OREGON STATE BAR

Taxation Section

VOLUME 18, NUMBER 1 Spring 2015

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When Is An Esop Appropriate?

*By John A. Magliana, Jr.**

Introduction

The purpose of this article is to identify certain circumstances and factors which have historically indicated that an employee stock ownership plan ("ESOP") may be appropriate and should be considered by a client and its legal counsel. The situations and factors identified below as potentially appropriate, do not constitute a comprehensive list and represent factors and circumstances which have traditionally provided a basis for a successful ESOP. This article is also not intended to be technical or detailed in nature, but rather is a general discussion based on the experience of the author after more than 30 years of business and tax practice and literally hundreds of ESOP transactions.

Background

Before describing those specific situations in which the author believes an ESOP may be appropriate, some basic information about ESOPs is essential. ESOP transactions are complex and require a thorough understanding of the business, operational, tax, financial and valuation issues related to implementing an ESOP. The use of experienced professionals (i.e., lawyers, accountants, valuation companies, plan administrators, etc.) to assess and implement an ESOP is critical, in order to avoid unnecessary expenditures, potentially significant liability and dissatisfaction with an ESOP. It is imprudent to begin the process of implementing an ESOP without first performing a detailed feasibility analysis. An appropriate ESOP feasibility study will analyze the business, operational, financial, design, valuation, tax and other legal aspects of a

Oregon Tax Institute

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June 04, 2015
Oregon Tax Institute
Presenters: Various
8:30 a.m. – 4:30 p.m.
Embassy Suites Portland

June 05, 2015
Oregon Tax Institute
Presenters: Various
9:00 a.m. – 5:00 p.m.
Embassy Suites Portland

potential ESOP transaction, taking into account the facts of each particular case. The ESOP feasibility analysis will ultimately provide invaluable insight and allow decision makers to make an informed choice regarding the implementation of an ESOP.

Although ESOPs are only usable by corporations, other business forms (e.g., limited liability companies) can be converted into a corporation prior to implementing an ESOP. An ESOP is a "qualified plan" (i.e., like profit sharing and 401(k) plans) and consequently, must comply with all of the applicable requirements for qualified plans in the Internal Revenue Code of 1986, as amended (the "Code"), Treasury Regulations, the Employee Retirement Income Security Act of 1974, as amended, and Department of Labor Regulations. Like all qualified plans, an ESOP also has an associated tax exempt trust (an "ESOT"), into which the sponsoring corporation makes deductible contributions on behalf of the corporation's employees who are "participants" in the ESOP. These contributions are allocated to the individual accounts of employee participants, typically based upon their individual compensation, relative to the total compensation paid to all other ESOP participants. These deductible cash contributions can be used by the ESOP to purchase stock of the sponsoring employer from the employer itself or the employer's shareholders, at a price which cannot exceed "fair market value" as determined by an independent appraiser. Unlike other types of qualified plans, an ESOP is permitted to borrow money to purchase stock of the sponsoring employer from the employer or its shareholders and can use the deductible cash contributions it receives from the employer corporation to pay back the loan taken out to purchase the shares. Another important difference between an ESOP and other types of qualified plans, is that an ESOP is permitted to hold 100% of its assets in stock of the sponsoring corporation. These ESOP attributes allow ESOP participants who are employees of the sponsoring corporation to acquire a beneficial ownership in the stock of the corporate plan sponsor, without having to invest their own money to buy that stock. Further, because ESOP contributions are deductible to the sponsoring corporation, when an ESOP uses these cash contributions to purchase shares from shareholders, it is buying the shares with "pretax" dollars. Similarly, in the case where the ESOP borrows money to purchase shares of the sponsor's stock, it is repaying the loan with "pretax" dollars when it uses the deductible employer cash contributions to repay the loan. The sponsoring employer can also pay cash dividends on the stock in the ESOP which will be deductible if distributed out to participants, or used by the ESOP to make principal or interest payments on a loan used by the ESOP to purchase the shares.

