IV. CONCLUSION

Is the CAP a fair appeals process for the taxpayer? Should the CAP ever be used if a taxpayer has the opportunity to appeal his/her issue in a CDP instead? Why isn't the CDP process expanded to include all the issues that are able to be reviewed in the CAP? If this were the case, the taxpayer would be able to seek judicial review of more collection issues. If possible, the Taxpayer should appeal his/her collection issue in the CDP process rather than the CAP process. This will ensure that the Taxpayer has the opportunity for judicial review which is essential in making sure there is proper oversight to such important collection tax issues that many taxpayers face. Without the potential judicial review of an appeals conference decision, the taxpayer is placed in a serious disadvantage for his/her tax issue.

The IRS Substitute for Return: Sudden Death, or Hold Your Breath?

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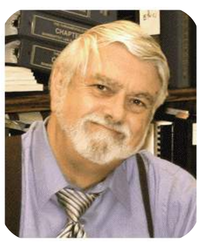

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Lawyers who handle consumer tax-discharge bankruptcy cases are presumably well acquainted with the five rules for income tax discharge.[1] These remarks address just one of them: the rule that, to discharge the taxes, the taxpayer must have filed his or her 1040 tax return for the tax year at issue, more than two years before filing the bankruptcy.[2]

In the typical bankruptcy case with delinquent income taxes the tax history will follow the ordinary, expected sequence of events: the taxpayer first files his or her return showing taxes due. There may or may not be a check with the return. Subsequently, the IRS assesses the taxes based on information on the return.

But in some cases the sequence is different: the taxpayer fails to file the 1040 in a timely manner, and eventually the IRS files a substitute for return ("SFR") for him or her. The SFR is always blank. It contains no information, and no actual dollar figure will appear with the SFR on a taxpayer's IRS Account Transcript. It is filed simply to get the account going in the IRS system. Sometime after the SFR is filed, the IRS may proceed to assess the actual tax liability, followed by the taxpayer filing a tardy 1040, or the reverse, *i.e.*, taxpayer files his or her 1040 before the IRS assesses the tax but after the SFR is filed. So, in those situations, you have a taxpayer's return filed either pre-assessment or post-assessment.

[1] *See* King's *Discharging Taxes in Bankruptcy*, Part 2, *Discharging Taxes in Chapter 7,* and Part 3, *Discharging Taxes in Chapter 13*.

[2] 11 U.S.C. § 523(a)(1)(B)(i) and (ii).

Here is an important point: the SFR by itself is not an assessment. Ordinarily SFR's do not contain tax liabilities. Technically, there is no such thing as an "SFR assessment." And, in most jurisdictions, whether the account begins with an SFR or not has little to no bearing on whether the tax is dischargeable.[3] In most jurisdictions, including the Ninth Circuit, it's what happens after an SFR is filed that determines dischargeability.

We all know that you never rely on the client for exact recollections of the sequence of events in connection with his or her back taxes. Most debtors' memories are seriously compromised by the time they see you in the office; they don't know for sure if they filed a tax return, if the IRS filed an SFR, whether they filed a collection appeal, whether there was an audit assessing additional taxes, or where they left their head, etc.

The best way to determine the actual dates of relevant events is to obtain the taxpayer's IRS Account Transcripts, and one for each tax year for which there are delinquent taxes. The account transcripts[4] are typically obtained by calling the IRS Priority Hotline[5] and requesting that they be faxed to the lawyer's office.[6]

The IRS commences its formal record (or "account") of each tax year with a 3-digit "transaction code," sometimes called a "master file code," in particular, code "150," appearing on the account transcript. This is the code that appears first in line on the history of the account. It is typically followed by a series of other events, each with its respective transaction code. Below the SFR entry it is not unusual to see, for example, code "460" for an extension to file the return, code "420" meaning that an audit was started, code "290" or "300" for an additional assessment, etc. Each code is accompanied by a short explanation. Hence, for example, code "420" usually appears with " … return has been referred to the Examination or Appeal Division." In other words, an audit.

