In the United States Bankruptcy Court

for the Northern District of Iowa

Western Division

CRAIG DANGLER and JANIS L. DANGLER Debtors.	Bankruptcy No. 94-51295XS Chapter 7
CRAIG A. DANGLER and JANIS L. DANGLER Plaintiffs vs. STATE OF IOWA (Department of Revenue) Defendant.	Adversary No. 94-5139XS

ORDER RE: DISCHARGEABILITY OF IOWA INCOME TAX

The matter before the court is the final trial of the Danglers' complaint to determine the dischargeability of their Iowa income tax liability for the tax years 1986, 1987, 1988 and 1989. The Danglers filed amended returns for those years to report embezzled funds as additional income. Trial was held July 20, 1995 in Sioux City, Iowa. Donald H. Molstad appeared for Plaintiffs Craig A. Dangler and Janis L. Dangler. Dale T. Baker appeared for Defendant Iowa Department of Revenue and Finance (IDOR). The court now issues its findings of fact and conclusions of law as required by Fed.R.Bankr.P. 7052. This is a core proceeding pursuant to 28 U.S.C. 157(b)(2)(I).

FINDINGS OF FACT

The Danglers filed a Chapter 7 bankruptcy petition on August 10, 1994. They listed on their schedules a joint obligation to the IDOR for taxes.

Janis Dangler worked at Norwest Bank in Sioux City from April 1985 until August 1990 when she was terminated for embezzlement. In January or February 1992, the U.S. Attorney filed criminal charges against her. She pleaded guilty and admitted embezzling $299,500 from January 1986 through August, 1990. She was sentenced to federal prison for 12 months and one day. She was in prison for seven months beginning in August, 1992. She spent two months in a half way house, two months under home arrest, and is now on supervised release. After the Danglers decided to file a bankruptcy petition, Janis made an agreement with Norwest that $75,000 of her debt for embezzlement will be nondischargeable.

Janis Dangler is 36 years old. She graduated from high school in 1977. She has had some college courses in communication skills and computers. She has had many years of experience working at financial institutions. She began as a teller in 1975 while she was in high school. She has also worked in customer relations and agricultural lending.

Craig Dangler is 38 years old. He graduated from high school in 1974. The Danglers were married in 1977. In September, 1978 they bought a home at 1515 South Cornelia, Sioux City. From 1980 through 1987 Craig Dangler worked for or with Derby Refining Company. He began as a salaried manager of a gas station in South Sioux City, Nebraska.

In October or November, 1982 Craig Dangler moved with his family to York, Nebraska where he operated a Derby gas station as a sole proprietor. He leased the station and purchased gas from Derby. The Danglers began to have financial difficulty during their time in York. They were unable to sell their house in Sioux City and had to continue making $300 monthly mortgage payments as well as $500 rent payments on their York residence. The gas station did not generate enough money to cover expenses and the Danglers accumulated debt. In 1984 the Danglers borrowed $5,000 from Janis's parents and approximately $5,000 from Craig's parents.

In September, 1984 the Danglers moved back to their house in Sioux City. Derby hired Craig Dangler as an area sales manager. The job required extended travel. He was terminated from that position in December, 1987 because of conflict with other personnel. His last salary was $28,500 per year.

Craig Dangler was unemployed for about four months and received unemployment benefits. In about April, 1988, he borrowed $14,000 from Norwest Bank to buy a truck and equipment, and to start his own lawn sprinkler business which he still operates. The sprinkler business is seasonal; Craig operates it for about six months a year. In the winters he has obtained other employment.