The Code also provides significant tax incentives to shareholders who sell their stock to an ESOP of "C" (not "S") corporations. Under Section 1042 of the Code, an electing shareholder of a private company who meets the requirements of that section and sells their shares to an ESOP that owns at least 30% of the sponsoring company's stock after the sale, can defer, or completely avoid, the income tax attributable to the gain on the sale of that stock, by investing in "qualified replacement property" (i.e., stocks, bonds or other securities of U.S. operating companies) within 12 months after the sale. Even without a Code Section 1042 election, the sale of stock to an ESOP is typically a transaction which results in the gain being taxed at preferential long term capital gain rates.

"S" corporations are permitted to sponsor and maintain ESOPs, although shareholders of "S" corporations are presently not permitted to make the Code Section 1042 election for stock sales to an ESOP, without first terminating the corporation's "S" election. In those situations which an ESOP is maintained by an "S" corporation, the ESOP's share of the "S" corporation's earnings will generally not be subject to state or federal income tax since the "S" corporation is a pass through entity and the ESOT is a tax exempt entity. Where an ESOP is the sole shareholder of an "S" corporation, the corporation will generally be able to accumulate all of its profits without state or federal income tax. It is possible to structure an ESOP transaction where the ESOP acquires all of the "C" corporation's outstanding stock from the corporation's shareholders, allowing the selling shareholders to elect Code Section 1042, if desired, and then make the "S" election.

Finally, the philosophical foundation for the ESOP, is to broaden the ownership of capital by employees. By allowing employees to acquire a beneficial interest in the stock in the sponsoring employer through the ESOP, employees will have the incentive to work more efficiently and productively, which should increase the sponsor's profits over time and consequently the value of the shares owned by the ESOP. The appreciation in value of the ESOP shares is then available to participants upon retirement or other termination of employment with the employer. Typically, ESOP participants receive either cash for their shares directly from the ESOP, or are distributed the shares "in kind" from the ESOP along with a "put option" requiring the distributed shares to be purchased by the ESOP or the sponsoring company.

Factors And Situations Conducive To A Successful Esop

The following are factors and situations which the author has found significantly influence whether an ESOP is appropriate and will be successful:

1. **Positive Company Attributes.** Generally, to be a good candidate for an ESOP, the company should have the following attributes:

    1.1. *Not Less Than 10 to 15 Employees* – There are several reasons for this. Since initial transaction costs for even small ESOPs can be $40,000 or more, these costs may be greater than the potential transaction tax benefits. For "S" corporation ESOPs, there are rules in

the Code which restrict the ability of a small number of participants from accumulating a disproportionate amount of the ESOP benefits. This could make an ESOP unavailable, even if all employees participate in the ESOP. Finally, small employee populations can be subject to disproportionate volatility due to death, illness, retirement, employee terminations, etc., which can be problematic with respect to the Code's contribution and deduction limitations applicable to ESOPs, especially if an ESOP borrowed money to purchase shares.

1.2. *Company Value of At Least $1 Million* – A company with a value, based upon an independent appraisal, of less than $1 million is very small for an ESOP transaction. Although I have implemented transactions at smaller valuation levels, these are the exception. Again, the issue of transaction fees and taxes make smaller transactions relatively more expensive. The smaller transactions that have been successful, involve "benevolent owners," who fostered some level of employee culture in their businesses prior to implementation of an ESOP and were committed to their employees owning the company after their retirement.

1.3. *Strong Successor Management* – If an ESOP is to be used as part of a transition plan, experienced and capable successor management must be in place. Without strong successor management, the company is at greater risk of not performing at its historical levels of profitability, which is a key factor in evaluating the appropriateness (i.e., affordability) of an ESOP.

1.4. *Profitable* – Although ESOPs have been used in "turnaround" situations involving unprofitable companies, this is not an optimal condition for implementing an ESOP. The stronger the profitability and cash flows, the greater potential for an ESOP's success. ESOPs need to be able to rely on the ability of the sponsoring corporation to make regular cash contributions to the ESOP, especially in the event that the ESOP has borrowed money to purchase stock and needs to make loan payments to the lender. Profits and cash flows are also important to fund the required repurchases of stock from participants on their retirement or other termination of employment.

1.5. *Stable* – A company that is stable, from a management, operational and financial perspective is best suited for an ESOP. Instability can result in employee dissatisfaction due to fluctuating stock values, insecurity and uncertainty. Related to the instability concern, is the caution that should be exercised with respect to companies in cyclical industries. It is essential to identify the business cycles and make sure the company can meet its business and ESOP cash flow needs in "down cycles."

