



Section of Taxation

Suite 400
1050 Connecticut Avenue, NW
Washington, DC 20036
202-662-8670
FAX: 202-662-8682
E-mail: tax@americanbar.org

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July 29, 2014

The Honorable Ron Wyden
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Orrin G. Hatch
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Re: Proposed Amendment to Section 523(a) of the Bankruptcy Code

Dear Chairmen and Ranking Members:

Enclosed please find a proposal for a statutory amendment to section 523(a) of Title 11 of the United States Code (the Bankruptcy Code). This proposal is submitted on behalf of the American Bar Association Section of Taxation and has not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, this proposal should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the proposal with you or your staff if that would be helpful.

Sincerely yours,

Michael Hirschfeld
Chair, Section of Taxation

Enclosure

cc: Mr. Joshua Sheinkman, Majority Staff Director, Senate Finance Committee
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee
Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee
Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Honorable Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Honorable John Koskinen, Commissioner, Internal Revenue Service
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service

**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
PROPOSED AMENDMENT TO SECTION 523(a)
OF THE BANKRUPTCY CODE**

This proposal (“Proposal”) for a statutory amendment to section 523(a) of Title 11 of the United States Code (the Bankruptcy Code) is submitted on behalf of the American Bar Association Section of Taxation and has not been approved by the House Delegates or the Board of Governors of the American Bar Association. Accordingly, this Proposal should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing this Proposal was exercised by Kenneth C. Weil for the Bankruptcy and Workouts Committee. Substantive contributions were made by the following members of the Bankruptcy and Workouts Committee and the Pro Bono and Low Income Tax Clinics Committee: Philip Rosenkranz, Thomas Allington, Maria Dooner, and Kent Anderson. The Proposal was reviewed by Lee Zimet, Chairman of the Bankruptcy and Workouts Committee. The Proposal was also reviewed by Bahar Schippel, Council Director for the Bankruptcy and Workouts Committee, and Frances Sheehy of the Section’s Committee on Government Submissions.

Although members of the Section of Taxation who participated in preparing this Proposal have clients who may be affected by this amendment addressed or have advised clients on the application of this proposal, no member has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this amendment.

Contact:

Kenneth C. Weil
Phone: (206)292-0060
Email: weilkc@weilkc.com

Date: July 29, 2014

EXECUTIVE SUMMARY

This legislative recommendation proposes an amendment to the first sentence of the last paragraph of section 523(a) to title 11 of the United States Code (generally referred to as the Bankruptcy Code).¹ That sentence currently reads as follows:

For purposes of this subsection, the term “return” means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements).

It is recommended that the phrase “other than timeliness” be added to the parenthetical language so that it would read “(including applicable filing requirements other than timeliness).”

Section 523(a)(1)(B) provides exceptions to discharge for a tax liability with respect to which (i) no return was filed or (ii) a return was filed late and the taxpayer filed for bankruptcy within two years thereafter. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)² added the Hanging Paragraph at the end of section 523(a) to address what constitutes a return under section 523(a). If a document does not qualify as a return under the Hanging Paragraph, it results in a nonfiled return under section 523(a)(1)(B)(i). This means discharge is denied for any tax reported on the document. Some courts have interpreted the phrase “applicable filing requirements” to include the filing-due-date. As a result, taxes on late returns, even if only one-day late, are denied a discharge in those courts (the “One-Day-Late Rule”). This reasoning has been followed in one circuit court and a number of bankruptcy courts.

The One-Day-Late Rule appears to conflict with section 523(a)(1)(B)(ii), which allows for the discharge of taxes on late-filed returns as long as two years have passed between the tax-return-filing date and the bankruptcy-petition-filing date. If returns under section 523(a)(*) are only timely filed ones, section 523(a)(1)(B)(ii) is reduced to a meaningless provision. We have not found anything in the legislative history that suggests such a dramatic change in section 523(a)(1)(B)(ii) was intended. The One-Day-Late Rule potentially denies a discharge for those taxpayers who are not penalized under the tax law for filing late.

¹ The entire paragraph is generally cited as 11 U.S.C. § 523(a)(*), and that paragraph is often referred to as the “Hanging Paragraph.” The citation is taken from note three in *McCoy v. Miss. State Tax Comm’n*, 666 F.3d 924, 926 n.3 (5th Cir. 2012) (“We use asterisk to cite to this unnumbered hanging paragraph, something we have done in other cases.”), *cert. denied*, 133 S.Ct. 192 (2012).

² P.L. 109-8, 119 Stat. 23.