Janis Dangler began embezzling from Norwest Bank in January, 1986. At that time, Craig Dangler had ceased leasing the gas station in York for about a year. However, Janis felt financial pressure from his outstanding business debts. She was working in the ag lending department at Norwest and had authority to issue loan advances on customers' lines of credit. She embezzled by documenting advances to such customers and then taking the money. She used the accounts of a few large customers who made numerous banking transactions and who had daily contact with her. She would document a false loan transaction and issue herself a cashier's check. In the next embezzlement transaction she would first make a false entry "paying" the previous "loan." Then she would make a second entry, documenting a new loan, which equaled the accumulated total previously embezzled plus an additional amount. The additional amount represented newly embezzled funds. In this way she was able to keep a mental record of the correct amount of customers' loans and also the total amount she had embezzled. If a customer called to ask about a balance, she could mentally subtract the amount of her cumulative embezzlements and give the correct figure. In order that customers would not have to pay interest on the false portions of their loan balances, she made interest payments. She did not keep a record of the amount spent on interest payments. She estimated the amount was approximately $50,000 to $75,000 between 1986 and 1990. As an alternative method of embezzlement, she would, from time to time, obtain money through entries on the bank's general ledger.

In February, 1992, the IDOR learned, through a newspaper article, of the criminal charges against Janis Dangler. In April, 1992, the IDOR assessed the Danglers for additional tax on account of the income from embezzled funds for tax years 1986, 1987, 1988 and 1989. The Danglers filed amended returns for each of those tax years in July, 1992 to report the embezzled funds as additional income. The Danglers reported the amount embezzled in 1990 on their original tax returns for that year. There was no evidence when the 1990 return was filed. Attached to the amended returns was a statement listing the amounts embezzled for each year:

1986	$ 18,000
1987	39,640
1988	78,860
1989	90,750
1990	72,250
	$299,500

Exhibits 2-5. Assuming Janis Dangler made interest payments of $75,000 in proportion to the amount embezzled for each year, she would have actually taken for her and her family's use these approximate amounts:

1986	$ 18,000 - 4,500 =	$13,500
1987	39,640 - 9,750 =	29,890

1988	78,860 - 19,500 =	59,360
1989	90,750 - 22,500 =	68,250
1990	72,250 - 18,750 =	53,500
	$75,000	**$224,500**

The Danglers had disposable income from legitimate sources in 1986 through 1989 as follows:

	1986	**1987**	**1988**	**1989**
Craig's wages	27,190	27,850	380	0
Janis' wages	13,208	15,161	15,832	16,562
Interest	170	84	82	137
Pension/annuity	138	0	0	0
Business profit	0	0	3,162	5,255
Depreciation	0	0	3,070	4,955
Unemployment	0	0	2,340	0
	40,706	43,095	24,866	26,909
Fed. withholding	5,049	5,395	1,945	2,004
State withhold	1,381	1,987	614	650
TOTAL	34,276	35,713	22,307	24,255

Exhibits 2-5, initial Iowa income tax return. The Danglers had the following total disposable income in 1986 through 1989:

	1986	**1987**	**1988**	**1989**
Legitimate income	34,276	35,713	22,307	24,255
Embezzlement	13,500	29,890	59,360	68,250
TOTAL	47,776	65,603	81,667	92,505

The Danglers did not submit a copy of their 1990 tax return as an exhibit. In answer to interrogatories, Janis Dangler stated that she earned an annual salary of $18,000 from 1984 to 1990 at Norwest Bank. Craig Dangler stated that his business income from River City Sprinkler since 1987 has been $17,000. Exhibits A and B, Interrogatory No. 5. Neither answer is accurate. Janis began at Norwest in 1985. She reported wages of $13,208 on her 1986 tax return. Her income increased to $16,562 in 1989. There was no evidence that Janis had a change in her job from 1989 to 1990. The court assumes that she received a raise in 1990 as she had in previous years, and finds that her annual gross salary at Norwest in 1990 was approximately $18,000. Craig began his business in 1988. He earned about $6,000 that year and roughly $10,000 in 1989. The interrogatories were answered in February 1995. The $17,000 figure may reflect his 1994 income. Craig did not include off-season wages in his answer to Interrogatory 5; he had virtually none through December 1989. The court will assume Craig's total gross wages and net business profit for 1990 were $17,000. At this rate of earnings, the Danglers would have made a total of $35,000 for the year. Their earnings through August, when the embezzlement was discovered and Janis was terminated, would have been approximately $23,333. During this eight-month period, Janis took home embezzled funds in the amount of $53,500.

