DISCHARGEABILITY OF TAXES AND STUDENT LOANS IN BANKRUPTCY AND THE AUTOMATIC STAY

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SERVICE ON THE UNITED STATES

In actions wherein a governmental agency is named as a party, Bankruptcy Rule 7004(b) (4) and (5) sets forth the service requirements for service upon the United States, its Officers and Agencies:

> (4) Upon the United States, by mailing a copy of the summons and complaint addressed to the civil process clerk at the office of the United States attorney for the district in which the action is brought and by mailing a copy of the summons and complaint to the Attorney General of the United States at Washington, District of Columbia, and in any action attacking the validity of an order of an officer or an agency of the United States not made a party, by also mailing a copy of the summons and complaint to that officer or agency. The court shall allow a reasonable time for service pursuant to this subdivision for the purpose of curing the failure to mail a copy of the summons and complaint to multiple officers, agencies, or corporations of the United States if the plaintiff has mailed a copy of the summons and complaint either to the civil process clerk at the office of the United States attorney or to the Attorney General of the United States.
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> (5) Upon any officer or agency of the United States, by mailing a copy of the summons and complaint to the United States as prescribed in paragraph (4) of this subdivision and also to the officer or agency. If the agency is a corporation, the mailing shall be as prescribed in paragraph (3) of this subdivision of this rule. The court shall allow a reasonable time for service pursuant to this subdivision for the purpose of curing the failure to mail a copy of the summons and complaint to multiple officers, agencies, or corporations of the United States if the plaintiff has mailed a copy of the summons and complaint either to the civil process clerk at the office of the United States attorney or to the Attorney General of the United States. If the United States trustee is the trustee in the case and service is made upon the United States trustee solely as trustee, service may be made as prescribed in paragraph (10) of this subdivision of this rule.

Addresses for a few of the most commonly named federal agencies can be found at: http://www.alsb.uscourts.gov/register-federal-and-state-goverment-units. To summarize, you will need to serve the United States Attorney in the district where the case is pending, the Attorney General of the United States, and the governmental agency in order to perfect service.

NON-DISCHARGEABLE TAXES

A tax claim is dischargeable only if the tax return was due more than three years, was filed more than two years before the filing of the bankruptcy petition and the tax was assessed at least 240 days before the filing. If a tax debt is discharged, so is the interest. If you file a bankruptcy petition too soon, neither the taxes nor the interest will be discharged.

11 U.S.C. § 523(a)(1)(A)-(C) sets forth the exceptions to discharge as follows:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt
>
> (1) for a tax or a customs duty-
>
> (A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed.
>
> (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 . . . .
>
> (B) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

In plain language, the tax is not priority and dischargeable if ALL the following conditions exist:

1. The Three-Year Rule. For the tax years in question, the most recent due date for filing the return is more than three years old. The three-year period is computed from the most recent date the tax return is due for the tax year. The Internal Revenue Code states that "returns made on the basis of the calendar year shall be filed on or before the 15th day of April following

the close of the calendar year . . . ." 26 U.S.C. § 6072(a). An extension to file the return delays the start time. 11 U.S.C. § 507(a)(8)(A)(i).[1]

2. The Two-Year Rule. A tax return or equivalent report or notice, if required, has been filed or given by the taxpayer for the tax year(s) in question at least more than two years preceding the filing of the date of the bankruptcy.[2] 11 U.S.C. § 523(a)(1)(B).

3. The 240-Day Rule. The tax claim was assessed at least more than 240 days preceding the filing date of the bankruptcy. 11 U.S.C. § 507(a)(8)(A)(ii).

4. The tax return in question was not fraudulent. 11 U.S.C. § 523(a)(1)(C).

5. The taxpayer has not engaged in activity deemed a willful attempt to defeat or evade the tax. 11 U.S.C. § 523 (a)(1)(C).

The first requirement is a straightforward calculation based on when the applicable return was due. If a return has been filed, the second requirement is also a straightforward calculation. The best way to verify if/when a return has been filed and a tax assessed is to obtain a tax transcript.[3] So, what about the debtor who did not file a "traditional return" or filed a return after

[1] 11 U.S.C. § 507(a)(8) hanging paragraph after (G) sets forth an otherwise applicable time period specified in this paragraph shall be suspended for any period during which the governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of one or more confirmed plans under this title, plus 90 days.