2. **Companies in Which Employee Involvement Can Make a Measurable Difference.** The chances of an ESOP being successful are also enhanced if the sponsoring employer's business is one in which employees can have a measurable impact on productivity and efficiency. One of the most successful ESOPs I implemented involved a large auto parts dealer. The company experienced 5% to 10% annual loss of revenues due to employee theft. Once the ESOP was implemented and the employees educated about how they could affect the profitability of the employer and consequently the value of the stock in their ESOP accounts, the theft problem vanished virtually overnight. There are similar stories in other industries such as manufacturing, processing, services, etc., where employee input can give valuable insight into areas that can be targeted for improvements in efficiency and productivity.

3. **Commitment to Employee Involvement Post Transaction.** Without a commitment to employee involvement and building an "employee ownership culture" after the ESOP transaction, the ESOPs potential for increased efficiency and productivity is illusory. Employee involvement does not mean that the employees have to run the business, but it does mean that they should be encouraged to want more information about the company and have some input into how it operates. The employee involvement process does not just happen by itself and there are consultants who specialize in designing and implementing this process to get the most from employees. Statistics continually validate that ESOP companies generally grow faster, have lower turnover, and higher productivity than their non ESOP counterparts. However, these results are dependent upon employee involvement and an employee ownership culture.

4. **No Other Available Buyer.** In the event that a buyer for a business cannot be identified, it is entirely appropriate to consider using an ESOP. Although the factors listed above will largely determine the success or failure of an ESOP, there are many reasons that a "good" business that otherwise has many of the attributes for success discussed above cannot find a buyer. This situation leaves the owner with the prospect of walking away from the business, if not for the possibility of an ESOP. This scenario is occurring with more frequency due to the demographics of the American population. As baby boomers reach retirement age at the rate of approximately 10,000 per day and their businesses come up for sale at an ever increasing rate, it has been estimated that for every seven businesses that come up for sale in the next 10 years, there will be only

one buyer. This growing trend means that ESOPs will increasingly be looked at as the only way for business owners to receive value from the sale of their businesses. Unfortunately, this also means that there will be pressure to implement ESOP transactions in situations where it may be difficult for an ESOP to succeed.

5. **Business Transition.** An ESOP can be an excellent vehicle to facilitate a business transition. Often times, the children of an owner, or successor management, cannot afford to purchase the owner's shares and the owner needs the money from the sale for retirement. As discussed above, since ESOPs can buy stock with pretax dollars, the purchase of an owner's shares will cost the ESOP substantially less than another buyer, such as the owner's children or management employees who must pay with "after tax" dollars. In addition, the owner may be able to defer indefinitely, or avoid, the income tax that would be imposed on the gain from the sale of the stock to a non ESOP purchaser. An ESOP also enables an owner to sell a portion of his or her company shares, in tax – advantaged "friendly" transactions, while maintaining control of the business. When an owner finally begins to consider selling control of the business, the owner will have had time to assess the success of the ESOP, before making a final decision on whom to sell to.

6. **Liquidity/Diversification.** For most business owners, the business represents their single most valuable asset. An ESOP may be appropriate in situations where an owner wants to diversify a portion of his or her business holdings, or acquire some personal liquidity. Since ESOPs offer tax and other advantages to both buyer and seller and are considered "friendly," an ESOP often provides an attractive alternative to bringing in a third - party partner (e.g., individual, private equity, etc.), who may demand concessions that an ESOP would not. Of course, the potential success of an ESOP in these situations is enhanced by the presence of many of the attributes discussed above. Historically, ESOPs have also been used to provide liquidity for estates in which a closely held business is the largest asset.

Conclusion

Although ESOP transactions are complex, their unique benefits are significant when implemented in those appropriate situations which enhance an ESOP's likelihood for success. Experienced professionals can minimize this complexity, much like information technology personnel that set up our computers and keep them working so we can use the applications we are familiar with. The most important factors which tend to determine the success or failure of an ESOP, are a commitment to employee ownership and a meaningful employee involvement process. Without these, implementing an ESOP can often be just a financial transaction, which will never allow the ESOP to achieve its full potential for increasing efficiency, productivity and value of the business, as well as overall employee satisfaction.

