

Northern Illinois Law Review

Comment

DEBTORS DESERVE THE DISCHARGEABILITY OF TAX LIABILITY TO BE “HONEST AND REASONABLE”

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I. INTRODUCTION

The idea of bankruptcy, or debt forgiveness, can be dated all the way back to the Old Testament.¹ The Old Testament spoke of a Jubilee Year that would take place every fifty years and would require people to forgive all debts:²

Consecrate the fiftieth year and proclaim liberty throughout the land to all its inhabitants. It shall be a jubilee for you; each one of you is to return to his family property and each to his own clan. The fiftieth year shall be a jubilee for you; do not sow and do not reap what grows of itself or harvest the untended vines. For it is a jubilee and is to be holy for you; eat only what is taken directly from the fields. In this Year of Jubilee everyone is to return to his own property.³

In the sixteenth century, the English considered bankruptcy individuals to be criminals and considered punishments that ranged from, “incarceration in debtors' prison all the way to the extreme sentence of death.”⁴ Three centuries later the English introduced the Statute of Anne, which included a chapter that rewarded debtors who paid off what they could by allowing their debts to be discharged.⁵ Realizing that some form of debt forgiveness was necessary for the success of a nation, the United States followed the lead of the English and incorporated the idea of bankruptcy into the United States Constitution.⁶

The bankruptcy system of the United States was enacted with two goals in mind: “to promote equality of distribution among similarly situated creditors” and “to afford the honest

¹ See *Deuteronomy* 15: 1-2 (New International Version) stating:

At the end of every seven years you must cancel debts. This is how it is to be done: Every creditor shall cancel any loan they have made to a fellow Israelite. They shall not require payment from anyone amount their own people, because the Lord's time for canceling debts has been proclaimed.

Id.

² See *Leviticus* 25: 10-13 (New International Version); see also *A Brief History of Bankruptcy*, BankruptcyData.com, <http://www.bankruptcydata.com/Ch11History.htm> (last visited Oct. 9, 2012).

³ *A Brief History of Bankruptcy*, *supra* note 2 (citing *Leviticus* 25:10-13 (New International Version)).

⁴ See *A Brief History of Bankruptcy*, *supra* note 2

⁵ See *id.*

⁶ The applicable section and clause of the Constitution grants Congress the power “[t]o establish an uniform Rule of Naturalizations, and uniform Laws on the subject of Bankruptcies thought the United States.” U.S. CONST. art. I, § 8, cl. 4.

debtor a fresh economic start.⁷ These two goals are known as the “twin pillars of bankruptcy law.”⁸ While the “twin pillars of bankruptcy law”⁹ have always been what Congress intended to accomplish through the bankruptcy laws, the laws have changed numerous times, and with the ever-evolving economy of the United States, they will continue to require amendments.¹⁰ The United States Bankruptcy Code has gone through many revisions since its inception.¹¹ After several short lived Bankruptcy Codes by Congress in the nineteenth century, the United States Congress passed the Bankruptcy Act of 1898, which lasted eighty years.¹² The Bankruptcy Act of 1898 was enacted because of the financial distress of the United States in 1893 and after much struggle in Congress.¹³ The Bankruptcy Act of 1898 comprised several key features.¹⁴ For example, a referee was appointed to each county so that people did not have to travel to federal courts for bankruptcy proceedings.¹⁵ Additionally, the Act incorporated a new definition of insolvency allowing debtors the ability to “liquidate their holdings” to pay off creditors so that fewer debtors could be brought into bankruptcy by creditors.¹⁶

Several amendments were made to the Bankruptcy Act of 1898 throughout the years.¹⁷ The Chandler Act of 1938¹⁸ expanded the ability of debtors to file voluntary bankruptcy petitions and included the ability of federal courts to call the Securities and Exchange Commission for

⁷ ROBERT E. GINSBERG ET. AL., GINSBERG & MARTIN ON BANKRUPTCY § 1.01 (5TH ed. 2012).

⁸ *Id.*

⁹ *Id.*

¹⁰ See *The Establishment of Bankruptcy Courts: “An Act To establish an uniform Law on the Subject of Bankruptcies”*, FEDERAL JUDICIAL CTR., http://www.fjc.gov/history/home.nsf/page/landmark_20.html (last visited Oct. 9, 2012).

¹¹ See *supra* note 3.

¹² Act of July 1, 1898, ch. 541, 30 Stat. 544, repealed by Pub. L. No. 95-598, 92 Stat. 2549 (November 6, 1978). The Bankruptcy Act of 1898, sometimes referred to as the “Nelson Act,” was the first bankruptcy code that lasted more than a few years and allowed companies for the first time to be protected from creditors along with individuals, *id.*

¹³ Vincent L. Leibell, Jr., *The Chandler Act-Its Effect Upon the Law of Bankruptcy*, 9 FORDHAM L. REV. 380, 383 (1940) (explaining when the discussion for The Bankruptcy Act of 1898 began and the frustrations between “the Wall Street creditors of the North and debtors of the South” in attempting to find acceptable bankruptcy laws).

¹⁴ See Act of July 1, 1898, ch. 541, 30 Stat. 544, repealed by Pub. L. No. 95-598, 92 Stat. 2549 (November 6, 1978).

¹⁵ See *id.*

¹⁶ Leibell, *supra* note 13, at 384.

¹⁷ See *id.*

¹⁸ Chandler Act, ch. 575, 52 Stat. 840 (1938) (repealed 1978).

help on complex corporate reorganizations.¹⁹ After eighty years, the Bankruptcy Act of 1898 was completely replaced by the current bankruptcy code: the Bankruptcy Reform Act of 1978.²⁰

Unlike many of the previous bankruptcy codes and amendments, the Bankruptcy Reform Act of 1978 was not passed due to “economic downturn,” but rather was motivated and passed because of “the explosion of consumer credit and resulting rise in consumer bankruptcies.”²¹ The key changes made by the Bankruptcy Reform Act of 1978 included: (1) the addition of federal homestead exemptions, (2) the “super discharge”²² feature to encourage debtors to file Chapter 13 petitions, (3) implementation of a trustee system, and (4) increasing “the jurisdiction of bankruptcy judges by allowing them to hear all matters arising in, under, or related to bankruptcy cases as adjuncts of the district court.”²³

Similar to its predecessor, the Bankruptcy Reform Act of 1978 has been subjected to various amendments since its inception.²⁴ The Bankruptcy Reform Act of 1994²⁵ was one of the main amendments and added new provisions to encourage debtors to file Chapter 13 plans instead of Chapter 7 plans.²⁶ The Bankruptcy Reform Act of 1994 also created the National Bankruptcy Commission.²⁷ The National Bankruptcy Commission was created to review, study, and submit a report on the bankruptcy laws and ascertain why in the last two decades consumer

¹⁹ Leibell, *supra* note 13, at 396 (discussing the importance of the Chandler Act and the expanding role the Securities and Exchange Commission in helping federal courts and trustees with Chapter X cases, which are complex corporate reorganizations).

²⁰ The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

²¹ Bret Fulkerson, *Consumer Bankruptcy Reform Past and Present*, J. TEX. CONSUMER L., Summer/Fall 2001, at 305 (citing Daniel A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 AM. BANKR. L.J. 311, 328-329 (1999)).

²² 11 U.S.C. § 1328(a) (2010). Chapter 13 discharge, or the “super discharge” as it is commonly referred to, allows debtors to discharge debts that would not be dischargeable in a Chapter 7 petition. Congress passed this section of the Bankruptcy Code to encourage debtors to file Chapter 13 petitions so that creditors would be paid more than they would if the debtor filed a Chapter 7 petition.

²³ See Chandler Act, ch. 575, at 306.

²⁴ *Id.*

²⁵ The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994).

²⁶ Chandler Act, ch. 575 at 307.