When the IRS files an SFR it shows up with code "150." The words next to code 150 are often misleading. They typically say "Return Filed and Tax Assessed," with a date and, if actual money is reported, the amount. Be aware that this is not the date the return was filed, and in many cases is not the date the tax liability was assessed. The date the return was filed will appear several lines above the code 150; look for "Return Due Date or Return Received Date (Whichever is Later)." The date shown there is either the date the taxpayer's 1040 return was filed, or the date an SFR was filed.

The question then arises, if the account begins with an SFR, does it mean the taxes cannot be discharged? The answer is *not necessarily*. To satisfy the 2-year rule prescribed at 11 U.S.C. § 523(a)(1)(B)(ii), the taxpayer must have filed his or her 1040 tax return more than two years before the petition is filed. So, for this purpose two questions must be answered; (1) did the taxpayer file something that qualifies as a return, and (2) if so, when?

The weight of authority in the Ninth Circuit is that merely because the IRS kicked off the account by filing an SFR it does not mean the debtor failed to file a tax return[7]. Delinquent taxpayers often file their 1040 returns after SFRs have already been filed. If they did file them, dischargeability may be determined by the date the returns were filed[8].

Did the taxpayer file a return? There are several clues to look for on the transcript. Several lines above the "Return Due Date …" find "Tax Per Return." If there is a dollar amount shown, that is almost certainly derived from the taxpayer's

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[3] Except in those jurisdictions in the Fifth Circuit *In re McCoy,* 666 F.3d 924 (5th Cir. 2012)*,* line of cases, discussed *infra*.

[4] Not to be confused with the "Transcript of Return," which the debtor is required to provide to the trustee if the return itself is not available. 11 U.S.C. § 521(e)(2)(A).

[5] Although, the IRS now has a way to obtain the transcripts electronically. *See* IRS.gov for details. The author finds it too cumbersome to use.

[6] They will usually fax them while you hold the phone.

[7] Outside the Ninth Circuit the cases are split on this question. The most recent opinion addressing it is the Tenth Circuit case, *In re Mallo*, __F.3d __ (10th Cir. 2014), 2014 WL 7360130, adopting the *McCoy* rule.

[8] This presumes that the returns were valid Form 1040 returns that contain the math necessary for the IRS to assess the taxes, are signed under penalty of perjury, etc. See the 4-pronged test found in *Beard v. Commissioner,* 793 F.2d 139 (6th Cir. 1986), followed by the majority of courts.

1040 and demonstrates the taxpayer filed the return. If he or she filed a 1040 return, it will typically be evident by code 150 showing an actual dollar amount, as well.

If the taxpayer files the return after an SFR is filed, in most cases it shows up further down on the respective transcript as code "976" or "977." These codes mean "Posted Duplicate Return."[9] But in almost all cases with an SFR filed, followed down the line by a 976 or 977, that code is the date the taxpayer filed his or her 1040 return; the IRS identifies it as an "amended" return for two reasons; they deem the 1040 to be an amendment of the SFR (by including actual information); and, they don't have a separate 3-digit code for an original return where the 150 code is already taken up by the SFR. But, a 976 or 977 is a 1040 "return" within the meaning of the two-year rule.

Accordingly, just because you see an SFR on the transcript, don't give up; instead, hold your breath … and hope you find evidence of the taxpayer's return somewhere on the transcript. The key clues include:

- A dollar amount shown with "Tax Per Return."
- A dollar amount shown with code "150."
- A transaction code 976 or 977 appearing on the transcript.
- Transaction codes 599, 610, 806 (require a call to IRS Hotline to verify). [10]

There are other clues to a taxpayer's return. However, if it isn't clearly determined by one or more of the above indicators, it's probably prudent to call the IRS Priority Hotline and simply ask the Hotline person whether or not your client filed a tax return for that year, and write down what she sees on the transcript that identifies it as the taxpayer's 1040 the Hotline person.

Let's assume a hypothetical that the account begins with an SFR and a blank 150, but it is determined that the taxpayer eventually filed his or her 1040 tax return. So, the first question, did the taxpayer file a 1040 tax return, is answered in the affirmative. Now what?

