests. The taxes for each tax year must meet all three tests to be discharged in a bankruptcy case.[2] The three tests are:

1) The 3-year test. The deadline for filing the tax return for the year in question, including extensions, must have been more than three years before the filing of the petition initiating the bankruptcy case (the Petition Date).[3]

2) The 2-year test. For the underlying taxes to be dischargeable, the returns for the tax years in question must have been filed more than two years before the Petition Date.[4]

3) The 240-day test. In order for taxes assessed after the filing of the original return to be dischargeable, the subsequent assessments, often arising after an audit or examination of the return(s), or after the filing of amended returns, must have been assessed more than 240 days plus 30 days before the Petition Date.[5]

There are certain events that toll the running of the 240-day test. These events include: 1) time during which an offer-in-compromise was pending, plus 30 days,[6] and 2) the existence of a stay of proceedings against collections, including a bankruptcy case, plus 90 days.[7]

This battleground of "dischargeability" of unpaid taxes centers around the 2-year test, specifically when was the return filed, if at all? If a late-filed return is deemed not to be a return, then the period for the 2-year test never begins to run.

The applicable provision of the Bankruptcy Code reads as follows:

> (a) [A] discharge…does not discharge an individual debtor from any debt –
>
> (1) for a tax –….
>
> (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.[8]

One takeaway is that a late-filed return is viewed by most courts as having never been filed, thus, the two-year rule can never be met.

The mechanics of the two-year rule are worth noting. The Ninth Circuit has used the following four-part test to determine whether a "return" was filed: "[I]n order for a document to qualify as a [tax] 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 allow calculation of tax; and (4) it must represent an "honest and reasonable attempt to satisfy the requirements of the tax law."[9]

The first three elements are typically not difficult to establish. The fourth element (whether the purported return was an "honest and reasonable attempt to satisfy the requirements of the tax law") is usually the focus of the court's analysis.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) added to Bankruptcy Code Section 523 the notorious, unnumbered (and uncitable) "Hanging Paragraph," which defines "return" as follows:

> For purposes of this subsection, the term "return" means

a return that satisfies the requirements of applicable non-bankruptcy 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 non-bankruptcy 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.[10]

Thus, under the definition of "return" in the Hanging Paragraph, a tax return that is not timely filed according to applicable law is not a return, cannot be subject to the two-year test, and the resulting taxes cannot be discharged in bankruptcy.

The Ninth Circuit's last pronouncement on the subject was in *In re Smith*.[11] In *Smith*, the court applied its earlier reasoning followed in *In re Hatton*[12] and determined that the debtor's tax return, which was filed 7 years late, was not an honest and reasonable attempt to satisfy the requirements of the tax law. The Ninth Circuit ignored the Hanging Paragraph. One California bankruptcy court, after analysis, found that a late-filed return did not constitute a return, and was thus non-dischargeable, despite the passage of all three of the applicable periods.[13]

The majority of courts that weighed in on the issue have held that late-filed returns do not constitute "returns" for the purpose of the 2-year rule, and thus the 2-year rule can never be met.[14] This has very serious consequences. In essence, taxes for years in which the return was filed late can never be discharged. As a result, there are significant efforts being made to convince those courts which hold to the "late-filed return is not a return" rule to reverse field, or to have the matter resolved by the U.S. Supreme Court.[15]

The Ninth Circuit Court of Appeals, whose decisions are binding on bankruptcy courts in California, is one of the majority of circuit courts holding that a late-filed return is not a return.[16] Nearly all federal courts of appeal that have visited the issue of whether a late-filed return constitutes a return, and is thus eligible for discharge, have held in the negative.[17] The lone court of appeal that has gone the other way is the Eighth Circuit,[18] which is slight comfort to California taxpayers.

Another permutation of the 2-year test that can blindside unsuspecting taxpayers is California Revenue and Taxation Code Section18622(a) which requires taxpayers who are assessed with additional taxes by the IRS to file a report with the California Franchise Tax Board reporting the assessment. The failure to file the report has been determined to trigger the "return never filed" prong of Bankruptcy Code Section 523(a)(1)(B)(i), leading to the non-dischargeability of the additional state income taxes assessed based on the IRS assessment.[19]

The IRS may also file a return filed on the taxpayer's behalf known as a substitute for return (SFR). The courts have used the fact that the IRS had to go the trouble of estimating the taxpayer's tax liability in lieu of a filed return as probative of whether a return filed by the debtor after the filing of the SFR was an "honest and reasonable attempt to satisfy the requirements of the tax law" and thus constitutes a return. The answer is nearly always in the negative.[20]

The three-part test set out above is used to determine the dischargeability of those taxes that can be subject to discharge. Some taxes, however, cannot be discharged under any circumstances. Taxes arising from a fraudulent return, or the debtor's willful evasion of taxes, are not dischargeable.[21] That means the taxpayer will never obtain relief from such tax liability without an agreement with the taxing authority. The bankruptcy court does not have the authority to reduce or eliminate such taxes.