²⁷ *Id.*

bankruptcies had increased 700 percent.²⁸ After the Commission submitted its report, coupled with numerous years of Senate and Congressional debates, President Bush signed the most current amendment to the Bankruptcy Code into law on April 20, 2005.²⁹

The most current version of the Bankruptcy Code, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA),³⁰ is considered one of the most technical and comprehensive reforms to the Bankruptcy Code. Facing a dramatic increase in consumer bankruptcies and fearing an increase in abuse of the system, Congress included stricter guidelines and rules to try and prevent debtor abuse in BAPCPA.³¹ One of the biggest additions to the Bankruptcy Code was the creation of a “means test” to limit the amount of consumers who could file a Chapter 7 petition.³² The “means test” takes into account the median income of the debtor, which includes the debtor's monthly income minus any Internal Revenue Service (IRS) allowed deductions, to determine if the debtor can qualify to file a Chapter 7 petition.³³ BAPCPA also introduced regulations where the debtor's attorney could face fines and penalties for not ensuring that the debtor qualified for the correct Chapter of bankruptcy that they filed.³⁴ Another addition that BAPCPA added, and at the heart of this Comment, was the addition of a hanging paragraph to the Bankruptcy Code section 523(a).³⁵

²⁸ *Id.* (citing Carlos J. Cuevas, *The Consumer Credit Industry, the Consumer Bankruptcy System, Bankruptcy Code Section 707(b), and Justice: A Critical Analysis of the Consumer Bankruptcy System*, 103 COM L.J. 359, 359 (1998)).

²⁹ *Bankruptcy Reform*, THE UNITED STATES DEPARTMENT OF JUSTICE: U.S. TRUSTEE PROGRAM,

<http://www.justice.gov/ust/eo/bapcpa/index.htm> (last visited Oct. 10, 2012). *See also* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

³⁰ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

³¹ *See* Chandler Act, ch. 575, at 307-308

³² *See* 11 U.S.C. § 707 (2010).

³³ *See Id.*

³⁴ Chandler Act, ch. 575, at 308-309

³⁵ 11 U.S.C. § 523(a) (2010). Section 523 of the Bankruptcy Code discusses exemptions to discharge for bankruptcy petitioners. Section 523(a) specifically discusses what tax liabilities a petitioner cannot be discharged from. Pre-BAPCPA section 523(a) did not define “return” for purposes of a tax “return.” The hanging paragraph defined “return” for the dischargeability of tax liabilities in bankruptcy proceedings with 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) 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

The focus of this Comment is on the hanging paragraph of section 523(a) and how it will affect the dischargeability of tax liabilities to bankruptcy petitioners. The hanging paragraph of section 523(a) has led courts to state, “[w]hether a properly completed, signed and filed Form 1040 is treated as a federal income tax return for dischargeability purposes depends on when it is filed”³⁶ Some Bankruptcy Courts have held that a strict statutory interpretation of the code would result in a taxpayer who filed after the April fifteenth deadline for the year the tax “return” was due to be classified as not having filed a return at all, which “” would prohibit them from discharging their tax liability for that year in a Chapter 7 bankruptcy. Contrary to this, other bankruptcy courts have argued that there is no time requirement explicitly stated in the statute requiring the old “honest and reasonable”³⁷ aspect of the “Beard test”³⁸ to be used.³⁹ Despite these holding, the IRS has asked courts to instead interpret the statute to allow late filers to discharge their tax liability for that year unless the IRS had assessed the person's taxes for them.⁴⁰ The IRS believes that the courts should use the pre-BAPCPA “Beard Test” to determine if a petitioner filed a “return” for bankruptcy purposes.⁴¹ Therefore, the issue of whether a person can discharge their tax liability through a Chapter 7 bankruptcy proceeding for a year that they filed a tax return after April fifteenth, but before the IRS had already assessed the taxes could arise in the future.

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) (2010).

³⁶ *In re Shin*, No. 10-83750, 2012 WL 986752, at *1 (Bankr. C.D. Ill. Mar. 22, 2012).

³⁷ See text *infra* note 45.

³⁸ *E.g.*, *In re Hindenlang*, 164 F.3d 1029, 1033 (6th Cir. 1999) (citing *Beard v. Commissioner*, 82 T.C. 766, 1984 WL 15573 (1984)).

³⁹ *Id.* at 6 (stating that “Judge Easterbrook opined that under the definition of ‘return’ added by BAPCPA, requiring compliance with ‘applicable filing requirements,’ an untimely returns is outside the scope of the definition and could not support a discharge of tax liability, as a matter of law.”); see *In re Payne* 431 F.3d 1055, 1060 (7th Cir. 2005) (Easterbrook, J., dissenting).

⁴⁰ *Id.*

⁴¹ See *In re Shin*, 2012 WL 986752, at 6.

Part II of this Comment will explain the background and history of the pre BAPCPA “Beard test” that was used by courts.⁴² It will elaborate on the key elements of the “Beard test” and the underlying purpose behind it.⁴³ Part II will also discuss why the “honest and reasonable” aspect of the “Beard test” should ultimately be used to determine dischargeability of tax liabilities for bankruptcy petitioners.⁴⁴

Part III of this Comment will discuss the applicable Internal Revenue Code sections that relate to the hanging paragraph of 11 USC Section 523(a).

Parts IV-X will discuss cases that have dealt with the “Beard test” and the hanging paragraph of 11 USC section 523(a). The cases will show how various courts have interpreted the “honest and reasonable” aspect of the “Beard test” along with how courts have started to interpret the hanging paragraph of 11 USC section 523(a). The cases show that as long as a bankruptcy petitioner has made an “honest and reasonable” attempt to satisfy tax laws they should be granted a discharge of their tax liabilities.⁴⁵

Finally, Part XI will present the conclusion that the hanging paragraph of 11 USC section 523(a) defeats the underlying principal of bankruptcy, to help debtors in need establish a fresh start.⁴⁶

II. THE “BEARD TEST”

The Bankruptcy Code allows a person to discharge their tax liability for tax years two years prior to the filing of their petition in a Chapter 7 case, if the person filed a tax “return” for

⁴² *In re Hindenlang*, 164 F.3d at 1033.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ See *In re Payne*, 431 F.3d 1055 (7th Cir. 2005); see *In re Colsen*, 446 F.3d 836 (8th Cir. 2006); see *In re Crawley*, 244 B.R. 121 (Bankr. N.D. Ill. 2000); see *In re Nunez*, 232 B.R. 778 (B.A.P. 9th Cir. 1998); see *In re Moroney*, 352 F.3d 902 (4th Cir. 2003); see *In re Shinn* No. 10-83750, 2012 WL 986752 (Bankr. C.D. Ill. Mar. 22, 2012).

⁴⁶ See U.S.C. § 523(a) (2010).

that year.⁴⁷ Attorneys recognized a loophole in the Code. They would advise their clients to file tax “returns” for years they missed and then wait two years to file for bankruptcy. This allowed the petitioners the ability to discharge all of their tax liabilities because they had technically filed tax “returns.”

Prior to BAPCPA the term “return” was not defined in the Bankruptcy Code,⁴⁸ which forced the courts to use a four-part test deemed the “Beard test” to determine if a taxpayer had a filed a “return” with the IRS.⁴⁹ The “Beard test” stated that in order for a taxpayer to have filed a “return” a document submitted to the IRS must: (1) purport to be a return; (2) be signed under penalty of perjury; (3) must contain sufficient data to allow calculation of tax; and (4) must represent an honest and reasonable attempt to satisfy the requirements of the tax law.⁵⁰ Under the “Beard test” bankruptcy petitioners often tried to argue that even if they filed their tax returns late, they nonetheless were still making an honest and reasonable attempt to satisfy the requirements of tax law.⁵¹ Some courts, agreeing with the bankruptcy petitioners, believed that the “honest and reasonable” factors simply required the courts to look at the face of the tax

⁴⁷ 11 U.S.C. § 523(a) (2010).

⁴⁸ *Id.*

⁴⁹ *E.g., In re Hindenlang*, 164 F.3d at 1033 (citing *Beard v. Commissioner*, 82 T.C. 766, (1984)).

⁵⁰ *Id.* The court gave the origin of the “Beard test” as follows:

This test was derived from two Supreme Court cases: *Germantown Trust Co. v. Commissioner*, 309 U.S. 304, 60 S.Ct. 566, 84 L.Ed. 770 (1940), and *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 55 S.Ct. 127, 79 L.Ed. 264 (1934). In *Germantown*, the Court was asked to decide whether a fiduciary Form 1041 filed by the petitioner, that stated no tax was due, qualified as a return under § 275(a) of the Revenue Act of 1932. *Id.* at 306, 60 S.Ct. 566. The determination would control the onset of the limitations period for assessing a deficiency. *Id.* at 307, 60 S.Ct. 566. The Court held “that where a fiduciary, in good faith, makes what it deems the appropriate return, which discloses all of the data from which the tax ... can be computed,” a proper return has been filed. *Id.* at 309, 60 S.Ct. 566. The Court in *Zellerbach*, also discussing the date at which the limitations period against the IRS begins to run for deficiency assessments, held that “[p]erfect accuracy or completeness is not necessary to rescue a return from nullity, if it purports to be a return, is sworn to as such, and evinces an honest and genuine endeavor to satisfy the law.” 293 U.S. at 180, 55 S.Ct. 127.