Footnote:

* John Magliana is a widely recognized mergers and acquisitions lawyer, with a substantial practice involving ESOP transactions.

Misinterpretations of ORS 305.217 Are Resulting in Taxpayers Losing Valid Deductions for Amounts Paid to Service Providers

By Eric Kodesch*

Miller v. Dep't of Rev.[1] concerned the deductibility of compensation paid by plaintiffs to independent contractors for services provided to plaintiffs' tree felling business. Although there was no dispute concerning whether plaintiffs made the payments at issue, plaintiffs failed to satisfy a federal information reporting obligation: plaintiffs did not timely issue Forms 1099-MISC. The Department of Revenue asserted that this failure triggered ORS 305.217 so that no Oregon deduction was allowed for the payments. The Magistrate Division of the Oregon Tax Court agreed, and its decision is consistent with the Department's interpretations of (i) the deduction disallowance provided by OAR 150-305.217(1)(a) and (ii) the reasonable cause exception provided by OAR 150-305.217(2). However, it appears that no one in the case raised the question of whether OAR 150-305.217(1)(a) is too broad or whether OAR 150-305.217(2) is too narrow. As described in this article, the answer to both of these questions is yes, so that nothing in Oregon law prevented the deduction.

Background

ORS 305.217 provides:

> "No deduction shall be allowed under ORS chapter 316, 317 or 318 to an individual or entity for amounts paid as wages or as remuneration for personal services if that individual or entity fails to report the payments as required by ORS 314.360 or 316.202 on the date prescribed therefor (determined with regard to any extension of time for filing) unless it is shown that the failure to report is due to reasonable cause and not done with the intent to evade payment of the tax imposed by ORS chapter 316 or to assist another in evading the payment of such tax."

The provision was enacted in 1987 and has not been amended.[2] The Department promulgated OAR 150-305.217 in 1992. Despite being on the books for nearly two decades, it appears that the Department did not seek to impose the provision until recently. Starting with the 2009 tax year, however, the Department began to raise the issue, at least in audits ultimately resolved by the Oregon tax court.[3] In these cases, the Magistrate Division relied on OAR 150-305.217(1)(a) to determine whether ORS 305.217 applied (i.e., whether the failure to timely file Form 1099-MISC with the IRS is sufficient to trigger the disallowance). The Magistrate Division also relied on OAR 150-305.217(2) to determine whether the taxpayer satisfied the statutory reasonable cause exception.

The Failure to Comply with a Federal Information Reporting Requirement Does Not Trigger ORS 305.217

By its own terms, ORS 305.217 potentially applies if a taxpayer "fails to report the payments as required by ORS 314.360 or 316.202 on the date prescribed therefor (determined with regard to any extension of time for filing)." That is, the deduction disallowance only applies if there is a failure to timely comply with an Oregon reporting requirement. The ORS 305.217 cases all involve Form 1099, and ORS 314.360(1) provides the applicable Oregon rules:

> "Fiduciaries required to make returns under laws imposing tax upon or measured by net income, proprietorships, partnerships, corporations, joint stock companies or associations or insurance companies, having places of business in this state, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, purchasers of stumpage and all officers and employees of the state or of any political subdivisions of the state, having the control, custody, disposal or payment of interest (other than interest coupons payable to bearer), rent, dividends, salaries, fees, wages, the purchase price of stumpage, emoluments or other fixed or determinable annual or periodical gains, profits and income, paid or payable, during any year to any taxpayer, shall make return thereof, under oath, to the Department of Revenue, under such regulations and in such form and manner and to such extent as it may prescribe." (Emphasis added.)

Pursuant to this grant of authority, the Department promulgated OAR 150-314.360. For tax years before 2011, the rule generally provided that "taxpayers are not required to file information returns as described in ORS 314.360."[4] The Department amended the rule in 2010 to phase in information reporting for payment years starting in 2011 (information returns due in 2012):

- 2011: information reporting with the Department only if the taxpayer issues 250 or more of any one type of federal information return.
- 2012: information reporting with the Department only if the taxpayer issues 100 or

more of any one type of federal information return.[5]

- 2013: information reporting with the Department only if the taxpayer issues 10 or more of any one type of information return.