Except when Janis spent the money directly, she deposited the embezzled funds in the Danglers' joint bank accounts. They had two checking accounts and one savings account. Embezzled funds were commingled with legitimate income. Janis did not keep records other than checkbook entries of any of her spending. The family did not have a household budget. When money was deposited, Janis Dangler spent it soon thereafter. Each bank account usually had a balance in the range of $500 to $1000. Between 1986 and 1989 there was never a time at which the balance exceeded $2500.

Janis Dangler's spending of the embezzled money on personal items for herself and her family began gradually. In 1986, Janis spent $10,000 to pay off the loans to their parents. She paid each loan in full in one payment. She did not tell her husband that she had paid the loans. She testified that they never discussed it.

Prior to the embezzlement, the Danglers had spent their vacations camping in nearby areas such as Nebraska or the Black Hills. In February, 1986 the Danglers went to Phoenix for a week and spent about $1000. Exhibits A and B, Interrogatory 11. In February, 1987 and February, 1988 they went to Las Vegas for three days each time. The Danglers testified at trial that they spent approximately $1000 to $1500 on each Las Vegas trip. In answer to their interrogatories, they stated that each trip cost $2500. In 1987 the Danglers also drove to Canada with their parents. In 1989 or 1990 they traded in a camper for $1500 and purchased a new camping trailer for $6000 to $7000. Sometime between 1986 and 1990 they traded in a ten-year old fishing boat and 35 hp motor and bought a new boat, trailer and 75 hp motor for $6000 to $7000. At the beginning of 1986 the Danglers had a 1979 Toyota pickup and a 1975 Monte Carlo for their personal use. Between 1987 and 1990, they traded for newer vehicles three times. In 1987 or 1988 the Danglers bought a 1986 Jeep Cherokee for $10,000. They paid off the loan on the Jeep, then traded it for a Suburban that was two or three years old. When the Suburban loan was nearly paid off, they traded it in for a new 1990 Chevy pickup. In addition, between 1988 and 1990 the Danglers bought a 1974 Porsche for $4000 to $5000. Craig Dangler testified that they may have paid cash for the Porsche.

The Danglers had worked on their house ever since they bought it and had done some remodeling beginning in September, 1984. In 1987, the Danglers obtained a line of credit from Norwest Bank and began making major improvements to their home. They built a 12' x 12' addition to their kitchen, built a double garage and did extensive remodeling in other areas of the home. They borrowed $14,000 on the line of credit. Approximately $6000 to $7000 of that amount was used to purchase the new fishing boat and the rest was spent on the house. Between $5000 and $8000 was paid to a contractor.

After the embezzlement was discovered, Janis Dangler entered into an agreement with Norwest to turn over items of property to the bank in restitution. Craig Dangler signed the agreement to relinquish his interest in the property and to obtain a release from the Bank. Pursuant to the agreement, the Danglers turned over property valued at approximately $125,000. The property included $35,000 borrowed from her parents and the proceeds from the sale of the Danglers' house. The personal property turned over to Norwest is described on a 58-item list. Exhibit 1. The list includes: guns, including a set of four collectors rifles for which Janis Dangler testified she paid $400 to $500 each; jewelry, including a 50-diamond tennis bracelet, a man's wedding band and other diamond jewelry; a computer; art prints; coin collections; baseball cards; several items of home entertainment electronics including a big screen television; and musical instruments. Janis bought the collectors rifles for Craig as a gift. He received at least two of them for Christmas in 1987. They were uncharacteristic of previous gifts she had given him. There was no evidence of when other particular items were purchased.

When Craig obtained his business loan from Norwest Bank, he filled out a financial statement. He had a separate bank account for his business expenses and handled payment of those himself. He tried to pay $300 per month on the business loan. Craig gave the profits from the business to Janis to be used for household expenses.