In re Hindenlang, 164 F.3d at 1033.

⁵¹ *E.g., In re Moroney*, 352 F.3d 902, 905 (4th Cir. 2003) (arguing that the terms honest and reasonable do not deal with the time frame in which the returns were filed, but rather that the honest and reasonable factors go to the truthfulness of the tax return content and intent to comply with the tax laws).

returns and not the intent of the petitioners.⁵² On the other hand, the IRS would often argue that people know the deadline for filing taxes is April fifteenth and that there is nothing honest or reasonable about filing taxes late.⁵³ The IRS also argued that even if a late filed tax return could be seen as a “honest and reasonable attempt to satisfy tax laws” and that if the IRS had to use their resources to assess taxes for the petitioner, then the late tax return served no purpose to the IRS and therefore did not satisfy the tax laws.⁵⁴ There will undoubtedly be bankruptcy petitioners who are not “honest and reasonable” and are trying to take advantage of the bankruptcy system. However, there also will be bankruptcy petitioners who are “honest and reasonable” who are trying to correct their lives and start fresh. By taking the view of the IRS and some bankruptcy courts that late filed tax forms cannot be “returns” for dischargeability purposes, the “honest and reasonable” bankruptcy petitioners will be hurt and will not have the opportunity to start their lives fresh.⁵⁵ This view ultimately undermines the main purpose of bankruptcy law.

III. APPLICABLE INTERNAL REVENUE CODE SECTIONS

As previously stated, section 523(a) of the Bankruptcy Code uses the term “return,” but does not define it specifically for bankruptcy purposes.⁵⁶ Instead, the Code says “the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including

⁵² *In re Colsen*, 446 F.3d 836, 840 (8th Cir. 2006) (holding that when deciding if a petitioner's tax return satisfies the “honest and genuine attempt” requirements to satisfy tax law, the court should only look at the face of the document).

⁵³ *In re Hindenlang*, 164 F.3d at 1034; *see In re Crawley*, 244 B.R. 121, 128 (Bankr. N.D. Ill. 2000) (holding that there is no requirement that tax returns must be filed prior to an assessment by the IRS in order to qualify as a “return” for dischargeability purposes in bankruptcy).

⁵⁴ *In re Hindenlang*, 164 F.3d at 1034-35. The court in *In re Hindenlang* stated:

[W]hen the debtor has failed to respond to both the thirty-day and the ninety-day deficiency letters sent by the IRS, and the government has assessed the deficiency, then the Forms 1040 serve no tax purpose, and the government has met its burden of showing that the debtor's actions were not an honest and reasonable effort to satisfy the tax law.

Id.; *see In re Moroney* 352 F.3d at 906; *see also In re Payne* 431 F.3d at 1057; *see In re Miniuk*, 297 B.R. 532, 542-543 (Bankr. N.D. Ill. 2003) (holding that petitioner's tax returns were not “honest and reasonable” attempts at satisfying the tax laws because the tax returns were filed after the government had already assessed the petitioner's tax liabilities for them. The court also stated that the petitioners were attempting to take advantage of the two-year “lookback” period).

⁵⁵ *See infra* note 168.

⁵⁶ *See* 11 U.S.C. § 523(a) (2010).

applicable filing requirements).”⁵⁷ Because section 523(a) deals with the dischargeability of tax liabilities, the next logical step to determine what “satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)” would be to look at the Internal Revenue Code (hereinafter “IRC”). The IRC section that discusses the applicable time requirements for filing a tax return states:

In the case of returns under section 6012, 6013, 6017, or 6031 (relating to income tax under subtitle A), 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 and returns made on the basis of a fiscal year shall be filed on or before the 15th day of the fourth month following the close of the fiscal year, except as otherwise provided in the following subsections of this section.⁵⁸

The reading of IRC section 6072(a) makes it clear that an individual must file a tax return by April 15th of the following year in order to satisfy the applicable filing requirements of tax law, which equate to nonbankruptcy law for section 523(a) purposes.⁵⁹ Therefore, a plain face interpretation of section 523(a) specifically states that a return made pursuant to IRC section 6020(a)⁶⁰ will be considered a “return,” but a return made pursuant to IRC section 6020(b)⁶¹ will not.⁶²

IV. *IN RE PAYNE*

During the “Beard test” era, but immediately after the release of the hanging paragraph

⁵⁷ *Id.*

⁵⁸ 26 U.S.C. § 6072(a) (2007).

⁵⁹ *See id.*; *see also supra* note 30.

⁶⁰ 26 U.S.C. § 6020(a) (2007) reads as follows:

If any person shall fail to make a return required by this title or by regulations prescribed thereunder, but shall consent to disclose all information necessary for the preparation thereof, then and in that case, the Secretary may prepare such return, which, being signed by such person, may be received by the Secretary as the return of such person.

26 U.S.C. § 6020(a) (2007).

⁶¹ 26 U.S.C. § 6020(b) (2007) states:

If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

26 U.S.C. § 6020(b) (2007).

⁶² 11 U.S.C. § 523(a) (2010).

addition to section 523(a), the majority in *In re Payne* found that tax returns filed after an IRS assessment were not “honest and reasonable.”⁶³ In *In Re Payne*, Payne filed no federal income tax return from 1986 until 1992.⁶⁴ In 1989, the IRS discovered that Payne had income in 1986 from which income tax had not been withheld and for which he might owe income tax on.⁶⁵ The next year, the IRS assessed Payne's income tax due of \$64,000 for 1986.⁶⁶ After crediting Payne with \$44,000 that his employer had withheld, the IRS attempted to collect the \$20,000 Payne owed.⁶⁷ In 1992, a few months after filing his 1986 return, he offered to compromise his tax liability with the IRS, but the IRS refused.⁶⁸ Payne ultimately filed for bankruptcy in 1997 and sought a discharge of his unpaid tax liability for 1986.⁶⁹ The bankruptcy judge and the district judge granted a discharge of the tax liability.⁷⁰ The government then appealed to the Seventh Circuit.⁷¹

A. THE MAJORITY DECISION

Section 523(a)(1)(B)(i) of the Bankruptcy Code forbids the discharge of federal income tax liability with respect to which a return was required to be filed but was not filed.⁷² Payne contended that by filing a return in 1992 for the tax year 1986, even if the return was six years late and filed after the IRS had assessed his tax liability, that he had still complied with the code.⁷³ Payne also argued that his return, even if six years late, met the statutory requirement of a return as contemplated by the Bankruptcy Code.⁷⁴ The bankruptcy judge and the district court

⁶³ *In re Payne*, 431 F.3d 1055, 1059-60 (7th Cir. 2005).

⁶⁴ *Id.* at 1056.

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *In re Payne*, 431 F.3d at 1056.

⁶⁹ *Id.* at 1056.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *In re Payne*, 431 F.3d at 1056.

⁷⁴ *Id.*

agreed with Payne and granted the discharge.⁷⁵ On appeal, the government argued that an untimely post-assessment return is not a “return” within the meaning of the Bankruptcy Code and therefore, Payne had never properly filed a 1986 return and could not be discharged with respect to his 1986 tax liability.⁷⁶

Judge Posner began his majority opinion for the Seventh Circuit Court by stating that neither the Bankruptcy Code nor the Internal Revenue Code defines the word “return.”⁷⁷ However, there is an abundance of case law interpreting what is and what is not a “return” because what does or does not qualify as a tax return is essential to the taxpayers.⁷⁸ Judge Posner went on to state the elements of the “Beard test,”⁷⁹ demonstrating what is necessary for a document to be deemed a return for IRS and bankruptcy purposes.⁸⁰ He explained a purported return that does not meet all four conditions to qualify as a return does not satisfy the role that a tax return is intended to play in the federal tax system of honest self-assessment.⁸¹

Judge Posner conceded that Payne’s purported return met the first three requirements of a return because it clearly purported to be a return, was signed under penalty of perjury, and contained enough information to allow the IRS to calculate Payne’s tax liability.⁸² However, because the IRS had already calculated and assessed Payne's tax liability before he filed his return, the return was of little value to the IRS.⁸³ Therefore, the critical question for Judge Posner was whether the fourth condition, that the return “evince an honest and genuine endeavor to

⁷⁵ *Id.*

⁷⁶ *Id.* at 1056-57.