[2] Also note that an IRS statement that return has not been filed prevails unless debtor has a certified or registered mail receipt. 26 U.S.C. § 7502(b). S*ee also Pugsley v. Comm'r*, 749 F.2d 691 (11th Cir. 1985).

[3] *See* https://www.irs.gov/uac/newsroom/how-to-get-a-transcript-or-copy-of-a-prior-year-tax-return for instructions on how to obtain a tax transcript or a copy of a tax return.

the IRS has already assessed the tax? What constitutes a "return" for discharge purposes has generated a split among the Circuits. So, WHAT IS A "RETURN?"

"Return" was not previously defined in the Bankruptcy Code. Prior to the Bankruptcy Abuse and Prevention and Consumer Protection Act ("BAPCPA"), the Bankruptcy Code relied on the test articulated in *Beard v. Comm'r*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986).[4] In *Beard*, the Court held that to be a "return" a document must:

- Purport to be a return;
- Be executed under penalty of perjury;
- Contain sufficient data to allow tax to be determined; and
- Represent an honest and reasonable attempt to satisfy requirements of the tax law.

Beard's last prong requires a subjective examination of the debtor's intent to comply with the tax laws. Under *Beard*, a debtor who cannot articulate a sufficiently acceptable reason for his/her late filed return(s) has not made a subjectively "honest and reasonable" attempt at compliance with the tax laws.

In an effort to clarify what constitutes a return for dischargeability purposes, BAPCPA added the following language:

> 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)[5] of the Internal Revenue Code of 1986, or similar State or local law, or a written

[4] The *Beard* test was derived from the Supreme Court opinions in *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 180, 55 S. Ct. 127, 79 L. Ed. 264 (1934), and *Germantown Trust Co. v. Comm'r of Internal Revenue*, 309 U.S. 304, 306-09, 60 S. Ct. 566, 567-69, 84 L. Ed. 770 (1940).

[5] 26 U.S.C § 6020 of the Internal Revenue Code permits the IRS to file a substitute return for a taxpayer under certain circumstances. A return filed under 6020(a) is prepared with the taxpayer's cooperation and signed by the taxpayer. A return filed by the IRS under 6020(b) is prepared by the IRS with information gathered by the IRS and not signed by the taxpayer. In other words, a return prepared by the IRS (also known as a "Substitute for Return" or "SFR") under IRC 6020(b) is NEVER a return for dischargeability purposes.

> 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.

11 U.S.C. § 523(a)(19)(*). This paragraph is known as the "hanging paragraph."

The phrase "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" clearly evidences Congress's intent to exclude returns prepared by the IRS pursuant to 6020(b). The section does not clarify whether a return filed by the debtor after the 6020(b) assessment has been made qualifies as a "return" and while the statute says that a return must satisfy "applicable filing requirements," it does not directly address late filed returns. This ambiguity has led to the split among Circuits wherein the geographical location of the debtor may very well determine whether the tax debt is dischargeable. The three most prevalent approaches are discussed below.

FIRST APPROACH: THE ONE-DAY LATE RULE

The First, Fifth and Tenth Circuits hold that the definition of return in the hanging paragraph encompasses the IRS Code filing deadlines for submitted returns. So, even a one-day late return cannot qualify as a return for purposes of discharge unless the return was filed under a safe harbor provision of 6020(a). *See In re Fahley*, 779 F.3d 1 (1st Cir. 2015); *In re McCoy*, 666 F.3d 924 (5th Cir. 2012); *In re Mallo*, 774 F.3d 1313 (10th Cir. 2014).

SECOND APPROACH: BETTER LATE THAN NEVER RULE

The Eighth Circuit has held that an actual return is a return, regardless when filed, because *Beard's* honest and reasonableness prong speaks to the taxpayer's attempt to complete the documents as a tax return. *In re Colsen*, 446 F.3d 836, 840 (8th Cir. 2006). The Eighth Circuit allows bankrupt taxpayers who filed returns after the IRS assessment of tax liability to discharge their tax debts after the two-year waiting period. The Eighth Circuit elected to focus on the specific

language from *Beard* that it is the **not the taxpayer but the purported return** that must "evince an honest and genuine attempt to satisfy the laws." *Colsen*, 446 F.3d at 840 n.5 (emphasis added).