Janis handled all the household expenses and family banking. She paid all the bills and did all the food shopping. Janis gathered the information at year end for taxes for the business and their personal taxes. Craig did not know specifically what they spent on living expenses, such as food. He did not look at the bills. Janis arranged for the documents to be drawn up for their home improvement loan and loans for the purchase of larger items. Craig signed the loan documents. Janis paid off the loans soon after they were made without telling him. Craig had general knowledge of the purchase prices and monthly installments for major purchases. He estimated their home mortgage payment was between $250-$300, the home improvement/boat loan payment was between $300-$400, and their car payments were between $250-$275 until March 1990 when they were $300 for the new pickup. He also believed they were making payments on the camper, although he could not remember how it was financed. He said there probably would be monthly payments on a Visa card. He knew they were not making payments to their parents. Janis testified that their home mortgage was $300 per month, including taxes, and that she spent between $400-$600 monthly for food. They have three sons, ages 15, 14 and 6.

DISCUSSION

The taxing authority bears the burden of proof by a preponderance of the evidence that taxes are nondischargeable, even if the complaint to determine dischargeability is brought by the debtor. Langlois v. United States, 155 B.R. 818, 820 (N.D.N.Y. 1993); Dube v. United States (In re Dube), 169 B.R. 886, 891 n.5 (Bankr. N.D. Ill. 1994), *aff'd*, 1995 WL 238674 (N.D. Ill. 1995). The burden of proof in this action is on the IDOR.

The parties agree that the age of the tax years and the date of assessment are such that the taxes at issue would be otherwise dischargeable under 11 U.S.C. 523(a)(1)(A). The IDOR's claim, however, is that the taxes are excepted from the Danglers' discharge under other provisions of 523. The IDOR has three theories. IDOR argues that the taxes are nondischargeable under 11 U.S.C. 523(a)(1)(B)(i) for failure to file required tax returns, under 523(a)(1)(C) for filing fraudulent returns or for a willful attempt to evade or defeat the taxes, or under

523(a)(4) as debt for embezzlement.

The court will first address the IDOR's claim under

523(a)(4). The IDOR argues that the Danglers' tax liability arose out of the embezzlement, and that the language of

523(a)(4) is broad enough to include debt for taxes owing on account of income from embezzlement. The IDOR has not cited authority for this interpretation of the statute and the court disagrees that it can be read so broadly. Section 523(a)(4) excepts "debt for embezzlement" from the discharge. "Debt" means liability on a claim; "claim" means a right to payment. 11 U.S.C. 101(12), (5). Norwest Bank holds a claim for embezzlement. The IDOR has a claim for taxes. The exceptions to discharge are to be construed narrowly in favor of the debtor. Caspers v. Van Horne (Matter of Van Horne), 823 F.2d 1285, 1287 (8th Cir. 1987). A plain reading of the statute precludes applying 523(a)(4) to IDOR's claim.

The court now turns to the IDOR's theory that the taxes are nondischargeable pursuant to 11 U.S.C. 523(a)(1)(C). Tax liability excepted under 523(a)(1)(C) is nondischargeable without regard to the date of the tax year. Graham v. Internal Revenue Service (In re Graham), 1994 WL 777359 at *5 (Bankr. E.D. Pa. 1994); 3 Collier on Bankruptcy 523.06[4].

The IDOR must prove either one of the two prongs in

523(a)(1)(C): that the Danglers filed fraudulent returns or that they willfully attempted to evade or defeat a tax. Graham, 1994 WL 777359 at *5. The two parts of 523(a)(1)(C) are independent provisions requiring different elements, although there may be some overlap between the two when taxpayers have filed a return. Id. at *5-6. In the joint pretrial statement, the IDOR raised only the issue of whether the Danglers' initial tax returns which failed to disclose income from the embezzled funds were fraudulent returns. Pretrial Statement, Contested Facts, 2(b). The court will decide the claim under

523(a)(1)(C) under the theory of fraudulent return, which may be determined by applying the same analysis used in civil tax fraud cases. Id. at *6 (referring to 26 U.S.C. 6653(b), now numbered 6663(a)); Kirk v. United States (In re Kirk), 98 B.R. 51, 54-55 (Bankr. M.D. Fla. 1989) (same); Hamilton v. United States (Matter of Hamilton), 1984 WL 21197 at *7, 84-2 U.S. Tax Cas. (CCH) 9875 (Bankr. S.D. Iowa Jan. 20, 1984). The elements of a fraudulent return are:

1. knowledge of the falsehood of the return;

2. an intent to evade taxes; and

3. an underpayment of the taxes.