⁷⁷ *Id.* at 1057.

⁷⁸ *In re Payne*, 431 F.3d at 1057.

⁷⁹ *See supra* note 44. The “Beard test” stated:

In order for a taxpayer to have filed a “return” a document submitted to the IRS must: (1) purport to be a return; (2) be signed under penalty of perjury; (3) must contain sufficient data to allow calculation of tax; and (4) must represent an honest and reasonable attempt to satisfy the requirements of the tax law.

In re Hindenlang, 164 F.3d at 1033.

⁸⁰ *In re Payne*, 431 F.3d at 1057.

⁸¹ *Id.* at 1057.

⁸² *Id.*

⁸³ *See id.* at 1058.

satisfy the law,” was met by the belated 1992 return.⁸⁴

Judge Posner concluded that the return was not an honest and genuine endeavor to satisfy the law for several reasons.⁸⁵ First, Payne offered no excuse for the late filing except in his lawyer’s oral statement that 1986 to 1992 was a difficult period for his client.⁸⁶ This statement was not supported by any evidence and was not considered by the court.⁸⁷ Second, Judge Posner concluded that the belated filing, unaccompanied by payment of the tax due, was not a reasonable effort to satisfy the basic requirements of tax law, namely, the requirement of filing a timely return and paying the amount of tax calculated on the return.⁸⁸ Payne’s tardiness clearly defeated the self-assessment purpose that a tax return is intended to play in the federal tax system.⁸⁹ Third, when Payne filed his late return, the IRS had already calculated the tax due.⁹⁰ This meant that he had already succeeded in defeating the main purpose of tax returns: to spare the IRS the burden of assessing a taxpayer’s income and tax liability.⁹¹ A return that is filed after the government has borne the considerable burden of determining the taxpayer’s income and tax liability does not serve the intended purpose of the filing requirement.⁹² Finally, Judge Posner wrote there was no suggestion in the case that Payne was already bankrupt in 1986 or that paying the \$20,000 tax when due would have driven him into bankruptcy.⁹³

Judge Posner concluded the majority opinion by restating the legal test is whether the taxpayer’s purported return is a reasonable endeavor to satisfy the taxpayer’s obligations.⁹⁴ He

⁸⁴ *Id.* at 1057.

⁸⁵ *In re Payne*, 431 F.3d at 1057.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *In re Payne*, 431 F.3d at 1057.

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.* at 1057-58.

⁹⁴ *Id.* at 1058.

concluded, for the several reasons discussed above, that Payne's efforts were not.⁹⁵ It can be interpreted from Judge Posner's discussion that the court believed the taxpayer had filed the late return to set the stage for a discharge in bankruptcy rather than to reasonably fulfill his tax obligations.⁹⁶ Judge Posner distinguished his holding from *In re Hindenlang*,⁹⁷ by stating his decision should not be read to indicate that a return filed after an IRS assessment of tax could never be deemed an honest and reasonable endeavor to comply with the tax law.⁹⁸ There might be circumstances beyond a taxpayer's control that prevent a timely filing before the tax is assessed.⁹⁹ The postal service, for example, might lose the return or deliver it to the wrong address, or the taxpayer might be physically or mentally incapacitated. However, there was no such excuse offered for Payne's six-year delay.¹⁰⁰

B. JUDGE EASTERBROOK'S DISSENT

In his dissent, Judge Easterbrook found Payne's return honest and reasonable for three reasons.¹⁰¹ First, he said that belated post-assessment returns are useful to the IRS because no matter how late they are filed, the returns replace IRS estimates with facts about the taxpayer's tax liability.¹⁰² Second, he said that the majority's view that an honest and reasonable return is one that leads to the collection of the tax is wrong.¹⁰³ Judge Easterbrook stated: "[t]he portion of the Internal Revenue Code that must be satisfied honestly and reasonably, if a document is to be called a return, is the statute requiring revelation of financial information, not the statute requiring payment."¹⁰⁴ Finally, he disagreed with the majority's focus on the subsidiary theme

⁹⁵ *In re Payne*, 431 F.3d at 1058.

⁹⁶ *See id.*

⁹⁷ *In re Hindenlang*, 164 F.3d 1029, 1034 (6th Cir. 1999).

⁹⁸ *In re Payne*, 431 F.3d at 1059.

⁹⁹ *Id.* at 1060.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* (Easterbrook, J., dissenting).

¹⁰² *Id.* at 1060.

¹⁰³ *In re Payne*, 431 F.3d at 1061 (Easterbrook, J., dissenting).

¹⁰⁴ *Id.* at 1061.

that Payne was satisfying “a condition precedent to obtaining a discharge [in bankruptcy], rather than to pay any of the taxes he owed.”¹⁰⁵ Judge Easterbrook concluded that whatever the court thought about Payne’s ethics, care, or strategy was not relevant to whether Payne’s return was honest and reasonable, because the question of what is an honest and reasonable tax return is strictly one of law rather than equity.¹⁰⁶ Judge Easterbrook stated that there is no equitable override to the Bankruptcy Code.¹⁰⁷ This principal tends to keep judges from using equity principles to do favors for taxpayers.¹⁰⁸

V. *IN RE COLSEN*

In the case *In Re Colsen*,¹⁰⁹ when Colsen failed to file tax returns for the years 1992 through 1996, the IRS prepared substitute returns and issued notices of deficiency.¹¹⁰ Toward the end of 1999, Colsen filed 1040 forms for the years 1992 through 1998.¹¹¹ Four years later, he filed a petition for relief of the taxes owed, under Chapter 7 of the Bankruptcy Code.¹¹² He claimed that his income taxes for the years 1992 through 1996 were dischargeable despite the provisions of 11 USC section 523(a)(1)(B)(i),¹¹³ which provides that a tax debt cannot be discharged in which a return “was not filed or given.”¹¹⁴ The IRS moved for summary judgment, claiming that the 1040 forms that Colsen filed were not reasonable returns under the statute because they were filed after the IRS assessments had taken place.¹¹⁵ The bankruptcy judge and bankruptcy appellate panel disagreed and ruled that the tax liabilities were dischargeable.¹¹⁶

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 1062.

¹⁰⁷ *Id.* at 1063.

¹⁰⁸ *In re Payne*, 431 F.3d at 1063 (citing *U.S. v. Noland* 517 U.S. 535 (1996)).

¹⁰⁹ *In re Colsen*, 446 F.3d 836 (8th Cir. 2006).

¹¹⁰ *Id.* at 838.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ 11 U.S.C. § 523(a)(1)(B)(i) provides that “[a] discharge ... does not discharge an individual debtor from any debt ... for a tax ... with respect to which a return or equivalent report or notice, if required ... was not filed or given.”

¹¹⁴ *In re Colsen*, 446 F.3d at 838.

¹¹⁵ *Id.* at 838.

¹¹⁶ *Id.*

A. THE MAJORITY DECISION

On appeal, Judge Arnold recognized that Judge Posner had concluded in *Payne* that the filing of a return post IRS assessment was not an “honest and reasonable” return that satisfied the statute.¹¹⁷ Posner said that a filing after the IRS had assessed a deficiency, plainly defeated the self-assessment role that a tax return is intended to play in the federal tax system and did not serve the intended purpose of the filing requirement, to spare the IRS the burden of determining the taxpayer’s income and tax liability.¹¹⁸ Yet, the Eighth Circuit dismissed Posner’s reasoning as to what “evinces an honest and reasonable endeavor to satisfy the law.”¹¹⁹

Judge Arnold, writing for the court, adopted the reasoning of Judge Easterbrook’s *Payne* dissent.¹²⁰ Easterbrook noted that “timely filing and satisfaction of one’s financial obligations are requirements different from the requirements for a return.”¹²¹ Easterbrook contended that when the return contained all the information necessary to calculate the tax liability, the statutory requirement, “evinces an honest and reasonable endeavor to satisfy the law,” was met because the proper objective of the return is to obtain accurate financial data.¹²² That the return was filed late or that there might be suspicious motives are not relevant to the taxpayer’s endeavor to satisfy the law by filing a return.¹²³

Judge Arnold held “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.”¹²⁴ He noted that the IRS clearly found late returns useful, because it requires them to be filed before the agency would consider

¹¹⁷ *Id.* at 840.