THIRD APPROACH: BACK TO *BEARD*

The United States Court of Appeals for the Eleventh Circuit declined to follow the One-Day-Late and the Eighth Circuit's Better-Late-Than-Never approaches in *Justice v. United States (In re Justice)*, 817 F.3d 738 (11th Cir. 2016). In *Justice*, the chapter 7 debtor sought a determination that Form 1040s he submitted many years after the deadline for filing tax returns, and after the Internal Revenue Service (IRS) had already issued notices of deficiency for the tax years in question, constituted "returns." Debtor sought to discharge the taxes owed for those tax years. 11 U.S.C. § 523(a) provides that an individual debtor is not discharged from a tax debt with respect to which a return was not filed. If the debtor's late Form 1040s qualify as returns, the exception to discharge in 11 U.S.C. § 523(a) for tax debts for which a required return "was not filed or given . . ." would not apply, and the tax debt could be dischargeable. Upholding the Bankruptcy Court's ruling, the Eleventh Circuit Court of Appeals held the tax forms debtor filed many years late, without any justification, and only after the IRS had issued notices of deficiency did not qualify as "returns" for dischargeability purposes and the debt was nondischargeable. The Court reasoned:

> Partly because the one-day-late rule limits the application of § 523(a)(1)(B)(ii) to the unusual situations in which the IRS prepares a return with the taxpayer's cooperation under § 6020(a), both Justice and the IRS argue that the rule is an incorrect interpretation of the statute. However, we hold that, even under Justice's preferred interpretation of § 523(*), his tax debts are non-dischargeable. We can assume *arguendo,* although we expressly do not decide, that the one-day-late rule is incorrect. We can do this because, even under this assumption, Justice's tax debts are nevertheless non-dischargeable for the following reasons.
>
> Thus, we assume *arguendo* that the applicable filing requirements Congress envisioned in the hanging paragraph do not include filing deadlines. Even if late-filed tax documents can sometimes qualify as returns, the BAPCPA definition also demands that a return satisfy "the requirements of applicable nonbankruptcy law."

> Both parties to this case, and all courts to consider the issue, agree that the term "applicable nonbankruptcy law" incorporates the *Beard* test.

Justice, 817 F.3d at 743.

With its decision in *Justice*, the Eleventh Circuit joined the majority of federal appeals courts (including the Fourth, Seventh and Ninth Circuits) in holding that the fourth *Beard* factor (an honest and reasonable effort to comply with the tax law) requires analysis of the entire time frame relevant to the taxpayer's action.

> Failure to file a timely return, at least without a legitimate excuse or explanation, evinces the lack of a reasonable effort to comply with the law. This interpretation comports with the common-sense meaning of "honest and reasonable." It is also consistent with the purpose of bankruptcy generally: to provide a "fresh start" to the "honest but unfortunate debtor." *In re Mitchell*, 633 F.3d 1319, 1326 (11th Cir. 2011). Indeed, we have observed that Congress's purpose in enacting the exceptions to discharge in § 523 was "[t]o ensure that only the honest but unfortunate debtors receive the benefit of discharge . . . ." *Id.* It would impede that goal to permit a taxpayer who has not made an honest and reasonable effort to comply with the tax laws to discharge his tax debts by limiting our analysis to the face of his tax documents.

Justice, 817 F.3d at 744.

The Court goes even further to set forth how policy considerations affected its decision:

> A significant factor in our decision to adopt the majority position espoused by the Fourth, Fifth, Seventh, and Ninth Circuits is the fact that our system of taxation relies on prompt and honest self-reporting by taxpayers. A taxpayer who does not file a timely return and who submits no information at all until contacted by the IRS frustrates the requirements and objectives of that system. Indeed, filing tax documents only after the IRS has gathered the relevant information and assessed a deficiency significantly undermines the self-assessment system. Delinquency in filing, therefore, is evidence that the taxpayer failed to make a reasonable effort to comply with the law.

Justice, 817 F.3d at 744.

The Eleventh Circuit ultimately concluded, based on the facts before it, that the outcome was the same whether the court relied on the *Beard* test or the bright-line test described in *McCoy v. Mississippi State Tax Comm'n (In re McCoy),* 666 F.3d 924 (5th Cir. 2012).[6]

WHERE DOES THAT LEAVE US?