DISCUSSION

Background

Section 523(a)(1) of the Bankruptcy Code³ sets forth exceptions to the discharge of tax liabilities. Section 523(a)(1)(A) provides restrictions on discharge based on the type of tax, date of assessment, and the age of the tax debt. Section 523(a)(1)(B)(i) and (ii) address non-filed and late-filed returns. Section 523(a)(1)(C) deals with fraudulent returns and willful attempts to evade or defeat the tax. The Hanging Paragraph in section 523(a)(*) states that a “return” for purposes of this subsection is “a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements).” The Hanging Paragraph also provides that the term “return” includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code (IRC) (return prepared by the Service with information disclosed by the taxpayer and signed by the taxpayer) but does not include a return made pursuant to IRC section 6020(b) (a return made by the Service after the taxpayer fails to file a return).⁴

Present Law

Courts have interpreted the “applicable filing requirements” language in the first sentence of the Hanging Paragraph in two different ways.⁵ Under the One-Day-Late Rule, courts read applicable filing requirements to include the due date for filing a tax return. This means a late-filed return, even one-day late, is not a return under section 523(a)(1) and taxes on those returns are nondischargeable.⁶

Other courts do not include timeliness as part of applicable filing requirements, *i.e.*, timely filing is not a precondition for the discharge of taxes. Applicable filing requirements looks to “what” is filed not “when” it is filed.⁷

³ 11 U.S.C. § 523(a)(1).

⁴ This recommendation deals solely with the One-Day-Late Rule. It takes no position on whether a taxpayer can file a valid income tax return for purposes of § 523(a)(1) after the IRS makes a deficiency assessment against the nonfiling taxpayer. *See, e.g., Martin v. United States (In re Martin)*, 500 B.R. 1 (D. Colo. 2013); and *Martin v. IRS (In re Martin)*, 508 B.R. 717 (Bankr. E.D. Cal. 2014).

⁵ The current text of the Hanging Paragraph is found in the Legislative History section of this recommendation.

⁶ *See, e.g., McCoy v. Miss. State Tax Comm’n (In re McCoy)*, 666 F.3d 924 (5th Cir. 2012), *cert. denied*, 133 S. Ct. 192 (2012); *Creekmore v. IRS (In re Creekmore)*, 401 B.R. 748 (Bankr. N.D. Miss. 2008); and *Pendergast v. Mass. Dep’t of Revenue (In re Pendergast)*, 494 B.R. 8 (Bankr. D. Mass. 2013). Currently, *McCoy* is the only circuit court opinion on this issue. *See also, In re Payne*, 431 F.3d 1055, 1060 (7th Cir. 2005) (Judge Easterbrook dissenting) (after BAPCPA, tax on late-filed return is nondischargeable).

⁷ *See, e.g., Gonzalez v. Mass. Dep’t of Rev. (In re Gonzalez)*, 506 B.R. 317, 328 (1st Cir. B.A.P. 2014) (definition of return in Hanging Paragraph appears grounded on what is filed not when it is filed); *Martin v. United States (In re Martin)*, 500 B.R. 1, 7 (D. Colo. 2013) (court declines to follow One-Day-Late Rule but does find tax nondischargeable); *Rhodes, III v. United States (In re Rhodes, III)*, 498 B.R. 357 (Bankr. N.D. Ga. 2013); and Office of Chief Counsel Notice 2010-16 (tax debt on late-filed return can be discharged).

Legislative History

The legislative history sheds no light on the meaning of “applicable filing requirements.” In 1997 and 1998, the first versions of the legislation that became BAPCPA were introduced in Congress. The House version proposed some changes to section 523(a)(1)(B), and some of that language made its way into BAPCPA. The House version had no “applicable filing requirements” language, and it provided as follows:

(iii) for purposes of this subsection [§ 523(a)(1)(B)], a return--

(I) must satisfy the requirements of applicable nonbankruptcy law, and 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 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 similar State or local law; and

(II) must have been filed in a manner permitted by applicable nonbankruptcy law ...⁸

This bill passed both the House and Senate but died in Conference.

In the 106th Congress, the Hanging Paragraph made its first appearance. The “applicable filing requirements” language can be found in the bill that passed the House and Senate and was sent to President Clinton for his signature. That bill provided as follows:

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.⁹

Thereafter, all subsequent versions of the bill included this exact language, and it is this

⁸ H.R. 3150, 105th Cong. § 515 (1998).