For taxes to be from a fraudulent return, or from a willful evasion of taxes, the taxing authority must show that the debtor acted with the specific intent of permanently evading taxes.[22] The courts have limited non-dischargeabilty of taxes based on a fraudulent return or willful evasion to cases in which the conduct amounting to attempted tax evasion is accompanied by an evasive motivation.[23]

It cannot be overemphasized that the discharge of unpaid income taxes, penalties, and interest in bankruptcy is a complex topic and should only be undertaken by an attorney with experience in such cases.

In addition, those responsible for withholding and remitting to the IRS certain payroll taxes called "trust fund taxes" but who fail to do so are personally liable for such trust fund taxes.[24] Assessments of trust fund taxes against an individual are non-dischargeable.[25]

Notably, such responsible persons include anyone who was responsible for withholding and remitting the trust fund taxes, not just the owner of the business. Therefore, the business owner who decides only to pay the employees their net payroll without remitting the trust fund taxes to the IRS is personally liable for such taxes.

The Dischargeability Analysis

For taxes that may be dischargeable, a determination of whether such taxes are dischargeable in bankruptcy starts with an analysis of the individual's account transcripts for each tax year in question that are obtained from the IRS.

Counsel should never rely on representations of the taxpayer/debtor or any third party, including the debtor's tax accountant, regarding the dates of the filing of returns, whether extensions were filed, when taxes were assessed, and the periods when offers-in-compromise, or other tolling events, were in effect. The only reliable sources of information are the IRS account transcripts.

A calculation for each of the three tests must be performed for each tax year in question. It is also good practice to request account transcripts for several years before, and several years after, the years that the debtor believes are unpaid. Recollection of the years for which taxes are due tend to blur in the minds of harried taxpayers who are faced with collection activity by the taxing authorities.

Often, a careful calculation regarding income tax dischargeability will show that the debtor needs to wait for the periods in one or more of the three tests to pass prior to filing a case. This may be measured in months, or even in years. Filing a bankruptcy case prior to the running of all three tests for all tax periods results in the taxes for which any of the periods have not run being non-dischargeable in the case that was prematurely filed.

With respect to taxes secured by a recorded tax lien, even if the underlying taxes are discharged, the lien remains.[26] The issue often arises post-bankruptcy when the taxpayer/debtor wants to sell a residence that was claimed exempt in bankruptcy. The tax lien remains as an encumbrance on the property, and the taxes must be paid at closing. The discharge of the underlying taxes prohibits the IRS and California Franchise Tax Board (FTB) from enforcing their lien against personal property (levies, garnishments, etc.), but the recorded lien against real property survives bankruptcy. The renewal of a lien by the IRS or FTB, which only has in rem rights against pre-bankruptcy property, does not violate the discharge injunction provided for at 11 USC Section 524.[27]

The determination of whether unpaid income taxes are dischargeable in bankruptcy is mainly a time-based analysis, so long as the taxes are not part of the never-dischargeable classification mentioned above. Thus, if unpaid income taxes meet all three tests for all years in question, then a bankruptcy case can probably be filed. If sufficient time has not passed, a calculation of the earliest date in which sufficient time will have run so that all three tests are met is made, and the taxpayer waits. Filing before the time regarding all three tests has run results in the tax claims being unaffected by the bankruptcy, which is not the intended result.

If the taxing authority is being particularly assertive and the taxes that do not yet qualify for a discharge are of a relatively small amount, and the larger amounts for previous years are dischargeable, a decision may be made to file the bankruptcy case sooner rather than waiting for the time to pass regarding all three tests for the smaller balance tax years. This has the effect of staying any further enforcement by the taxing agencies for any year. Although some of the years will not be discharged, and will remain payable after the conclusion of the bankruptcy case, the taxpayer is spared the pain of further enforcement by the taxing agency.