For payments made in 2014 and later years, a taxpayer has an information reporting requirement with the Department if the taxpayer "issues more than 10 information returns, where the recipient, winner, or the payer has an Oregon address."[6]

None of the ORS 305.217 cases appears to involve a taxpayer that had an ORS 314.360 information reporting requirement. Nonetheless, the Department relied on OAR 150-305.217(1)(a), which purports to apply the deduction disallowance if the taxpayer fails to comply with either the Oregon information reporting obligation or the federal obligation. That is, OAR 150-305.217(1)(a) provides that the deduction is disallowed if "[t]he employer does not file any information returns, such as 1099's or W-2's, as required by federal law, ORS 314.360 or 316.202" (emphases added).[7] However, as the legislature limited ORS 305.217 to situations in which the taxpayer failed to satisfy an Oregon information reporting requirement, the attempt to extend the statute to incorporate the federal reporting requirement is invalid.[8] If the legislature intended to deny a deduction for taxpayers that complied with Oregon information reporting requirements but not federal requirements, it would have so provided in ORS 305.217.[9] In addition, if the Department believes that ORS 305.217 should apply in such a situation, it can use the broad grant of authority pursuant to ORS 314.360 to have the Oregon information reporting requirement mirror the federal one. To date, the Department has chosen not to do so. Accordingly, it appears that ORS 305.217 should not have disallowed the applicable deduction in the recent cases.

The Department's Interpretation of the Reasonable Cause Exception Is Too Narrow

When ORS 305.217 potentially applies, the deduction still is allowed if "it is shown that the failure to report is due to reasonable cause and not done with the intent to evade payment of the tax imposed by ORS chapter 316 or to assist another in evading the payment of such tax." ORS 305.217. This requires a taxpayer to demonstrate:

1. Reasonable cause, and
2. No intent to evade or assist in evading.

For this purpose, OAR 150-305.217(2) provides:

> "In the case of a failure to file as described in subsection (1)(a) of this rule, the expense will be allowed if the employer can show there was a circumstance beyond the employer's control that caused the failure to file returns as required by law. Refer to OAR 150-305.145(4) for examples of situations that are accepted by the department as a circumstance beyond the employer's control."

This rule does not discuss the "intent to evade" prong of the statutory reasonable cause defense. More importantly, OAR 150-305.217(2) attempts to limit the ORS 305.217 reasonable cause exception to the OAR 150-305.145(4) standard of "beyond the employer's control." This is improper because:

1. The Department promulgated OAR 150-305.145(4) pursuant to the legislature's affirmative grant of authority in ORS 305.145(4) to "establish by rule instances in which the department may, in its discretion, waive any part or all of penalties provided by the laws of the State of Oregon that are collected by the department." There is no similar grant of discretionary authority in ORS 305.217. There does not appear to be a basis for limiting the mandatory reasonable cause exception of ORS 305.217 to a standard adopted using the discretionary authority allowed by ORS chapter 305.
2. The grant of authority provided by ORS 305.145(4) applies in situations described in ORS 305.145(4)(a) ("[g]ood and sufficient cause"), ORS 305.145(4)(b) ("first-time offense"), or ORS 305.145(c) ("enhance long-term effectiveness, efficiency or administration"). In creating an exception for ORS 305.217, however, the legislature did not use language from ORS 305.145(a), (b), or (c). If the legislature had intended parity between the provisions, it would have provided that the ORS 305.217 deduction disallowance does not apply, for example, if the taxpayer had "good and sufficient cause" for the failure. Instead, the legislature adopted the lower threshold of "reasonable cause."

The federal Form 1099 reporting requirements include a penalty for failing to timely file, with a reasonable cause exception.[10] ORS 305.217 incorporating the federal reasonable cause standard makes more sense than OAR 150-305.145(4), especially as the Department takes the position that not satisfying the federal reporting requirement, in and of itself, triggers ORS 305.217.

Treas Reg § 301.6724-1 provides the federal standard for determining whether a taxpayer had reasonable cause for a failure to timely file Form 1099. This involves a two-part test. The taxpayer must:

1. Either (a) have "significant mitigating factors" (the Oregon rule omits this) or (b) show that "[t]he failure arose from events beyond the filer's control,"[11] **and**
2. Have acted in a "reasonable" manner before and after the failure occurred.