⁹ S.3186, 106th Cong. § 714 (2000). This bill became a part of H.R. 2415, 106th Cong. § 1 (2000) (“The provisions of S. 3186 of the 106th Congress, as introduced on October 11, 2000, are hereby enacted into law.”) H.R. 2415 is the bill that was pocket vetoed by President Clinton.

version that was enacted in 2005 and is in the Bankruptcy Code today.

The best legislative description of this “new” provision is found in a report inserted into the Congressional Record when the 2000 Bill, as approved in Conference, was under consideration for final approval in the Senate. It provided as follows:

In general, taxpayers cannot be discharged from taxes unless a return was filed. Courts have struggled with what constitutes filing a return. The tax code authorizes the Secretary of Treasury to file a return on behalf of a taxpayer if either (1) the taxpayer provides information sufficient to complete a return, or (2) the Secretary can obtain sufficient information through testimony or otherwise to complete a return.

The conference agreement modifies section 523(a) of the Bankruptcy Code to provide that a return filed on behalf of a taxpayer who has provided information sufficient to complete a return constitutes filing a return (and the debt can be discharged) but that a return filed on behalf of a taxpayer based on information the Secretary obtains through testimony or otherwise does not constitute filing a return (and the debt cannot be discharged).¹⁰

The Committee Reports accompanying BAPCPA describe the amendment as follows:

Section 714 of the Act amends section 523(a) of the Bankruptcy Code to provide that a return prepared pursuant to section 6020(a) of the Internal Revenue Code, or similar State or local law, constitutes filing a return (and the debt can be discharged), but that a return filed on behalf of a taxpayer pursuant to section 6020(b) of the Internal Revenue Code, or similar State or local law, does not constitute filing a return (and the debt cannot be discharged).¹¹

The “applicable filing requirements” language is never mentioned in any BAPCPA-related committee reports, whether in committee reports for legislation that was never enacted or in the committee reports for BAPCPA itself.¹²

¹⁰ 146 Cong. Rec. S11716 (daily ed. Dec. 7, 2000).

¹¹ H.R. Rep. No. 109-031, pt. 1 at 103 (2005).

¹² A House Committee Report in 1999 did mention, without explanation, the applicable nonbankruptcy requirement. H.R. Rep. No. 106-123, at § 814 (1999) (This section “also specifies that a tax return, for purposes of section 523(a)(1)(B) must satisfy the requirements of applicable nonbankruptcy law”)

Analysis

If correct, the One-Day-Late Rule seems to make other rules in section 523(a) of the Bankruptcy Code unnecessary, which rules help define what qualifies as a return and help determine the dischargeability of the tax reported on those returns. This paragraph of the recommendation examines the impact of the One-Day-Late Rule on section 523(a)(1)(B)(ii), the reference to section 6020(b) in the Hanging Paragraph, and the Hanging Paragraph directive to apply applicable nonbankruptcy law.

Section 523(a)(1)(B)(ii) provides for the dischargeability of tax on late-filed returns after two years passes from the filing date. If the One-Day-Late Rule is correct, the tax on late-filed returns does not become dischargeable after two years, even though the language in section 523(a)(1)(B)(ii) states otherwise. The Bankruptcy Court in the Colorado *Martin* case observed as follows:

This interpretation says too much, however, essentially rendering section 523(a)(1)(B)(ii) superfluous. Section 523(a)(1)(B)(ii) provides that taxes for which a return was filed “after such return was last due” and less than 2 years prior to the date of bankruptcy are not discharged. This section refers specifically to late-filed tax returns, and is the only place in section 523(a) where late filing is specifically referenced. To read “return” in section 523(a)(1)(B)(i) as meaning “timely-filed return” would make the discharge exception of section 523(a)(1)(B)(ii) entirely coincidental with that of section 523(a)(1)(B)(i), except in the case of tax returns prepared under section 6020(a) of the Tax Code more than two years prior to bankruptcy.¹³

In other words, if the One-Day-Late Rule is correct, there was no need to leave the two-year late-filed rule in the Bankruptcy Code. As set forth in the next paragraph, the section 6020(a) exception has never had any meaning as returns are almost never filed under that provision.