¹¹⁸ *Id.*; *see supra* note 92, 93.

¹¹⁹ *In re Colsen*, 446 F.3d at 840.

¹²⁰ *Id.* at 840.

¹²¹ *Id.* (citing *In re Payne*, 431 F.3d 1055, 1060-61 (7th Cir. 2005) (Easterbrook, J., dissenting)).

¹²² *See In re Payne*, 431 F.3d at 1061 (Easterbrook, J., dissenting).

¹²³ *See id.* at 1062.

¹²⁴ *In re Colsen*, 446 F.3d at 840.

offers to compromise tax liabilities.¹²⁵ The court affirmed the Bankruptcy Court and Bankruptcy Appellate Panel's discharge of the taxes.¹²⁶

VI. HONEST AND REASONABLE

There is currently a sharp split among the circuits regarding what constitutes an honest and reasonable tax return for the purpose of the discharge of tax liabilities in bankruptcy.¹²⁷ It is likely that the Supreme Court will have to step in and resolve this issue in the future. Judge Posner's arguments are more perceptive than Judge Easterbrook's and Judge Arnold's, and Payne's and Colsen's returns were not honest and reasonable ones. To write, as Judge Easterbrook and Judge Arnold did, that the tardy filer's motives and circumstances are not relevant to what evidences an honest and reasonable endeavor to satisfy the law would seem to lead to an unwarranted and narrow definition of a filer's obligation in the tax system.¹²⁸ It is certain that the lawyers and accountants who represent and deal with debtors seeking bankruptcy protection must be familiar with what represents an honest and reasonable tax return and the issues raised in these cases. Failure to recognize the several issues involved might result in an individual's being denied a discharge in bankruptcy.

VII. *IN RE CRAWLEY*

In 2000, the United States Bankruptcy Court for the Northern District of Illinois addressed whether the IRS was correct in asserting that a tax return cannot count as a "return" for bankruptcy purposes if the IRS had already assessed taxes for the taxpayer.¹²⁹ Chief Bankruptcy Judge, John H. Squires, held that "there is no requirement that purported income tax return must be filed before taxing authority has assessed tax for years in question, in order for

¹²⁵ *Id.* at 841.

¹²⁶ *Id.*

¹²⁷ *See In re Payne*, 431 F.3d 1055 (7th Cir. 2005); *see also In re Colsen*, 446 F.3d 836 (8th Cir. 2006).

¹²⁸ *Id.*

¹²⁹ *In re Crawley*, 244 B.R. 121 (Bankr. N.D. Ill. 2000).

purported return to qualify as 'return,' within meaning of dischargeability exception.”¹³⁰

In *In re Crawley*, the debtor filed a Chapter 7 bankruptcy petition wishing to discharge tax liabilities for the years 1985 through 1995.¹³¹ The debtors, the Crawleys, filed their tax returns on time for taxable years 1977 through 1985, however they did not pay any taxes or file their tax returns on time for taxable years 1985 through 1994.¹³² When the Crawleys went to purchase a new home in 1996, they were unable to obtain financing without providing income tax returns from previous years.¹³³ The Crawleys then employed an accountant, Dennis Cipcich, to prepare the delinquent tax returns for the taxable years 1985 through 1994.¹³⁴ Under oath, the Crawleys signed the delinquent tax returns and Cipcich then filed the returns with the IRS in June 1996 and July 1996.¹³⁵ Cipcich testified that he did not review the tax returns with the Crawleys and prepared them based only on the information that was available to him.¹³⁶ After the returns were submitted to the IRS, Mrs. Crawley testified that she noticed errors in the returns and reported the errors to Mr. Cipcich, however the Crawleys did not file amended tax returns.¹³⁷ The Crawleys sought to discharge the \$294,549 that the IRS asserted they owed through their Chapter 7 bankruptcy petition.¹³⁸

In determining whether the tax returns filed by the Crawleys were dischargeable, Judge Squires looked to The Bankruptcy Code section 523(a)(1)(B)(i).¹³⁹ The IRS argued that the Crawleys failed to file qualifying “returns” because they overstated their income, and therefore

¹³⁰ *Id.* at 126-27.

¹³¹ *Id.* at 125.

¹³² *Id.* at 124.

¹³³ *Id.*

¹³⁴ *In re Crawley*, 244 B.R. at 124-25.

¹³⁵ *In re Crawley*, 244 B.R. at 124-25.

¹³⁶ *Id.* at 125.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.* at 125-26 (citing 11 U.S.C. § 523(a)(1)(B)(i) (2010)).

their “returns” should not be dischargeable.¹⁴⁰ The IRS went on to argue that the court should adopt the reasoning taken in *In Re Hindenlang*, “that when returns are filed after the IRS has assessed the tax, such documents do not further the Internal Revenue Code tax purpose of self-assessment, because they come at a time after the IRS has compiled information and computed tax liability of the taxpayer.”¹⁴¹ Judge Squires rejected this view because there was no evidence presented that the IRS made an assessment of the Crawleys taxes and because this view “ignores the plain language of the bankruptcy statute which makes no such express requirement that only taxes for which tax returns filed by debtor taxpayers before a taxing authority makes its own assessment are eligible for discharge.”¹⁴² Citing *In re Savage*,¹⁴³ Judge Squires wrote, “[e]ffectively, a debtor, for whom the IRS prepares substitute returns, could never discharge taxes. We find nothing in the Bankruptcy Code that would lead us to adopt the IRS’s argument.”¹⁴⁴

Judge Squires summed up his argument by stating:

This Court will not read into § 523(a)(1)(B)(i) the requirement that a debtor must have filed a return prior to an assessment by the IRS. To follow the USA’s argument would undercut one of the principal policy considerations of the Bankruptcy Code to interpret exceptions to discharge narrowly and to provide the honest debtor with a fresh start. The argument of the USA requires a strained interpretation and application of the statutory language of § 523(a)(1)(B)(i), which does not expressly base the discharge of taxes on whether a return was filed prior to assessment.¹⁴⁵

Judge Squires ruled that the Crawleys had filed “returns” that satisfied the Bankruptcy Code and therefore the Crawleys tax returns were dischargeable.¹⁴⁶ However, while the Crawleys had filed “returns” for purposes of dischargeability, they ultimately were unable to discharge

¹⁴⁰ *In re Crawley*, 244 B.R. at 126.

¹⁴¹ *In re Crawley*, 244 B.R. at 126.

¹⁴² *Id.*

¹⁴³ *In re Savage*, 218 B.R. 126 (B.A.P. 10th Cir. 1998).

¹⁴⁴ *In re Crawley*, 244 B.R. at 127 (citing *In re Savage*, 218 B.R. 126 (B.A.P. 10th Cir. 1998)).

¹⁴⁵ *In re Crawley*, 244 B.R. at 127 (internal citations omitted).

¹⁴⁶ *See id.* at 129.

their tax liabilities because they were found to have willfully attempted to evade or defeat the payment of taxes.¹⁴⁷ Even though the Crawleys were not able to discharge their tax liabilities because they willfully attempted to evade or defeat the payment of taxes, Judge Squires' ruling on whether the Crawleys filed “returns” for the purpose of the Bankruptcy Code is one that favors bankruptcy petitioners and one the courts should follow today.¹⁴⁸

VIII. *IN RE NUNEZ*

Another case that dealt with the issue of what a “return” was for bankruptcy purposes, and a case that Judge Squires followed in *In re Crawley*,¹⁴⁹ was the 1999 case *In re Nunez*.¹⁵⁰ The Bankruptcy Appellate Panel for the Ninth Circuit had to determine if a “debtor's nine-year delay in filing tax return forms, until after the IRS had already prepared substitute returns and assessed liability for tax years in question” prevented the forms from qualifying as “returns” for dischargeability purposes of the Bankruptcy Code.¹⁵¹ Judge Meyers, writing for the Bankruptcy Appellate Panel, held that the debtor's delayed tax return forms, even after the IRS had assessed the debtor's taxes and prepared substitute forms, did not prevent the forms from qualifying as “returns” for bankruptcy dischargeability purposes.¹⁵²

In *In re Nunez*, the debtor filed for Chapter 7 bankruptcy in 1997 looking to discharge his tax liabilities for the years 1984 through 1993.¹⁵³ The debtor failed to file tax returns for the years he sought to discharge.¹⁵⁴ Because the debtor failed to file his tax returns, in 1993 the IRS prepared substitute returns and assessed taxes that the debtor owed.¹⁵⁵ In 1994, the debtor completed and submitted 1040 forms to the IRS that contained the same wage information as the

¹⁴⁷ *See id.*

¹⁴⁸ *See In re Crawley*, 244 B.R. at 129.