Graham, 1994 WL 777359 at *6; Kirk, 98 B.R. at 55. The intent required is the specific intent to evade a tax believed to be owing. Kirk, 98 B.R. at 54; Howard v. United States (Matter of Howard, 167 B.R. 684, 687 n.3 (Bankr. M.D. Fla. 1994). The government must show that the taxpayers filed false returns with a bad intent "calculated to cheat or defraud." Hamilton, 1984 WL 21197 at *7; Garthwright v. United States (In re Garthwright), 102 B.R. 211, 213 (Bankr.

D. Or. 1989).

The element of underpayment is not disputed. The Danglers have scheduled IDOR's claim. Knowledge of the falsity of the returns may be proved by evidence that the Danglers knew they had income that was not being reported. Because it is unlikely that the taxing authority will have direct evidence of fraudulent intent, the court may infer the taxpayers' intent from their entire course of conduct or "badges of fraud." Recklitis v. Commissioner, Internal Revenue, 91 T.C. 874, 910 (1988); Dube v. United States (In re Dube), 169 B.R. 886, 891 (Bankr. N.D. Ill. 1994) *aff'd* 1995 WL 238674 (N.D. Ill. 1995); Berzon v. United States (In re Berzon), 145 B.R. 247, 250 (Bankr. N.D. Ill. 1992). The court finds and concludes that the returns filed by the Danglers were fraudulent returns for each tax year at issue as to Janis Dangler and for tax years 1988 and 1989 as to Craig Dangler.

In Recklitis, the court made a nonexclusive list of factors the court could consider as evidence of civil tax fraud:

(1) understating income;

(2) maintaining inadequate records;

(3) failing to file tax returns;

(4) giving implausible or inconsistent explanations of behavior;

(5) concealing assets;

(6) failing to cooperate with tax authorities;

(7) engaging in illegal activities;

(8) attempting to conceal illegal activities;

(9) dealing in cash and

(10) failing to make estimated tax payments.

Recklitis, 91 T.C. at 910, citing Bradford v. Commissioner, Internal Revenue, 796 F.2d 303 (9th Cir. 1986). Other courts have compiled similar lists naming other factors, including: a pattern of underreporting large amounts of income over a period of time, Dube, 169 B.R. at 892; Berzon, 145 B.R. at 250; Hamilton v. United States (Matter of Hamilton), 1984 WL 21197 at *8, 84-2 U.S. Tax Cas. (CCH) 9875 (Bankr. S.D. Iowa Jan. 20, 1984); transfers to family members, transfers for inadequate consideration, or transfers that reduce the taxpayers' assets subject to execution, Dube, 169 B.R. at 892; failure to report income from criminal activities, Hamilton, at *8; a willingness to make false statements under oath, Id.

Janis clearly knew that she and her husband had income from enbezzlement. The embezzlement scheme continued for about four and a half years and provided nearly a quarter of a million dollars for the family's personal use. She also knew the income was not being reported to the State of Iowa. She did not tell their tax preparer of the embezzled income. She signed the tax returns. Her criminal conviction and failure to report large amounts of income are sufficient to raise an inference of fraudulent intent. See Rogers v. Commissioner, Internal Revenue, 111 F.2d 987, 989 (6th Cir. 1940) (upholding fraud penalty against taxpayer convicted of embezzlement whose income for three consecutive years was more than twice that reported). Janis admitted that she concealed her criminal activity, another badge of fraud.