Martin references returns prepared under section 6020(a), which appears on its face to be a very broad exception to the One-Day-Late Rule. The Hanging Paragraph allows late-filed returns prepared by the Service with the consent of the taxpayer under the rules of section 6020(a) to qualify as returns. This rule makes sense as discharge is for the honest and cooperative taxpayer, and the taxpayer described in section 6020(a) is clearly that. The problem is that the section 6020(a) exception is illusory. Returns are almost never prepared pursuant to section 6020(a).¹⁴ This means, other than the rare Tax

¹³ *Martin v. United States (In re Martin)*, 482 B.R. 635, 639 (Bankr. D. Colo. 2012), *rev'd*, 500 B.R. 1 (D. Colo. 2013) (both the bankruptcy court and district court rejected the One-Day-Late Rule; they disagreed on whether the taxpayer had made a reasonable attempt to comply with the tax law.)

¹⁴ Chief Counsel Notice 2010-16 at p.2 (“the supposed ‘safe harbor’ of section 6020(a) is illusory”); and *see*

Court stipulation involving a late-filed return, there are no exceptions to the One-Day-Late Rule in the Hanging Paragraph.

Section 6020(b) returns are prepared by the Service without the taxpayer's consent. Such returns are always late-filed. The Hanging Paragraph states that returns prepared under section 6020(b) are not returns for purposes of section 523(a). This rule makes sense as discharge is for the honest and cooperative taxpayer, and the taxpayer described in section 6020(b) is clearly not that. If the One-Day-Late Rule is correct, there is no need to add a reference to section 6020(b) in the Hanging Paragraph that such returns are not returns.¹⁵ In other words, the One-Day-Late Rule makes this language superfluous.

The Hanging Paragraph mandates that a return must satisfy the requirements of applicable nonbankruptcy law, *i.e.*, tax law. Tax law has never had a *per se* timeliness requirement in its definition of a return. The test that is used in tax cases (and in bankruptcy cases when the One-Day-Late Rule is not followed) is found in *Beard v. Comm'r*.¹⁶ Under the *Beard* test, a document qualifies as a return as follows:

- (1) It contains sufficient data to allow calculation of tax;
- (2) It purports to be a return;
- (3) It represents an honest and reasonable attempt to satisfy the requirements of the tax law; and
- (4) It is signed under penalty of perjury.

The only place a *per se* timeliness requirement could be interjected into the *Beard* test is in the third element. Courts have split over how to determine what “represents an honest and reasonable attempt to satisfy the requirements of the law.” Some courts have used an objective approach focusing on the document itself, and others have applied a more subjective approach that considers the intent of the taxpayer in creating and executing the document.¹⁷

Regardless of the approach used by courts, objective or subjective, timeliness is not the controlling factor under applicable nonbankruptcy law. Timeliness plays no part in the *Beard* objective approach, and timeliness is not the only determinative factor in the

Wogoman v. IRS (In re Wogoman), 475 B.R. 239, 249 (10th Cir. B.A.P. 2012) (citing Notice 2010-16 with approval and acknowledging the Service's statement that relief under section 6020(a) is illusory because it prepares returns under section 6020(a) “in only a minute number of cases.”)

¹⁵ *Gonzalez v. Mass. Dep't of Rev. (In re Gonzalez)*, 506 B.R. 317, 328 (1st Cir. B.A.P. 2014); and *Martin v. IRS (In re Martin)*, 508 B.R. 717, 727 (Bankr. E.D. Cal. 2014).

¹⁶ 82 T.C. 766, 777 (T.C. 1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986).

¹⁷ *See, e.g., Martin v. United States (In re Martin)*, 482 B.R. 635, 639 (Bankr. D. Colo. 2012) (objective approach), *rev'd*, 500 B.R. 1 (D. Colo. 2013) (subjective approach finding that taxpayer had not made a reasonable attempt to comply with the tax law); and *Martin v. IRS (In re Martin)*, 508 B.R. 717 at 723-724 and 731 (Bankr. E.D. Cal. 2014) (court adopted objective approach and looked only to face of the document).

Beard subjective approach. There is no support for the One-Day-Late Rule in applicable nonbankruptcy law.¹⁸ This means the One-Day-Late Rule is in direct conflict with the language of the Hanging Paragraph that mandates the application of nonbankruptcy law.