¹⁴⁹ *See id.*

¹⁵⁰ *In re Nunez*, 232 B.R. 778 (B.A.P. 9th Cir. 1998).

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.* at 779-80.

¹⁵⁴ *Id.* at 780.

¹⁵⁵ *In re Nunez*, 232 B.R. at 780.

substitute forms prepared by the IRS.¹⁵⁶ Similar to *In re Crawley*, the IRS contended that Mr. Nunez did not submit “returns” for purposes of 11 U.S.C. § 523(a)(1)(B)(i) and therefore his tax liabilities were not dischargeable.¹⁵⁷ The IRS argued that the Mr. Nunez simply copied the figures provided on the substitute forms by the IRS, that Mr. Nunez's 1040 forms served no tax purpose and that Mr. Nunez's forms did not go along with the “self-reporting mechanisms of the Internal Revenue Code.”¹⁵⁸ Mr. Nunez on the other hand, argued that 11 U.S.C. § 523(a)(1)(B) “did not include an exception based on whether a return was filed before or after an assessment by the IRS and did not place a time limit on when the returns are to be filed.”¹⁵⁹ The debtor went on to argue that the only time limit specifically stated in the statute was the two-year waiting period between filing a return and seeking a discharge.¹⁶⁰

Like Judge Squires in *In re Crawley*, Judge Meyers looked to 11 USC § 523(a)(1)(B) to determine whether Mr. Nunez's tax liabilities were dischargeable.¹⁶¹ Judge Meyers did not buy into the IRS's contention that “[o]nce the IRS makes an involuntary assessment against a non-filing taxpayer, such as the debtor here, the taxpayer cannot claim that he has filed a return simply by tendering a standard form that reflects the IRS's prior determinations.”¹⁶² Judge Meyers wrote, “[s]everal courts have rejected this argument on the ground that it requires reading a requirement into the Bankruptcy Code that is not explicitly there.”¹⁶³ He continued by stating, “section 523(a)(1)(B) does not state that the return must be filed prior to an assessment by the IRS in order to be effective for dischargeability purposes.”¹⁶⁴ The Bankruptcy Appellate Panel believes that section 523(a)(1)(B) can be satisfied even if the IRS has prepared substitute

¹⁵⁶ *In re Nunez*, 232 B.R. at 780.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *In re Nunez*, 232 B.R. at 781.

¹⁶² *In re Nunez*, 232 B.R. at 781.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

tax forms for the taxpayer, if the debtor works with the IRS and takes actions to acknowledge the substitute forms are accurate and complete.¹⁶⁵

The ruling in *In re Nunez* is one that Bankruptcy Courts should acknowledge and follow today.¹⁶⁶ Rather than hurting bankruptcy petitioners who filed 1040 tax forms late by denying them the ability to discharge their tax liabilities, the Bankruptcy Appellate Panel of the Ninth Circuit acknowledged that there is no time requirement in section 523(a)(1)(B) that talks about pre or post assessment by the IRS.¹⁶⁷ The Ninth Circuit also realized that this could lead to abuse by bankruptcy petitioners, and added the caveat that as long as a debtor “cooperates with the IRS and takes actions that amount to adopting the substitute returns”¹⁶⁸ their tax liabilities still qualify for discharge under section 523(a)(1)(B).¹⁶⁹ The *In re Nunez* and *In re Crawley* rulings are good examples of how bankruptcy petitioners seeking to discharge tax liabilities should be treated by the courts.¹⁷⁰ No pre or post IRS tax assessment should be taken into consideration, and the petitioners should be treated on a case-by-case basis to see if they are willing to work with the IRS and fulfill the “honest and reasonable”¹⁷¹ requirement of the “Beard test.”¹⁷² This approach will ensure that the underlying principal behind bankruptcy, to help debtors in need, stays intact.

IX. *IN RE MORONEY*

While *In re Crawley* and *In re Nunez* decided that late filed 1040 tax forms, even after the IRS had assessed taxes for the taxpayer, were still eligible for discharge, the case *In re Moroney* had the opposite outcome.¹⁷³ The United States Court of Appeals was also presented with whether “delinquent personal income tax filings, submitted years after the Internal Revenue

¹⁶⁵ *Id.* at 781.

¹⁶⁶ *See id.*

¹⁶⁷ *See In re Nunez*, 232 B.R. at 781.

¹⁶⁸ *Id.*

¹⁶⁹ *See id.*

¹⁷⁰ *See In re Nunez*, 232 B.R. at 781; *see also In re Crawley*, 244 B.R. 121, 129 (Bankr. N.D. Ill. 2000).

¹⁷¹ *See In re Hindenlang*, 164 F.3d 1029, 1033 (6th Cir. 1999).

¹⁷² *See id.*

¹⁷³ *In re Moroney*, 352 F.3d 902 (4th Cir. 2003).

Service has already prepared its own assessments, constitute 'returns' for purposes of the Bankruptcy Codesubstitutes.”¹⁷⁴ Judge Wilkinson, writing for the Fourth Circuit, held that “income tax forms unjustifiably filed years late, where the IRS has already prepared substitute returns and assessed taxes, do not constitute 'returns' for purposes of 11 U.S.C. § 523(a)(1)(B)(i).”¹⁷⁵

In *In re Moroney*, the debtor, Mr. Moroney, did not file timely 1040 income tax forms for the years 1990 and 1992.¹⁷⁶ In court, Mr. Moroney did not provide an explanation or any evidence as why he filed his taxes late, instead his attorney simply stated that Mr. Moroney “just didn't get around to filing his tax returns' because he was 'extremely busy.’”¹⁷⁷ Because of Mr. Moroney's failure to file his tax returns on time, the IRS prepared “Substitutes for Returns” for Mr. Moroney and assessed taxes to him of \$23,197 for 1990 and \$45,567 for 1992.¹⁷⁸ In 1998 Mr. Moroney filed his 1040 income tax returns for the years 1990 and 1992.¹⁷⁹ The IRS, taking its usual approach, argued that because Mr. Moroney had filed his income tax returns late, he had not filed “returns” within the meaning of 11 U.S.C. § 523(a)(1)(B).¹⁸⁰

Unlike how Judge Squires and Judge Meyers interpreted 11 U.S.C. § 523(a)(1)(B), Judge Wilkinson and the Fourth Circuit believed that a debtor's timing when filing tax returns was relevant when analyzing dischargeability of tax liabilities.¹⁸¹ Judge Wilkinson believed that because Mr. Moroney filed his tax returns late, which resulted in the IRS assuming “the onerous task of estimating Moroney's taxes without his assistance,” coupled with Mr. Moroney's lack of an explanation as to why he filed his returns late could not amount to a “honest and reasonable”

¹⁷⁴ *Id.*

¹⁷⁵ *Id.* at 907.

¹⁷⁶ *Id.* at 903.

¹⁷⁷ *Id.* at 903-04.

¹⁷⁸ *In re Moroney*, 352 F.3d at 904.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.* at 904.