For purposes of this rule:

- **Significant Mitigating Factors:** Treas Reg § 301.6724-1(b)(2) describes as a significant mitigating factor, "[t]he fact that the filer has an established history of complying with the

information reporting requirement with respect to which the failure occurred." Accordingly, there is no federal Form 1099 penalty for a taxpayer that generally satisfies information reporting requirements.

- **Reasonable Manner:** Treas Reg § 301.6724-1(d)(1) defines acting in a reasonable manner as (1) applying the "standard of care that a reasonably prudent person would use under the circumstances in the course of its business in determining its filing obligations and in handling account information" and (2) undertaking "significant steps to avoid or mitigate the failure." Thus, for example, a taxpayer with a reasonable information system in place that corrects for the failure to timely file a Form 1099 within 30 days of discovery demonstrates that it acted in a reasonable manner.

The IRS's interpretation of the federal statutory reasonable cause exception for failing to timely file a Form 1099 is more forgiving that the Department's interpretation of the Oregon statutory analogue. Further, the IRS's interpretation adheres to a "reasonable cause" standard, whereas the Department applies a "good and sufficient cause" standard. In determining whether the ORS 305.317 reasonable cause exception applies, the Oregon Tax Court and the Department should use the guidance provided by the IRS.

Conclusion

ORS 305.217 imposes a harsh penalty on taxpayers that fail to comply with Oregon information reporting obligations for payments made to service providers. The Department's expansive interpretation of the scope of the provision and its restricted interpretation of the reasonable cause defense add to the severity of the provision. More importantly, the Department's administrative rule is not consistent with Oregon tax law and exceeds its authority. Unless the statute is amended, the Department should revise its rule to conform to the statute.

Footnote:

* Eric Kodesch is a partner at Stoel Rives LLP in Portland, Oregon. The author thanks Chris Heuer for his assistance with this article.

1. TC-MD 140085C, 2014 Ore Tax LEXIS 135 (Or Tax Mag Div Aug. 4, 2014)
2. Or Laws 1987, ch 843, § 2.
3. A search of Oregon cases reveals that ORS 305.217 is first cited in an Oregon Tax Court case in 2013. Then, in quick succession, the Magistrate Division issued three decisions upholding the Department's use of ORS 305.217 to disallow a deduction because the taxpayer did not timely file Forms 1099-MISC with the IRS: *Miller; Williams v. Dep't of Rev.,* TC-MD 130420C, 2014 Ore Tax LEXIS 21 (Or Tax Mag Div Feb. 10, 2014); and *Phoudavong v. Dep't of Rev.,* TC-MD 130147N, 2013 Ore Tax LEXIS 218 (Or Tax Mag Div Dec. 30, 2013).
4. *Former* OAR 150-314.360(1) (2010).
5. *See former* OAR 150-314.360(3)(a)-(c) (2011).
6. OAR 150-314.360(3). The rule thus requires information reporting if the taxpayer issues 10 information returns of any type, rather than 10 of the same type.
7. The rule did not reference federal law until a 2007 revision to the rule. This may explain the lack of cases discussing ORS 305.217 for years before 2009.
8. *See Miller v. Employment Division,* 290 Or 285, 289, 620 P2d 1377 (1980) ("An agency may not amend, alter, enlarge or limit the terms of a legislative enactment by rule."); *see* also Kelly v. Dep't of Rev., TC-MD 070742C, 2008 Ore Tax LEXIS 80 (Or Tax Mag Div May 8, 2000) (invalidating administrative rule promulgated by Department because it went beyond statute).
9. *See Con-way Inc. & Affiliates v. Dep't of Rev.,* 20 OTR 417, 420 (2011) (when the legislature desires a certain outcome "it knows how to say so"), *aff'd,* 353 Or 616 (2013). Further, the legislature amended ORS 314.360 in 2013 to add a $50-per-information return penalty in addition to the ORS 305.217 deduction disallowance. *See* Or Laws 2013, ch 734, § 1. As in ORS 305.217, the legislature chose to have the penalty triggered by a failure to satisfy the Oregon obligation as determined pursuant to the Department's administrative rules, rather than the federal requirement.
10. *See* IRC §§ 6721(a) (imposing penalty), 6724(a) (providing reasonable cause exception).
11. Treas Reg § 301.6724-1(c)(1)(iv) allows reasonable reliance on an employee to be an event beyond the taxpayer's control for purposes of establishing reasonable cause. *Cf.* OAR 150-305.145(5)(b)(B) ("[r]eliance on an employee of the taxpayer to prepare a return on time" not a circumstance beyond taxpayer's control). This further demonstrates problems with bootstrapping the ORS 305.217 reasonable cause exception to OAR 150-305.145(4).