Martin Smith v. United States Internal Revenue Service (*In re Smith*), 828 F.3d 1094 (9th Cir. July 13, 2016), *petition for cert. filed* (U.S. October 10, 2016) (No. 16-497) was submitted to the United States Supreme Court on October 10, 2016. In *Smith*, the United States Court of Appeals for the Ninth Circuit affirmed the district court's order reversing the bankruptcy court and entered summary judgment in favor of the IRS in a debtor's adversary proceeding seeking a determination that his federal income tax liabilities were dischargeable in bankruptcy. In *Smith*, the debtor did not file a 2001 tax form on time. Instead, he filed a Form 1040 seven years after it was due and three years after the IRS had filed a SFR and assessed a deficiency against him. Smith captioned his return "original return to replace SFR" and the IRS accepted it. Smith reported more income than the SFR and the IRS assessed an additional $60,000 of taxes, interest and penalties against him. The IRS contended the taxes that it assessed before Smith filed his belated 2010 were nondischargeable as taxes for which "no return" had been filed. The bankruptcy court permitted the discharge, but the district court reversed. The Ninth Circuit followed the 2000 decision in *In re Hatton*, 220 F.3d 1057 (9th Cir. 2000), in which the Circuit held that the Tax Court's definition of "return" applies to the Bankruptcy Code as amended in 2005, and that Smith's tax filing was not an honest and reasonable attempt to comply with the Tax Code. The Ninth Circuit focused on the fact that Smith failed to make a tax filing until seven years after his return was due and three

[6] In *McCoy*, the Court held that the hanging paragraph's purportedly plain text meant that all late returns could not be returns because they fail with applicable filing requirements, namely the requirement of timely return filing.

years after the IRS went to the trouble of calculating a deficiency and issuing an assessment. Under these circumstances, Smith's "belated acceptance of responsibility" was not a reasonable attempt to comply with the tax code. *Smith*, 828 F.3d at 1097.

To put the Circuit split in perspective, if Smith lived in the Eighth Circuit he could discharge the taxes; if he lived in the First, Fifth or Tenth Circuit, he would be forever barred even if his return was filed one day late. If Smith lived in the Fourth, Seventh, Ninth or Eleventh Circuit, *Beard* would apply and he would have to prove that he made an "honest and reasonable" attempt at compliance with the tax laws in order to discharge his taxes.

Update: On February 21, 2017, the United States Supreme Court denied *certiorari*, leaving the split among the Circuits unresolved. In May of this year, the Third Circuit also joined the Eleventh Circuit and adopted the *Beard* approach in *Giacchi v. U.S.* (*In re Giacchi*), 15-3761 (3d Cir. May 5, 2017) holding that the timing of the filing of a tax form is relevant in deciding on whether the late-filed return was an "honest and reasonable attempt to comply with tax law."

DISCHARGEABILITY OF STUDENT LOANS

An individual debtor may not discharge student loans through bankruptcy unless the debtor can show that repayment would cause "undue hardship." 11 U.S.C. § 523(a)(8). The term "undue hardship" is not defined in the Bankruptcy Code. The Eleventh Circuit has adopted the test set out in *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987) (the "*Brunner* test") to determine undue hardship for discharge of student loans. Under *Brunner*, the debtor is entitled to a discharge of student loans if the debtor proves payment of the loans would cause undue hardship to the debtor and debtor's dependents. The three prongs of the test, as stated by the 11th Circuit, are:

> (1) That the debtor cannot maintain, based on current income and living expenses, a "minimal" standard of living for herself and her dependents if forced to repay the loans;
> (2) That additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
> (3) That the debtor has made good faith efforts to repay the loans.
> *Brunner*, 831 F.2d at 396.

Recently, the Eleventh Circuit Court of Appeals issued its opinion in *ECMC v. Acosta-Conniff (In re Acosta-Conniff),* No. 16-12884, 2017, 2017 WL 1396164 (11th Cir. April 19, 2017).

In *In Re Acosta-Conniff*, the chapter 7 debtor received a discharge of debt, excluding $112,000 of student loan debt, and filed an adversary proceeding seeking a discharge of her student loan debt under 11 U.S.C. § 523(a)(8). The Bankruptcy Court found the debtor had met the burden of proof of demonstrating undue hardship under *Brunner*, and discharged her student loan debt in full. Creditor ECMC appealed. Upon appeal, the District Court concluded the debtor had failed to meet her burden under the second prong of the *Brunner* test and reversed the Bankruptcy Court. Debtor appealed the matter to the Eleventh Circuit Court of Appeals. The Eleventh Circuit explained that the three prongs of the *Brunner* test, each of which must be proven, look to three different time periods. The first prong focuses on the debtor's present ability to repay the student loan debt. The second prong looks to the future to determine the likelihood or unlikelihood that the debtor "could become able to repay" the debt. And, the third prong looks to past conduct to determine if the debtor's actions show a good faith effort to repay the student loan. Appellant debtor argued that the District Court applied the incorrect standard of review. The 11th Circuit explained that factual findings for each prong should be reviewed for clear error, but interpretation of any legal question concerning the factual findings, such as whether or not a debtor has met the