Craig Dangler was not charged with embezzlement. He claims he had no knowledge of his wife's embezzlement or the income it provided until she told him in August 1990. He said he had no reason to discuss their finances with Janis as long as they were surviving. He said he assumed they were just doing financially better as time went on. This explanation is not credible. The Danglers' life style between 1986 and 1990 can hardly be described as "surviving." It was reasonable for Craig to leave primary responsibility for banking chores to Janis because she had bank experience and for several years his work required extensive travel. However, it was not reasonable for him to abdicate complete

responsibility for his own financial situation. It is significant that his behavior did not change after he lost his job with Derby.

Craig Dangler was more knowledgeable about the family's financial matters than he would have the court believe. He knew of each purchase of a motor vehicle, the new boat, the new camper. Presumably, he helped select these items. He signed the loan documents when the Danglers obtained loans to acquire these items. He knew their purchase prices, the amount of the loans and the monthly payments. He knew his wife's salary at Norwest and knew when she received raises. He handled all the finances of his business. In 1988, when he filled out a financial statement to obtain his business loan, he knew his financial net worth. He knew the gross income, expenses and profit from his business. He signed their joint tax returns.

It is difficult to believe that Craig and Janis never discussed whether they could afford the major purchases they were making. An additional fact makes Craig's credibility suspect. Craig testified that he knew they were not making payments on the loans from their parents. It is not plausible that he would not consider or discuss with Janis whether they ought to make some payment to their parents at a time when they were spending lavishly on themselves.

The court cannot accept Craig Dangler's explanation that he had no idea that the family had money from an unexplained source. Although Janis's embezzlement and spending on personal property items began gradually, eventually it reached a level which Craig could not have missed or ignored.

The court has found, as discussed above at page 5, that in 1986, Janis took from the bank approximately $13,500. She spent $10,000 repaying the loans to their parents. There was no evidence of paying other debts. The Danglers spent the remaining $3,500 on themselves. In 1987, Janis embezzled approximately $30,000. That year the Danglers were earning more than they ever had before; they each had an increase in wage income. It was irresponsible for Craig not to notice the embezzlement income, especially in 1987. However, the court finds that for 1986 and 1987 Craig did not know of the illegal income.

In 1988 the situation changed completely. The amount embezzled increased sharply to about $60,000. Craig had lost his job with Derby and was starting his sprinkler business. The family income from legitimate sources went down by more than one-third of the previous year's income. In 1989, Janis brought home about $68,250 in embezzled funds, while the family's legitimate income increased by less than ten percent from the previous year to $24,255. The Danglers' answers to interrogatories, Exhibits A and B, Interrogatory No. 5, imply that their annual rate of income for 1990 may have been as much as $35,000. By August, 1990 when the embezzlement was discovered, they had taken $53,500 for their own use from embezzlement. During the time Janis was embezzling the most money, the Danglers were earning the least.

Craig testified that he thought they were making the following installment payments:

Mortgage	$250 - 300
Home Improvement/Boat Loan	300 - 400
Car Loan	250 - 300

For the sake of illustration, the court will assume the lower figure, in which case the family spent $800 per month on these payments. In 1988, the family's legitimate income provided them with disposable income of about $1,859 per month ($22,307 12). In 1989 their legitimate income was $2,021 per month ($24,255 12). In 1988, the Danglers would have had $1,059 remaining after the above installment payments to pay for food, clothing, utilities, medical expenses, and all other expenses for a family of five. In 1989 they would have had $1,221 remaining for these expenses.

If the legitimate income were their only source of income, the Danglers would have been living at subsistence level. Yet during the period 1988 onward, their standard of living improved at the same time that Craig had lost his job and the family had a large reduction in legal income. Janis testified that it was in 1988 that their spending on personal property items became noticeable. In February, 1988, the Danglers took a trip to Las Vegas. Between 1988 and 1990, they bought the Porsche and the new camper. They traded up their primary motor vehicle two or three times, eventually buying a new truck. They continued to make major renovations to their home in 1988. The Danglers saved virtually

none of the embezzled funds; they spent it on themselves. Cf. First Alliance Bank v. Crider (In re Crider), 171 B.R. 909, 912 (Bankr. N.D. Ga. 1994) (debtor not charged with knowlege of wife's embezzlement; most money was deposited in son's savings account).