If You're Late, You Can't Return! Discharge of Tax From Late Return in Doubt

*By Kent Anderson**

A frequently used technique for resolving unpaid personal income tax debt is now in doubt. Practitioners should take care in advising delinquent tax return filers. Bankruptcy may not be available, even after a two-year waiting period, to discharge the tax debt.

Whether or not a tax obligation is dischargeable in bankruptcy is, in part, determined by 11 U.S.C. § 523(a)(1). That statute provides:

A discharge under section 727 (Chapter 7), 1141 (Chapter 11), 1228(a), 1228(b), or 1328(b) (for Chapter 13) of this title does not discharge an individual debtor from any debt—

> (1) for a tax or a customs duty—
>
> > (A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;
> >
> > (B) with respect to which a return, or equivalent report or notice, if required—
> >
> > > (i) was not filed or given; or
> > >
> > > (ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition;

This language has long been interpreted to mean that a tax return must have been filed more than two years prior to commencement of the bankruptcy case for the tax debt to be dischargeable.

In 2005, Congress defined "return" for the first time. Language was inserted, in the now infamous, "Hanging Paragraph" following § 523(a), as part of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA):

> . . . 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. 11 USC § 523(a)(*).

In 2012, the 5th Circuit decided *McCoy v. Mississippi State Tax Commission* (*In re McCoy*), 666 F.3d 924 (5th Cir. 2012). That decision, relying on the new definition of return, focused on the parenthetic language "including applicable filing requirements," and held that an untimely filed state tax return was not a "return" for bankruptcy discharge purposes. Therefore, the tax was not dischargeable. Now, two more circuits have followed this reasoning.

The *McCoy* case was based on Mississippi state law. However, a second case, *Mallo v. Internal Revenue Service* (*In re Mallo*), 774 F.3d 1313 (10th Cir. 2014), came to the same result by applying the 26 U.S.C. § 6072(a) language "shall be filed on or before" a particular date as an "applicable filing requirement." Thus, a federal income tax return that was filed after the due date, despite the intervening delay of more than two years between the tax filing and commencement of the bankruptcy case, was disqualified as a "return" for bankruptcy discharge purposes.

The third opinion, *Fahey v. Mass. Dep't of Revenue* (*In re Fahey*), *2015 U.S. App. LEXIS 2458* (*1st Cir. February 18, 2015*), has followed this line of analysis and has similarly determined that a tax return, filed one day late, will never qualify the resulting debt as dischargeable in bankruptcy. The line of reasoning may be referred to as the "one-day-late" rule. Although a dissenting opinion by Judge Thompson argues for a more debtor-friendly interpretation of the provision, the majority is emphatic that a simple, plain language interpretation of the statute prohibits discharge of the tax due on late filed tax returns.

Before this unfavorable interpretation of the 2005 BAPCPA legislation, a typical non-filer or late-filer may have been told to file the missing returns and then wait two years to file bankruptcy, with the promise that the unpaid tax will be discharged and the problem would be solved. This advice can no longer be given without strong qualification.

While the 9th Circuit has yet to address whether it will follow the "one-day-late" rule, three other circuits have applied it and ruled decisively against the taxpayer. It would be imprudent to assume a different result in the 9th Circuit.

There remain two other avenues for converting an unfiled or late-filed return into a future dischargeable debt. The tax court offers one alternative and a collaborative effort with the IRS to prepare a tax return pursuant to 26 U.S.C. § 6020(a) provides another. A stipulated resolution in the U.S. Tax Court should meet the requirements of "a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal" set forth in the § 523(a) "Hanging Paragraph." It will now be even more important to file a timely Tax Court complaint in response to a Statutory Notice of Deficiency. The additional language "a return prepared pursuant to section 6020(a) of

the Internal Revenue Code of 1986" suggests the second route to a dischargeable tax debt for a delinquent taxpayer.

