

Taxpayers Beware: A Tax Debt May Not Be Dischargeable in Bankruptcy If the Tax Return Is Filed Late

When considering filing bankruptcy, the dischargeability of a taxpayer's outstanding federal tax debt is a significant consideration. In many cases, taxpayers are able to discharge personal income taxes through bankruptcy. However, as recently made clear by the Tenth Circuit Court of Appeals, there are significant traps for the unwary.

Background

The Bankruptcy Code generally assumes that debts are dischargeable. The Code, however, identifies certain categories of debt that are excepted from this general rule. Personal income tax is dischargeable only if all four of the following conditions are met:

1. Tax return was due more than three years prior to bankruptcy filing ("Three-Year Rule").
2. Tax return was filed more than two years prior to bankruptcy filing ("Two-Year Rule").
3. Taxes were assessed more than 240 days prior to bankruptcy filing ("240-Day Rule").
4. The taxpayer did not file a fraudulent return or willfully attempt to evade paying taxes ("Fraud Rule").

The first three requirements appear to be simple time measurement rules; however, these rules have caused significant angst for unwary taxpayers. In particular, the Two Year Rule requires a taxpayer to have filed a return. Section 523(a) of the Bankruptcy Code specifically states that a tax debt is excluded from discharge if a return was not filed. This seemingly straightforward rule raises the question of what does it mean to file a tax return.

POSTED:

Jan 26, 2015

RELATED PRACTICES:

[Tax](#)

<https://www.reinhartlaw.com/practices/tax>

RELATED PEOPLE:

[Michael G. Goller](#)

<https://www.reinhartlaw.com/people/michael-goller>

Mallo v. Comm'r (10th Cir. 2014)

In *Mallo v. Commissioner*, the Tenth Circuit Court of Appeals was faced with the question of whether a late personal income tax return (Form 1040), filed after the IRS assessed a tax liability, is a "return" for purposes of the exclusion from discharge set forth in Section 523 of the Bankruptcy Code.

The case is a consolidated appeal involving two taxpayers that both failed to file timely federal income tax returns. Each of the taxpayers filed a bankruptcy petition. In one case, the bankruptcy court determined that the tax debts were not discharged because the taxpayers had not filed a return. In the other case, the bankruptcy court determined that the late-filed returns were returns, meaning the tax debt was dischargeable in the bankruptcy proceeding.

On appeal, the Tenth Circuit held that late Forms 1040 were not returns under the Bankruptcy Code. The relevant language cited by the court is found in the "hanging paragraph" of Section 523 of the Bankruptcy Code. This paragraph defines a "return" as a "return that satisfies the requirements of applicable non-bankruptcy law (including applicable filing requirements)" and further states that a "return" does not include a substitute return prepared by the IRS without consent of the taxpayer under Section 6020(b) of the Internal Revenue Code.

The court reviewed the plain language of the statute and determined that the reference to applicable filing requirements includes filing deadlines. As such, the court concluded that Section 523 "plainly excludes late-filed Form 1040s from the definition of a return" and therefore tax debts reflected on the Form 1040s were not dischargeable in bankruptcy.

In holding in this manner, the court determined it unnecessary to resolve the issue of whether a post-assessment tax return qualifies as a return under the common law test developed in *Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986). The court also rejected the taxpayers' argument that Section 523 is ambiguous as to whether "applicable filing requirements" includes the requirement that the returns be timely.

Prior cases had applied the Beard rule to determine whether a post-assessment return can qualify as a return in the Bankruptcy Code. *See e.g., In re Colsen*, 446 F.3d 836 (8th Cir. 2006). The Tenth Circuit's decision, however, is consistent with a Fifth Circuit decision and numerous bankruptcy court decisions. *See e.g., In re McCoy*, 666 F.3d 924 (5th Cir. 2012); *Perkins v. Mass. Dep't of Revenue*, 507 B.R. 45



(D. Mass. 2014); In re Cannon, 451 B.R. 204 (Bankr. N.D. Ga. 2011). These decisions consistently take the position that the "hanging paragraph" of Section 523 of the Bankruptcy Code means a late-filed return may not qualify as a return for purposes of discharging a tax debt.

Other Traps for the Unwary

The prohibition on discharging tax debts on late-filed returns is not the only trap for the unwary. Taxpayers and representatives should carefully monitor the time periods described above. Certain common actions made by a taxpayer attempting to resolve an outstanding tax debt may toll the time period requirements noted above. In particular, the filing of an Offer in Compromise extends the 240-Day Rule by the number of days the offer is pending, plus 30 days. The filing of a request for a Due Process Hearing tolls the period for the Three-Year Rule and the 240-Day Rule while the appeal is pending, plus 90 days. Taxpayers considering a bankruptcy might consider an installment agreement (which should not extend the time period requirements) instead of other defensive measures. Prior to filing a bankruptcy action, taxpayers and their representatives should confirm the time period requirements noted above have been met.

If you have questions about tax debt traps to avoid in bankruptcy, please contact [Michael G. Goller](#) or your Reinhart attorney. They will be happy to assist you.

These materials provide general information which does not constitute legal or tax advice and should not be relied upon as such. Particular facts or future developments in the law may affect the topic(s) addressed within these materials. Always consult with a lawyer about your particular circumstances before acting on any information presented in these materials because it may not be applicable to you or your situation. Providing these materials to you does not create an attorney/client relationship. You should not provide confidential information to us until Reinhart agrees to represent you.