For Bankruptcy Purposes, the Ninth Circuit Bankruptcy Appellate Panel Asks: When is a Tax Return Not a Tax Return? — Then Provides An Answer Different From Other Circuits’

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Court of Appeals Rejects Literal Construction of Bankruptcy Code section 523(a)(1), Ruling Court Must Determine Whether Debtors Subjectively Made an Honest and Reasonable Attempt to Satisfy the Tax Law

In a December 17, 2015 decision in United States v. Martin (In re Martin), 2015 WL 9252590 (9th Cir. BAP 2015) the Bankruptcy Appellate Panel of the Ninth Circuit Court of Appeals (the “Panel”), defined what qualifies as a tax return for dischargeability purposes, specifically disagreeing with three other Courts of Appeals.

Section 523(a)(1)(B)(i) excepts from discharge tax debt when the debtor taxpayer was required to file a tax return but did not do so. Likewise, section 523(a)(1)(B)(ii) excepts from discharge tax debt associated with untimely filed tax returns filed within two years of the debtor’s bankruptcy filing, and section 523(a)(1)(C) excepts from discharge tax debt associated with tax returns that are fraudulent or evasive.

Prior to 2005, the Bankruptcy Code contained no definition of a “return.” Rather, the courts required for a document to be treated as a 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.

United States v. Hatton (In re Hatton), 220 F.3d 1057, 1060—61 (9th Cir. 2000) (citing United States v. Hindenlang (In re Hindenlang), 164 F.3d 1029, 1033 (6th Cir. 1999)).
In 2005, Congress passed Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") and grafted the "return" definition onto the nondischargeability statute in a hanging paragraph at the end of section 523(a), cited as § 523(a)(*). The hanging paragraph is comprised of two sentences:

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) 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.

Emphasis added.

The First, Fifth and Tenth Circuits have also addressed the issue of what is a “tax return”, holding that the term “applicable filing requirements” is unambiguous and that the plain and ordinary meaning of the term necessarily includes deadlines for filing returns. See, e.g., Fahey v. Massachusetts Dept of Revenue (In re Fahey), 779 F.3d 1, 4–5 (1st Cir. 2015); Mallo v. IRS (In re Mallo), 774 F.3d 1313, 1325–27 (10th Cir. 2014); McCoy v. Miss. State Tax Comm’n (In re McCoy), 666 F.3d 924, 928, 932 (5th Cir. 2012). Under these decisions, if a Form 1040 is filed one month, one day or one hour late, then the tax liability for that tax year can never be discharged.2

The Panel rejected this literal construction of Section 523(a)(*) by comparing the language added by BAPCPA to other dischargeability provisions of the Bankruptcy Code, and concluding that the proper standard to determine whether a return had been filed was the four factor test set forth in United States v. Hatton (In re Hatton), 220 F.3d 1057, 1060–61 (9th Cir. 2000), described above.

Importantly, the Panel found that the Court had incorrectly applied the fourth prong: whether the document represented an honest and reasonable attempt to satisfy the requirements of the tax law. Rather than examining only the Forms 1040 provided to the IRS, an objective test, the Panel ruled that the Court should have considered the debtors’ reasons for filing the Forms 1040 late, a subjective test. On remand, it directed the Court to consider other factors, such as the length of the delay, the reason for the delay, and the number of tax years missed.
Ninth Circuit Set to Review Section 523(a)(* ) Issue

The IRS is not expected to appeal United States v. Martin (In re Martin) because the issue of what should be a tax return for dischargeability purposes has already been appealed in the pending case of Smith v. IRS (In re Smith) (Docket No. 14-15857). Although, the debtors in In re Martin will have to await the outcome of the In re Smith case, the In re Martin decision provided the Panel with an opportunity to provide its views to the 9th Circuit.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Los Angeles lawyers:

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1 This test is also known as the Beard test which was established in the tax court decision of Beard v. Commissioner, 82 T.C. 766, 774-79 (1984), aff'd 793 F.2d 139 (6th Cir.1986).

2 The IRS, in Chief Counsel Notice CC-2010-016, 2010 WL 3617597, does not advance this literal position. Rather, the IRS asserts if the taxpayer files a Form 1040 after an assessment has been made and reports an additional amount of tax, only the additional portion of the tax not previously assessed is dischargeable.