The practice of preparing a return pursuant to section 6020(a) has become so uncommon as to render it an unlikely alternative. Yet one case cited by the majority in ***Fahey*** shows a bankruptcy court willing to construe an IRS assessment made after the submission of information by the taxpayer as meeting the requirements of that statute. ***See In re Kemendo, 516 B.R. 434*** (***Bankr. S.D. Tex. 2014***). If a substitute for return is pending, it may be helpful to supply information to the IRS in order to assist in the calculation of any tax due.

The ABA Taxation Section has made a formal recommendation to Congress for a change in the nondischargeability languge of 11 U.S.C. § 523(a) to remedy this problem. It recommends that the phrase "other than timeliness" be added to the parenthetical language so that it would read "(including applicable filing requirements ***other than timeliness***)." The National Taxpayer Advocate supports a change of this nature and, in its 2014 Report to Congress, recommends amendment of the bankruptcy code in order to "provide that a late-filed tax return may be considered a return for purposes of obtaining a bankruptcy discharge."

Footnote:

* Kent Anderson is an attorney at Kent Anderson Law Office, where he practices in the areas of bankruptcy and tax law

Portland Luncheon Series

The Section holds a monthly lunch and CLE in Portland at the Red Star Tavern, 503 SW Alder Street, Portland. The cost to attend the luncheon is $32, and reservations or cancellations should be made at least 7 days before the luncheon. This information, and other Section information, is available on the Taxation Section's website at: *http://www.osbartax.com/Events/view/Portland-Luncheon-Series*.

April 16, 2015
Sports Taxation
12:00 - 1:30 p.m.
Presenter: Professor Roberta Mann
University of Oregon School of Law

May 20, 2015
Foreign Asset and Bank Account Reporting
12:00 - 1:30 p.m.
Presenter: Dan Eller
Schwabe Williamson & Wyatt

June 11, 2015
Ethics for Tax Practitioners
12:00 - 1:30 p.m.
Presenter: Peter Jarvis,
Holland & Knight

September 17, 2015
Oregon Legislative Update
12:00 - 1:30 p.m.
Presenter: Robert Manicke
Stoel Rives

October 15, 2015
Developments in Federal Criminal Tax
12:00 - 1:30 p.m.
Presenter: Bob Weaver
Garvey Schubert Barer

November 19, 2015
Perspectives and Updates from the Bench
12:00 - 1:30 p.m.
Presenter: Judge Henry Breithaupt
Oregon Tax Court

Future Events

Apr 06, 2015
NTLC Monthly Meeting
12:00-1:00 p.m.

Apr 15, 2015
NTLC Happy Hour or Pubtalk

May 4, 2015
NTLC Monthly Meeting
12:00-1:00 p.m.

May 14, 2015
Portland Tax Forum:
Estate Planning
Presenter: Louis Nostro
Multnomah Athletic Club

May 20, 2015
NTLC Happy Hour or Pubtalk

Jun 01, 2015
NTLC Monthly Meeting
12:00-1:00 p.m.

Jun 17, 2015
NTLC Happy Hour or Pubtalk

Jun 18, 2015
Portland Tax Forum:
Business Succession Tax
Planning
Presenter: David Herzig
Multnomah Athletic Club

Jul 06, 2015
NTLC Monthly Meeting
12:00-1:00 p.m.

Jul 15, 2015
NTLC Happy Hour or Pubtalk

Aug 03, 2015
NTLC Monthly Meeting
12:00-1:00 p.m.

Aug 19, 2015
NTLC Happy Hour or Pubtalk

Sep 07, 2015
NTLC Monthly Meeting
12:00-1:00 p.m.

Sep 16, 2015
NTLC Happy Hour or Pubtalk

Oct 05, 2015
NTLC Monthly Meeting
12:00-1:00 p.m.

Oct 21, 2015
NTLC Happy Hour or Pubtalk

Nov 02, 2015
NTLC Monthly Meeting
12:00-1:00 p.m.

Nov 18, 2015
NTLC Happy Hour or Pubtalk

Dec 07, 2015
NTLC Monthly Meeting
12:00-1:00 p.m.

Dec 16, 2015
NTLC Happy Hour or Pubtalk