There are several issues that arise in connection with when the taxpayer filed the return. The first question is: was the return filed more than two years before the petition was or will be filed? If not, the client should be advised to wait until the 2-year period from the date the return is filed expires. A tax for which the return was filed within 2 years preceding the petition date is excepted from discharge per 11 U.S.C. § 523(a)(1)(B)(ii).

Let's assume, again hypothetically, the taxpayer filed or will file the 1040 more than two years before the petition date. The next question is, was the return filed before the tax was assessed, or after? The dischargeability of the tax may depend on whether the return was filed *before*, or *after*, the assessment.

Look on the transcript for code "290" or code "300." In cases begun with an SFR, these are the codes indicating the dates the assessments were eventually made. If there is no dollar figure with the code, you can disregard that date. Look for a 290 or a 300 showing an actual dollar amount. That is the date those dollars were assessed,[11] and the date for that assessment must be more than 240 days before the bankruptcy petition is filed for that assessment to be dischargeable.

In some jurisdictions a tax return filed late (after the due date), regardless of whether filed pre- or post-assessment, is not a valid tax return. This is the line of cases arising from a Fifth Circuit case, *McCoy v. Mississippi State Tax Comm'n*, 666

[9] The information on the transaction codes is found in the IRS publication Document 6209 - ADP and IDRS Information, 2014.

[10] Code "599" usually suggests a 1040, but in some cases it does not. Similarly, codes 806 and 610 with a dollar amount suggest a 1040. The 610 code indicates "Credits the tax module with a payment received with the return." Any of these codes should prompt you to contact the Priority Hotline to verify.

[11] Keep in mind to be dischargeable the assessment must be more than 240 days before the petition date in order to satisfy the 240-day rule prescribed by 11 U.S.C. § 507(a)(8)(A)(ii) (one of the five rules).

F.3d 924 (5th Cir. 2012), which I refer to as the "McCoy rule." *McCoy* held that certain language inserted into the Bankruptcy Code by BAPCPA[12] means that if the tax return is filed late, even for just one day, for that reason alone it is by definition not a valid return.[13] Under this interpretation, whether the return is filed by the due date is the litmus test.

Under this rule, if the return is filed after the due date,[14] the date the tax was assessed, or the return was filed, is irrelevant. This rule has been adopted by a number of jurisdictions. But, the Ninth Circuit has not heretofore adopted the *McCoy* rule.

The IRS rejects the McCoy rule; IRS policy[15] is that merely filing late, by itself, does not determine whether the return is valid or invalid for purposes of the 2-year rule. However, the IRS explicitly argues that a return filed not just late but *after the tax is assessed* is invalid for bankruptcy cases. Basically the IRS argues that a post-assessment return serves no purpose, because the taxes have already been determined. For this reason they argue it serves no purpose and hence is not a valid tax return.

This is the last question that must be addressed; if the return is filed after an SFR *and after the tax is assessed*, is it a valid return for purposes of the 2-year rule?

The two most recent California bankruptcy cases that have addressed the issue have rejected both the McCoy rule and the IRS position on post-assessment returns, and held that merely filing the return late and after the assessment does not, by itself, render the return invalid. *McCoy* mentioned and rejected. *Martin v. Internal Revenue Serv*. (Bankr. E.D. Cal., 2014); *In re Smith* (Bankr.N.D. Cal. 2014).

Instead, the courts have determined the validity of the tax return based on what is typically called the 4-part *Beard* Test. *Beard v. Commissioner,* 82 T.C. 766, 774-79 (1984), *aff'd,* 793 F.2d 139 (6th Cir.1986)).

The *Beard* opinion sets the following criteria:

- First, there must be sufficient data to calculate tax liability;
- Second, the document must purport to be a return;
- Third, the taxpayer must execute the return under penalties of perjury;
- Fourth, there must be an honest and reasonable attempt to satisfy the requirements of the tax law.

The main focus of the two opinions (and many cases in other jurisdictions addressing the same issues) is typically the fourth prong; under the particular facts in the case was the filing of the return "an honest and reasonable attempt to satisfy the requirements of the tax law"? This is a subjective test, not the bright-line *McCoy* rule.