burden of proof sufficient to obtain a hardship discharge of student loan debt, is a legal conclusion subject to *de novo* review. The Eleventh Circuit stated that the District Court, which only reviewed the second prong of *Brunner* in this case, did not indicate whether it was applying clear error or *de novo* review, and could not "confidently conclude" that the lower court applied the clear-error standard. The case was remanded with instructions to apply a clear-error review of the Bankruptcy Court's findings for all three prongs of the *Brunner* test. The Circuit Court also made special mention of the District Court's observations that the debtor must "bear the consequences of her decision to obtain loans…" while assessing the second prong of the *Brunner* analysis. The Circuit stated:

> As noted, the second prong is a forward-looking test that focuses on whether a debtor has shown her inability to repay the loan during a significant portion of the repayment period. It does not look backward to assess blame for the student debtor's financial circumstances. Thus, even if the court concludes that a debtor has acted recklessly or foolishly in accumulating her student debt, that does not play into an analysis under the second prong. Nor should it be considered on remand in analysis of that prong.

And in footnote 2, stated:

> We neither foreclose nor endorse a possible argument that the third prong, which looks to a debtor's good faith, might be implicated in an extreme case by a debtor who unnecessarily and unreasonably amasses substantial additional debt at a time when she is obligated to pay a student loan, and who then argues that, because she now has so many other bills to pay, she should receive an undue hardship exemption as to her student debt. We merely note that our holding regarding the need to look only to the debtor's future ability to pay applies solely to the second prong.

THE AUTOMATIC STAY

11 U.S.C. § 362(a) generally bars any action to collect debtor's liability upon filing of a bankruptcy. 11 U.S.C. § 362(k) sets forth that an individual injured by any willful violation of the automatic stay shall recover actual damages, including costs and attorney's fees. However, a debtor many not obtain punitive damages against the United States. 11 U.S.C. § 106(a)(3). Congress has made 26 U.S.C. § 7433 and 11 U.S.C. § 362(h) the exclusive remedies for improper IRS collection.

If you believe an agency of the United States has violated the automatic stay, please contact your local Assistant United States Attorney, as many issues can be resolved expeditiously and without the need for formal proceedings. That said, not every post-petition action by a governmental agency constitutes a violation of the stay.

For instance, the automatic stay does not prevent the IRS from auditing a debtor. 11 U.S.C. § 362(b)(9) allows tax audits and investigations which includes the issuance of "Notices of Deficiency" and demands for tax returns as well as 26 U.S.C. § 6672 Trust Fund Recovery Penalty investigations. Although the Notice of Deficiency is legally required upon assessment (which may occur post-petition when Debtor complies with the obligation to file returns pursuant to 11 U.S.C. § 1308), it is often seen as a stay violation by practitioners and debtors.

The IRS may also off-set pre-petition income tax overpayments (refunds) against pre-petition income tax debts. 11 U.S.C. § 362(b)(26) This off-set is not a stay violation.

The automatic stay does not prevent commencement or continuation of a criminal proceeding. 11 U.S.C. § 362(b)(1). Actions to enforce a governmental unit's police or regulatory power include enforcement of a judgment other than a monetary judgment are exempt. 11 U.S.C. § 362(b)(4). This means that the government may continue to collect criminal restitution while

the debtor is in bankruptcy and may execute against property of the bankruptcy estate. 11 U.S.C. § 523(a)(13); *see also Partida v. United States,* 531 B.R. 881, BAP No. NV 14-1482 (May 27, 2015) holding that the Mandatory Victim Restitution Act, 18 U.S.C. § 3613, trumps the automatic stay. Criminal forfeiture actions are also excepted from the automatic stay by virtue of 11 U.S.C. § 362(b)(1). *See also United States v. Erpenbeck*, 682 F.3d at 480-481 (6th Cir. 2012) and *In re Smouha*, 126 B.R. 921, 928 (S.D. N.Y. 1992). Civil forfeiture proceedings are excepted from the automatic stay by the "police power" exception of 362(b)(4). *In re Chapman*, 264 B.R. 565, 571-572 (Bankr. 9th Cir. 2001).