¹⁸¹ *Id.* at 906.

attempt to comply with tax law.¹⁸² Judge Wilkinson summed up the Fourth Circuit's opinion by writing:

We agree with the weight of authority that a debtor's delinquency is relevant to determining whether the debtor has filed a return. The very essence of our system of taxation lies in the self-reporting and self-assessment of one's tax liabilities. Timely filed federal income tax returns are the mainstay of that system. A reporting form filed after the IRS has completed the burdensome process of assessment without any assistance from the taxpayer does not serve the basic purpose of tax returns: to self-report to the IRS sufficient information that the returns may be readily processed and verified. Simply put, to belatedly accept responsibility for one's tax liabilities, only when the IRS has left one with no other choice, is hardly how honest and reasonable taxpayers attempt to comply with the tax code.¹⁸³

While the Fourth Circuit's ruling was not in favor of the debtor and appeared to make delinquent tax returns filed after the IRS has made its own assessment ineligible for discharge, Judge Wilkinson acknowledged that not all tax returns filed after IRS assessment would be ineligible.¹⁸⁴ As they had in the past, the IRS asked the Court to adopt the ruling that “any post-assessment filing can never qualify as a return for purposes of section 523(a)(1)(B)(i).”¹⁸⁵ The Fourth Circuit responded by saying, “[t]his simply goes too far. Circumstances not presented in this case might demonstrate that the debtor, despite his delinquency, had attempted in good faith to comply with the tax laws.”¹⁸⁶ These statements coincide more with Judge Squires' and Judge Meyers' rulings that there should not be a pre or post assessment time requirement read into section 523(a)(1)(B), and that every debtor should be given the opportunity to show that their tax returns were “honest and reasonable” attempts to fulfill tax law and should be eligible for discharge.¹⁸⁷

¹⁸² *Id.*

¹⁸³ *In re Moroney*, 352 F.3d at 904 (internal citations omitted).

¹⁸⁴ *Id.* at 907.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *See In re Nunez*, 232 B.R. 778, 781 (B.A.P. 9th Cir. 1998); *see also In re Crawley*, 244 B.R. 121, 129 (Bankr. N.D. Ill. 2000).

X. *IN RE SHINN*

The United States Bankruptcy Court for the Central District of Illinois recently encountered the question whether “a properly completed, signed and filed Form 1040 is treated as a federal income tax return for dischargeability purposes.”¹⁸⁸ Chief Bankruptcy Judge, Thomas Perkins, held that “the new definition of ‘return,’ added by BAPCPA to section 523(a), means that an untimely filed 1040 cannot be considered to be a return for dischargeability purposes, unless the narrow exception in IRC § 6020(a) applies.”¹⁸⁹

In *In re Shinn*, the debtor filed a Chapter 7 bankruptcy claim wishing to discharge his debts and federal income tax liability from 1998 through 2006.¹⁹⁰ The IRS stipulated to all of the years other than 2001 and 2002.¹⁹¹ The debtor filed tax returns for all years other than 2001 and 2002.¹⁹² The IRS assessed “a deficiency in income tax for 2001 in the amount of \$38,327.00, plus penalties and interest of \$18,427.08” and “a deficiency in income tax for 2002 in the amount of \$38,925.00, plus penalties and interest of \$10,931.69.”¹⁹³ In 2006, the debtor responded to the assessed penalties by filing a late 1040 form claiming a tax liability amount of \$21,893 for 2002.¹⁹⁴ The form purported to be signed by the debtor and his wife on April 14, 2003, with his tax preparer signing the previous day.¹⁹⁵ Similarly, in 2006, the debtor filed his 2001 1040 form claiming a tax liability amount of \$23,963.¹⁹⁶ The debtor's form maintained that he filed the form on April 15, 2002, with the tax preparer signing the form on April 13, 2002.¹⁹⁷ However, the debtor admitted that he did not generate payments to the IRS for the years of 2001 or 2002, but

¹⁸⁸ *In re Shinn*, No. 10-83750, 2012 WL 986752, at *1 (Bankr. C.D. Ill. Mar. 22, 2012).

¹⁸⁹ *In re Shinn*, 2012 WL 986752, at *6 (internal quotations omitted).

¹⁹⁰ *Id.* at *1.

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *In re Shinn*, 2012 WL 986752, at *1.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

attempted to mitigate his late payments by conceding that “his wife at the time (he [was] divorced) [was] spending the funds that were set aside for the tax payments.”¹⁹⁸ The IRS filed a motion for summary judgment claiming that the late tax returns filed by the debtor were not to be regarded as a legal tax return “because they were filed after the IRS assessed the [Debtor’s] tax liabilities.”¹⁹⁹ The IRS claimed that the late tax returns should have been treated in accordance with section 523(a)(B)(1)(i).²⁰⁰ Conversely, the debtor claimed that, although his 1040 forms were late for purposes of section 523(a)(1), they were dischargeable because “(1) the returns were filed prior to two years before the date of the petition; (2) the liability was due three years prior to the filing of the petition; and (3) the liability was assessed more than 240 days prior to the petition.”²⁰¹

A minority of courts have held that “the nondischargeability statute has separate provisions for unfiled tax returns and for late filed tax returns,”²⁰² and “it is not at all apparent why a debtor who files a completed 1040 after the filing deadline should be treated the same as one who never files a return at all.”²⁰³ A majority of federal bankruptcy courts, however, have held that a signed 1040 form could be filed as a tax return even if it was filed after “a unilateral assessment by the IRS.”²⁰⁴

In holding that the contemporary definition of “return” provides that “an untimely filed

¹⁹⁸ *Id.*

¹⁹⁹ *In re Shinn*, 2012 WL 986752, at *2.

²⁰⁰ *Id.* Debtors are discharged for a tax debt in which a required return was not filed. 523(a)(1)(B)(i).

²⁰¹ *In re Shinn*, 2012 WL 986752, at *2.

²⁰² *Id.* (citing *Matter of Arenson*, 134 B.R. 934 (Bankr. D. Neb. 1991), *aff’d* *Arenson v. U.S. Through I.R.S.*, 145 B.R. 310 (D. Neb. 1992); *In re Walsh*, 260 B.R. 142 (Bankr. D. Minn. 2001), *aff’d* *Walsh v. U.S.*, 2002 WL 1058073 (D. Minn. 2002); *In re Mickens*, 214 B.R. 976 (N.D. Ohio 1997), *aff’d* 173 F.3d 855 (6th Cir. 1999); *In re Shrenker*, 258 B.R. 82 (Bankr. E.D.N.Y. 2001)).

²⁰³ *Id.*

²⁰⁴ *Id.* (citing *In re Nunez*, 232 B.R. 778 (B.A.P. 9th Cir. 1999); *In re Savage*, 218 B.R. 126 (B.A.P. 10th Cir. 1998); *U.S. v. Klein*, 312 B.R. 443 (S.D. Fla. 2004); *In re Payne*, 306 B.R. 230 (Bankr. N.D. Ill. 2004), *aff’d* 331 B.R. 358 (N.D. Ill. 2005); *In re Woods*, 285 B.R. 284 (Bankr. S.D. Ind. 2002), *rev’d* *U.S. v. Woods*, 2004 WL 882057 (S.D. Ind. 2004); *In re Crawley*, 244 B.R. 121 (Bankr. N.D. Ill. 2000); *In re Pierchoski*, 220 B.R. 20 (Bankr. W.D. Pa. 1998), *vacated* 243 B.R. 639 (W.D. Pa. 1999)).

1040 cannot be considered to be a return for dischargeability purposes,²⁰⁵ the court reasoned that the “Beard test,”²⁰⁶ formulated by the Sixth Circuit in *Beard v. Commissioner of Internal Revenue*,²⁰⁷ followed by the Fourth Circuit,²⁰⁸ and also the Seventh Circuit’s opinion in *In re Payne*,²⁰⁹ and the Eighth Circuit’s opinion in *In re Colsen*,²¹⁰ was controlling as to the issue of whether “a properly completed, signed and filed Form 1040 is treated as a federal income tax return for dischargeability purposes.”²¹¹

Despite Judge Perkins's holding that “an untimely filed 1040 cannot be considered to be a return for dischargeability purposes,”²¹² the IRS asked Judge Perkins to instead adopt the holding of *In re Hindenlang*.²¹³ In *In re Hindenlang*, the court held “that a 1040 is too late to be a return only if filed after the IRS has already assessed the tax liability.”²¹⁴ Judge Perkins noted that the IRS had been pushing courts to adopt this position in the federal courts for years and finally gained traction in the circuit courts.²¹⁵ Judge Perkins however, said the IRS's position was seriously flawed as a matter of statutory interpretation and did not adopt the holding of *In re Hindenlang*.²¹⁶ He gave his reasoning by stating:

Presumably, Congress was made aware of the IRS's position during the eight years that bankruptcy reform legislation was pending prior to the

²⁰⁵ See *In re Shinn*, 2012 WL 986752, at *6.