In *Martin*, the IRS had assessed the taxes on March 16, 2009. The debtors filed the salient tax returns on June 2, 2009. The opinion observed that: "The IRS accepted the Martins' three Form 1040s and adjusted its assessments to match the amounts stated therein." In answering the question, were the returns honest and reasonable attempts to satisfy the requirements, the court cited the fact that the taxpayers had retained the services of an accountant to prepare their returns in August of 2008, and finally signed and filed them in June of 2009, less than three months after the assessments. Based on that fact pattern the *Martin* court found the tax returns to be valid for bankruptcy purposes, and the taxes were discharged.

[12] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

[13] The text *McCoy* points to is "(including applicable filing requirements)" found in the hanging paragraph attached to 11 U.S.C. § 523(a)(19).

[14] For IRS taxes this would be April 15, or October 15, of the following year.

[15] *See* Notice of Office of Chief Counsel CC-2010-016, *Litigating Position Regarding the Dischargeability of Tax Liabilities Reported on Late-Filed Returns and Returns Filed After Assessment*, dated September 20, 2010.

In *Smith*, the bankruptcy court originally held the taxes to be dischargeable. But in this case the taxpayer's conduct after the assessment was more problematical and based on those facts the District Court reversed the bankruptcy court's ruling. Like *Martin*, the *Smith* District Court opinion rejected the *McCoy* litmus test, and based its ruling on the *Beard* criteria, in particular the fourth prong, honest and reasonable attempt. The tax transcript in question for tax year 2001 began with an SFR. Subsequently the court recited the facts that the IRS assessed the taxes on July 31, 2006, but the taxpayers did not file the returns until seven years after the due date and three years after the IRS assessed them and commenced collection. The court ruled that: "the 'honest and reasonable attempt' factor necessarily involves an individualized review of the equities." The court went on to note, "the meaning of 'return' must take into account the late-filer's evidence of a good faith attempt to comply…" In this case, based on these individualized facts, the court held it could not find the taxpayer's conduct to meet that test. Hence, the taxes were held non-dischargeable.

In both cases, the taxpayers' post-assessment returns resulted in IRS adjustments to the assessments. Hence, it could be argued that they both served a purpose and therefore should be deemed valid. In the case of *Martin* the assessments increased the liabilities for one year and decreased them for another.[16] In the case of *Smith*, the taxpayer's return resulted in an additional assessment of $40,095.[17] In neither case did this fact appear to be significant to the court. However, cases in other jurisdictions have often cited the change in the liability, based on the tardy 1040, as indicating the return served a purpose and hence is deemed valid.[18]

Some courts deem a tax return filed after the filing of an SFR to be, by definition, invalid, for failing the Fifth Circuit *McCoy* litmus test. However, outside of the *McCoy* environment, whether an SFR was filed or not has little to no bearing on the validity of a subsequently filed tax return. The weight of authority is that a post-SFR, pre-assessment filed return is a valid return. On the other hand, a post-SFR, post-assessment return is more problematical, but is not dispositive.

Here in the Ninth Circuit the two most recent cases addressing the issue arrived at different conclusions, but both based their rulings on the individual facts of each case, and relied on the *Beard* Test to govern the issue. The fact that the returns were filed after both the SFR's and the assessments were filed, was not dispositive.

The upshot of all this is that the fact that the returns were filed after the SFR was filed did not determine the outcome.

What was dispositive was the taxpayer's overall conduct regarding the tax liabilities, and in particular, the extent to which it can be shown that the taxpayer acted with an "honest and reasonable attempt" to comply with the tax laws. Particular attention was paid to the taxpayers' post-assessment behavior.

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16 *Martin*, fn. 6

17 *Smith*, fn.1

18 For example, *Izzo v. United States,* 287 B.R. 158, 162 (Bkrtcy.E. D.Mich. 2002) ("The IRS argues that if the debtor's amended returns had resulted in an *increase* in his liability, they would have possibly served a tax purpose. However, there is simply no basis for the Court to conclude that returns which increase a taxpayer's liability serve a purpose under the tax code while returns that have the effect of reducing a taxpayer's liability do not."). Same ruling, *In re Colsen*, 311 B.R. 765 (Bankr. N.D. Iowa, 2004).