The parenthetical “applicable filing requirements” refers to “what” is filed not “when.”¹⁹ Applicable filing requirements would include (i) filed under penalty of perjury, (ii) in the correct place, (iii) on the proper form, and (iv) substantially complete. The “what not when” interpretation is consistent with the Hanging Paragraph references to sections 6020(a) and 6020(b). The inclusion of those references show that dischargeability hinges on the taxpayer’s cooperation with the taxing authority not timeliness.²⁰

This analysis is consistent with the Service’s view of the issue. The Office of Chief Counsel rejected the One-Day-Late Rule, concluding instead that “[r]ead as a whole, section 523(a) does not provide that every tax for which a return was filed late is nondischargeable.”²¹ When presented with the opportunity to use the One-Day-Late Rule, the United States has declined to do so in multiple cases.²²

Under the One-Day-Late Rule, events beyond the taxpayer’s control may result in tax being nondischargeable. While the Tax Code provides many grounds for abating penalties arising from filing a return late,²³ no leeway appears to be provided under the One-Day-Late Rule. For example, if the Service’s electronic filing system goes down late on April 15 from system overload, while there may not be a late-filing penalty, that return may be late under the One-Day-Late Rule.²⁴ Since the One-Day-Late Rule reads the two-year rule of section 523(a)(1)(B)(ii) out of the Bankruptcy Code, if held nondischargeable under the One-Day-Late Rule, the tax on the one-day-late return would remain nondischargeable forever.

The One-Day-Late Rule may negatively impact disaster victims and members of the military serving in designated combat zones. Such taxpayers are allowed to file their returns late, without penalty. But, these are late-filed returns, which means the tax on

¹⁸ *Martin v. IRS (In re Martin)*, 508 B.R. 717, 729 (Bankr. E.D. Cal. 2014) (in discussing the addition of timeliness to the *Beard* test, Court stated it is a “judicially constructed fiction that lacks any support in the ‘applicable nonbankruptcy law.’ ”)

¹⁹ *Gonzalez v. United States (In re Gonzalez)*, 506 B.R. 317, 328 (1st Cir. B.A.P. 2014).

²⁰ *Id.*; and *see*, 146 Cong. Rec. S11716 (daily ed. Dec. 7, 2000) (distinguishing between the cooperating and noncooperating taxpayer).

²¹ Office of Chief Counsel Notice 2010-16 at 2; and *see*, SBSE 05-0613-0054 (June 28, 2013) (citing Notice 2010-16 with approval).

²² *See, e.g., Martin v. IRS (In re Martin)*, 508 B.R. 717 (Bankr. E.D. Cal. 2014); *Martin v. United States (In re Martin)*, 500 B.R. 1 (D. Colo. 2013); *Smythe v. United States (In re Smythe)*, 2012 W.L. 843435 (Bankr. D. Wash. 2012); and *Casano v. United States (In re Casano)*, 473 B.R. 504 (Bankr. E.D.N.Y. 2012).

²³ *See* I.R.M. 20.1 (Penalty Handbook).

²⁴ *See, Martin v. United States (In re Martin)*, 2014 W.L. 508 B.R. 717, 726-727 (Bankr. E.D. Cal. 2014) (courts following *McCoy* would hold debtors who file their own return on April 16 would have nondischargeable tax debt).

those returns may not be eligible for discharge.²⁵

The One-Day-Late Rule marks a significant change in the discharge of taxes in bankruptcy. Prior to *McCoy*, there had never been any question that the honest and cooperative taxpayer, after giving the taxing authority a reasonable time to collect, qualified for a discharge of taxes.²⁶ The Hanging Paragraph advanced this goal by providing clarity regarding issues that were litigated prior to its enactment.²⁷ The use of the phrase “applicable nonbankruptcy requirements” was certainly meant to do the same, but its interpretation needs clarification.

Absent legislative guidance, some courts will continue to include timeliness as part of the applicable filing requirements. This recommendation simply asks that section 523(a)(*) be amended to exclude timeliness from the applicable filing requirements.

LEGISLATIVE RECOMMENDATION

It is recommended that the first sentence of 11 U.S.C. § 523(a)(*), which is also known as the Hanging Paragraph, be amended to read as follows:

For purposes of this subsection, the term “return” means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements other than timeliness).

²⁵ I.R.C. §§ 7508, 7508(a); Rev. Rul. 2007-59, 2007-2 C.B. 582 (special-late-filing rules for military in combat zones and disaster victims do not change return due date; they only waive penalties).

²⁶ See *Waugh v. IRS (In re Waugh)*, 109 F.3d 489, 492 (8th Cir. 1997), *cert. denied*, 522 U.S. 823 (1997) (discussing three-way tension among general creditors, the debtor, and the tax collector).

²⁷ See, e.g., *Gushue v. United States (In re Gushue)*, 126 B.R. 202 (Bankr. E.D. Pa. 1991) (Tax Court settlement not equivalent of filed return); and, *Carapella v. United States (In re Carapella)*, 84 B.R. 779 (Bankr. M.D. Fla 1988 (filing of Form 870 waiver of assessment considered a valid return)).