It cannot be overemphasized that the discharge of unpaid income taxes, penalties, and interest in bankruptcy is a complex topic and should only be undertaken by an attorney with experience in such cases. How specific taxes are treated in bankruptcy requires an analysis by a qualified attorney with experience in the area. If handled properly, the bankruptcy process can free the taxpayer of unserviceable tax debt, which, in some cases, can be well into the hundreds of thousands, if not millions, of dollars. ■

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1 Since the principal amount of taxes, as well as applicable penalties and interest, are treated the same in nearly all instances in the bankruptcy process, all references to "unpaid income taxes" will include taxes, penalties, and interest. *See* In re Bossert, 201 B.R. 553, 559 (Bankr. E.D. Wash. 1996).

2 The provisions of the United States Bankruptcy Code, 11 U.S.C. §101 *et. seq.* (hereinafter the "Bankruptcy Code") regarding dischargeability of taxes pertain only to individuals. 11 U.S.C. §523(a)(1).

3 11 U.S.C. §523(a)(1)(A); 11 U.S.C. §507(a)(8)(i).

4 11 U.S.C. §523(a)(1)(B).

5 11 U.S.C. §523(a)(1)(A); 11 U.S.C. §507(a)(8)(A)(ii).

6 11 U.S.C. §507(a)(8)(ii)(I).

7 11 U.S.C. §507(a)(8)(ii)(II).

8 11 U.S.C. §101 *et. seq.*

9 In re Hatton, 220 F. 3d 1057, 1059, 1060-61 (9th Cir. 2000).

10 The "Hanging Paragraph," commonly cited as 11 U.S.C. §523(*).

11 In re Smith, 828 F. 3d 1094 (9th Cir 2016).

12 Hatton, 220 F. 3d at1059, 1060-61.

13 In re Van Arsdale, No. 13-40873 CN, Adversary No. 14-4035 CN (Bankr. N.D. Cal 2017). *But see* Golden v. United States, No. 14-24616-E-13, Adversary No. 21-2012 (Bankr. E. D. Cal. Apr. 22, 2022) (Bankruptcy court accepted debtors' explanations for failing to timely file tax returns and ruled that the returns, filed after the Internal Revenue Service had initiated the "substitute for return" assessment process, constituted "an honest and reasonable attempt to satisfy the requirements of the tax law", and thus were "returns" for the purposes of the 2-year rule, resulting in the discharge of the taxes). As a decision of a bankruptcy court, *Golden* is not binding on any court. It does, however, create a ray of hope for taxpayers attempting to discharge late-filed taxes in bankruptcy.

14 *See infra* notes 18-19.

15 *See* Boudreau v. R.I. Div. of Taxation, 562 B.R. 853, 858 n.7 (Bankr. D.R.I. 2017) (rejecting the argument that to hold late-filed taxes non-dischargeable was draconian, led to an absurd result, and was inconsistent with the purposes of bankruptcy relief).

16 *See* In re Smith, 828 F. 3d at 1096-97. In *Smith,* the Ninth Circuit applied *Hatton* and determined the debtor's tax return that was filed 7 years late was not an "honest and reasonable attempt to satisfy the requirements of the tax law" and that the taxes were not dischargeable due to failure to satisfy the two-year rule. In *Hatton*, the Ninth Circuit adopted the oft-cited four-part test first announced in *Beard v. Comm'r* (82 T.C. 766 (1984), *aff'd*, 793 F. 2d 139 (6th Cir. 1986) (*per curiam*)). The "Beard Test" guided most courts in determining whether a late-filed tax return met the definition of a return. Subsequent to passage of the Bankruptcy Abuse and Consumer Protection Act in 2005, which included the Hanging Paragraph, the trend has been toward less reliance on the *Beard* test, which gave courts some discretion as to what constituted a return, and toward more reliance on the Hanging Paragraph. This strict application of the Hanging Paragraph has resulted in what has come to be known as the "one-day rule," which provides that if the return is filed one day late, then under 11 USC Section 523(*) the two-year rule is never met and the taxes in question are not dischargeable. *See* Casano v. Internal Revenue Serv., 473 B.R. 504, 506 (Bankr. E.D. N.Y. 2012) (counting cases); Internal Revenue Serv. v. Starling, No. 20-CV-7478 (CS), at *6 (S.D. N.Y. Sept. 16, 2021) (reversing the Bankruptcy Court's ruling that a late-filed return was a return).