²⁰⁶ The Beard test is a four prong test that determines whether a taxpayer document purporting to be a “return” is truly a legal tax return: (1) it must purport to be a return; (2) it must be signed 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. See *Beard v. Commissioner of Internal Revenue*, 82 T.C. 766, 777 (T.C. 1984), *aff'd*, 793 F.2d 139 (6th Cir.1986).

²⁰⁷ *Beard v. Commissioner of Internal Revenue*, 82 T.C. 766 (T.C. 1984).

²⁰⁸ *In re Moroney*, 352 F.3d 902 (4th Cir. 2003) (debtor filed late 1040 forms after IRS had assessed his tax liability for the years in question. The Fourth Circuit held preparing substitute returns and assessed taxes by the IRS do not constitute “returns” for purposes of 11 U.S.C. § 523(a)(1)(B)(i)). In *re Moroney*, 352 F.3d at 907.

²⁰⁹ *In re Payne*, 431 F.3d 1055 (7th Cir. 2005) (“The court reasoned that the legal test is not whether the filing of a purported return has some utility for the IRS, but whether it is “a reasonable endeavor to satisfy the taxpayer's obligations.”) *Id.* at 1058.

²¹⁰ *In re Colsen*, 446 F.3d 836 (8th Cir.2006) (affirming the judgment discharging the liability, holding that the “honesty and genuineness of the filing should be determined on the face of the form itself, not from the filer's delinquency or the reasons for it. Since the debtor's 1040s allowed his tax obligation to be computed accurately, they served a valid purpose under the tax laws.”) *In re Shinn*, 2012 WL 986752, at *5.

²¹¹ See *In re Colsen*, 446 F.3d 836, 838 (8th Cir. 2006).

²¹² *In re Shinn*, 2012 WL 986752, at *6

²¹³ *Id.* (citing *In re Hindenlang*, 164 F.3d 1029, 1034 (1999)).

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.*

2005 enactment of BAPCPA. Yet, when Congress settled on a definition of “return,” it did not adopt the long-sought-after rule advocated by the IRS in so many bankruptcy cases. In its argument before this Court, the IRS does not attempt to explain how the new definition came to be included in the bill that became BAPCPA or why its preferred definition was left on the cutting room floor. In effect the IRS is asking this Court to adopt its position not *because of* the language of the new definition, but *in spite of* that language. This Court is simply not inclined to engage in the judicial legislation to which that would amount.²¹⁷

Judge Perkins took a similar approach to Judge Squires and Judge Meyers in *In re Crawley* and *In re Nunez*, by not reading a pre or post assessment position into the Bankruptcy Code section 523(a)(1)(B).²¹⁸ However, instead of allowing bankruptcy petitioners who have filed their 1040 tax forms late to still be eligible to discharge their tax liabilities, Judge Perkins instead read section 523(a)(1)(B) to not allow any late filed 1040 tax return to be eligible for discharge.²¹⁹ Judge Perkins's interpretation of section 523(a)(1)(B), unlike Judge Squires's and Judge Meyers's, will hurt bankruptcy petitioners.²²⁰ There are “honest and reasonable”²²¹ bankruptcy petitioners who need their past tax liabilities discharged to start fresh lives. If those petitioners had filed their 1040 tax returns even a day late, on April 16th or later, then Judge Perkins's interpretation of section 523(a)(1)(B) will not allow their tax liabilities to be eligible for discharge.²²² So, while Judge Perkins correctly identified that section 523(a)(1)(B) should not have a pre or post IRS assessment requirement read into it, he ultimately made a ruling that will hurt “honest and reasonable”²²³ bankruptcy petitioners who filed their 1040 tax returns late.²²⁴

XI. CONCLUSION

²¹⁷ *In re Shinn*, 2012 WL 986752, at *6.

²¹⁸ *See In re Shinn*, No. 10-83750, 2012 WL 986752, at *6 (Bankr. C.D. Ill. Mar. 22, 2012); *see In re Nunez*, 232 B.R. 778, 781 (B.A.P. 9th Cir. 1998); *see In re Crawley*, 244 B.R. 121, 129 (Bankr. N.D. Ill. 2000).

²¹⁹ *See In re Shinn*, No. 10-83750, 2012 WL 986752, at *6 (Bankr. C.D. Ill. Mar. 22, 2012).

²²⁰ *See id.*; *see In re Nunez*, 232 B.R. 778, 781 (B.A.P. 9th Cir. 1998); *see In re Crawley*, 244 B.R. 121, 129 (Bankr. N.D. Ill. 2000).

²²¹ *See In re Hindenlang*, 164 F.3d 1029, 1033 (6th Cir. 1999).

²²² *In re Shinn*, 2012 WL 986752, at *6.

²²³ *See In re Hindenlang*, 164 F.3d 1029, 1033 (6th Cir. 1999).

²²⁴ *In re Shinn*, 2012 WL 986752, at *6.

Overall, bankruptcy is a concept that arose so that debtors who fell on hard times had the opportunity to start their lives fresh and continue to try to live normal lives. Bankruptcy is supposed to help honest and reasonable petitioners who need a second chance with creditors. The idea behind the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005²²⁵ was to prevent bankruptcy abuse, however the hanging paragraph of section 523(a) will hurt bankruptcy petitioners who have made honest and reasonable attempts to file their 1040s on time. Courts have stated that the statutory interpretation of the code would have the outcome that a taxpayer who files after the April 15th deadline for the year the tax “return” was due to have not filed a “return” and therefore not able to discharge their tax liability for that year in a Chapter 7 bankruptcy.²²⁶ However, the IRS has asked courts to instead interpret the statute to allow late filers to discharge their tax liability for that year unless the IRS had assessed the person's taxes for them.²²⁷ Therefore, the issue of whether a person can discharge their tax liability for a year that they filed a tax return after April 15th, but before the IRS assessed the taxes for the person can arise in the future. Although courts have not been presented this issue yet, based on the cases out there interpreting the new hanging paragraph to 11 USC section 523(a) it appears courts will not rule in favor of allowing the discharge of tax liability.

Also, the Bankruptcy Abuse Prevention and Consumer Protection Act addition of the hanging paragraph to 11 USC § 523(a) failed to correctly define “return” for taxpayers.²²⁸ Because of this incorrect definition, there is the potential for bankruptcy petitioners to be hurt rather than helped. Therefore, Congress should finally define the term “return” for bankruptcy purposes, and until they do so the Bankruptcy Courts should revert back to using the old “Beard

²²⁵ See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

²²⁶ See *In re Nunez*, 232 B.R. 778, 781 (B.A.P. 9th Cir. 1998).

²²⁷ See *id.*

²²⁸ 11 U.S.C. § 523(a) (2010).

test.”²²⁹ While the “Beard test” would require bankruptcy petitioners to again have to satisfy the four requirements of the test and prove that their returns were “honest and reasonable,”²³⁰ the “Beard test” would allow more bankruptcy petitioners the ability to discharge their tax liabilities.²³¹ If courts take the approach that Judge Perkins and the Bankruptcy Court for the Central District of Illinois recently took, the interpretation of the hanging paragraph of 11 USC § 523(a) will lead to honest bankruptcy petitioners who filed their tax returns after April 15th to not be able to discharge their tax liabilities for that year.²³² Instead, courts should adopt the approach taken by Judge Squires and Judge Meyers in *In re Crawley* and *In re Nunez* and not read into 11 USC § 523(a)(1)(B)(i) that a tax return be timely filed in order to qualify as a “return” for dischargeability purposes.²³³

Ultimately the hanging paragraph of 11 USC § 523(a) defeats the underlying principal of bankruptcy, to help debtors in need establish a fresh start.²³⁴ The idea of helping debtors in need has been in existence since the days of the Old Testament,²³⁵ and is something we as a society should continue to strive to do.

²²⁹ See *In re Hindenlang*, 164 F.3d 1029, 1033 (6th Cir. 1999).

²³⁰ See *id.*

²³¹ See *id.*

²³² See *In re Shinn*, No. 10-83750, 2012 WL 986752, at *6 (Bankr. C.D. Ill. Mar. 22, 2012).

²³³ See *In re Crawley*, 244 B.R. 121 (Bankr. N.D. Ill. 2000); see also *In re Nunez*, 232 B.R. 778 (B.A.P. 9th Cir. 1998).

²³⁴ See 11 U.S.C. § 523(a) (2010).

²³⁵ See *Deuteronomy* 15: 1-2 (New International Version).