17 Mallo v. Internal Revenue Serv., 774 F. 3d 1313, 1325 (10th Cir. 2014) (late filed return was not a return, based on plain meaning of 11 U.S.C. §523(*); In re Fahey, 779 F. 3d 1, 9-10 (1st Cir. 2015); McCoy v. Mississippi State Tax Comm'n, 666 F. 3d 924, 931-32 (5th Cir. 2012); Kline v. Internal Revenue Serv., 581 B.R. 597, 603-04 (Bankr. W.D. Ark. 2018).

18 Colsen vs. United States, 446 F. 3d 836, 840 (8th Cir. 2006) (a post-assessment return can qualify as a return per 11 USC Section 532(a)). In *Colsen*, the 8th Circuit focused on the face of the form the debtor filed, and not the debtor's intent or attendant facts: "We therefore hold that the honesty and genuineness of the filer's attempt to satisfy the tax laws should be determined from the face of the form itself, not from the filer's delinquency or the reasons for it. The filer's subjective intent is irrelevant." Colsen, 446 F. 3d at 840.

19 In re Berkovich, 619 B.R. 397 (B.A.P. 9th Cir. 2020); *aff'd* Berkovich v. California Franchise Tax Bd. (In re Berkovich), No. 20-60046, slip op, at 3 (9th Cir. Oct. 14, 2021) (adopting the published decision of the Bankruptcy Appellate Panel as the decision of the 9th Circuit with the exception of a single footnote, which did not affect the outcome of the case).

20 Izzo v. United States, 340 B.R. 586, 587 (E.D. Mich. 2006); In re Hindenlang, 164 F. 3d 1029, 1035-35 (6th Cir. 1999). *But see* n.13 *supra*.

21 11 U.S.C. §523(a)(1)(C).

22 Hawkins v. Franchise Tax Bd., 769 F. 3d 662, 669 (9th Cir. 2014) (evidence of spending well in excess of income, or spending on a lavish lifestyle, insufficient to show the required intent to evade tax).

23 *Id.* at 668. *See also* Vaughn v. Comm'r, 765 F. 3d 1174, 1180, (10th Cir. 2014) (purchase and transfer of a house to girlfriend; establishment and transfer of funds to a trust for a stepdaughter); United States v. Coney, 689 F. 3d 365, 377 (5th Cir. 2012) (concealment of currency transactions); In re Gardner, 360 F. 3d 551, 558 (6th Cir. 2004) (concealment of assets through special bank accounts); United States v. Fretz, 244 F. 3d 1323, 1329 (11th Cir. 2001) (failure to file tax returns); Tudisco v. United States, 183 F. 3d 133, 137 (2d Cir. 1999) (failure to file returns); United States v. Fegeley, 118 F. 3d 979, 984 (3d Cir. 1997) (failure to file returns); In re Birkenstock, 87 F. 3d 947, 951–52 (7th Cir. 1996) (failure to file returns and attempt to conceal income); Dalton v. IRS, 77 F. 3d 1297, 1302 (10th Cir. 1996) (concealment of asset ownership).

24 26 U.S.C. §6672 (assessment of responsible person liability for failure to withhold payroll taxes); REV. TAX CODE §6829(a) (same); In re George, 95 B.R. 718, 720 (B.A.P. 9th Cir. 1989).

25 11 U.S.C. §523(a)(1); 11 U.S.C. §507(a)(8)(C); In re Gust, 197 F. 3d 1112 (11th Cir. 1999).

26 Isom v. Internal Revenue Serv., 901 F. 2d 744, 745 (9th Cir. 1990).

27 Morton v. National Bank of New York City, 866 F. 2d 561 (2nd Cir. 1989) (extension of a valid lien is not in conflict with the Bankruptcy Code); Larson v. Norwest Bank of Fargo, N.A., 979 F. 2d 625, 627 (8th Cir. 1992) (filing of addendum to preserve a lien is in harmony with Bankruptcy Code); In re Jarrett, 293 B.R. 127, 132 (Bankr. N.D. Ohio 2002) ("In the case of prepetition property—i.e., property which the creditor obtained a lien on prior to the time the debtor filed for bankruptcy—it is well established that the act of renewing a lien does not conflict with the discharge injunction of 11 U.S.C. § 524").