The court finds that Craig knew the family had income from an additional source by 1988. The income was knowingly omitted from their tax returns. Although Craig did not actively participate in his wife's embezzlement, fraudulent intent as to the tax returns can be inferred from all the circumstances and from his conduct. Computer Products, Inc. v. Nahabedian (In re Nahabedian), 87 B.R. 214, 216 (Bankr. S.D. Fla. 1988). In Nahabedian, the husband was aware his wife was bringing home checks in amounts larger than the husband could have believed she would have received for salary or bonuses. The court attributed fraudulent intent for the husband's assistance in and benefit from the wife's embezzlement scheme. Id. at 216. In Kirk v. United States (In re Kirk), 98 B.R. 51 (Bankr. M.D. Fla. 1989), the husband had been convicted of tax evasion for failure to report income from the sale of illegal drugs. In attributing fraud to the wife for purposes of

523(a)(1)(C), the court found that she knew of unreported income and benefitted from the criminal activity of her spouse. Id. at 58. The court concludes, under all the facts of this case, that Craig Dangler's failure to report known income was done with the intent to evade taxes. His liability for the taxes for 1988 and 1989 should be excepted from his discharge.

The Danglers argue their failure to report the embezzled funds as income and to pay taxes on the embezzled income was not intentional because they did not know that embezzled money was reportable income. Janis testified that had she known of the tax consequences, she would have thought of a way to pay the tax. The Danglers cite Irvine v. Commissioner, Internal Revenue (In re Irvine), 163 B.R. 983 (Bankr. E.D. Pa. 1994), in support of their argument. In Irvine, the court held the debtor's income tax deficiency dischargeable because the IRS failed to prove either prong of 523(a)(1)(C). The court found credible the debtor's explanation that he omitted the embezzled funds from his tax returns because he did not know it was reportable income. The court considered testimony by the debtor's psychiatrist that the debtor "did not consider the embezzled funds to be his." Id., 163 B.R. at 987. The court noted that one of the tax returns at issue was filed after the debtor had been convicted and sentenced for the crime. The court concluded that the omission was an error, not an attempt to conceal the illegal funds. Id. at 988.

The bankruptcy court in Pennsylvania accepted Irvine's excuse for failing to report embezzlement income on his tax returns; I do not find credible and do not accept the same excuse from Danglers. The Danglers knew that the embezzled income was "income" in an ordinary sense, in that it allowed them to pay expenses and purchase items in the same way their legitimate income did. The only difference was that their wages and business profit were from legal sources and the embezzled money was not. It is not logical to believe that honest wage earners should have to report income, but people who acquire their income illegally should have no income tax liability. The argument that the Danglers would have paid their taxes if they had known of the tax consequences of embezzlement is implausible. It is more plausible that Danglers did not report the funds on their returns precisely because they were embezzled--that they considered that one does not pay taxes on secretly obtained money because the income is secret. Moreover, reporting the income and paying the tax could have lead to discovery of the embezzlement. The court finds and concludes that the Danglers' claim that they did not know embezzled funds are reportable income is unreasonable. They did not have a good faith belief that the illegal funds were not reportable income.

Because I conclude that Janis Dangler's taxes for 1986-1989 and Craig Dangler's taxes for 1988 and 1989 are nondischargeable under 11 U.S.C. 523(a)(1)(C), I need not reach the state's argument under 11 U.S.C. 523(a)(1)(B)(i) that those taxes should not be discharged because amended returns were not filed. This argument will be considered as to Craig Dangler's taxes for 1986 and 1987.

Section 523(a)(1)(B)(i) provides that a chapter 7 discharge does not discharge an individual from any debtor "for a tax . . . with respect to which a return, if required--was not filed." IDOR contends that amended returns were required by Iowa law as to the embezzled funds, but they were not filed within the meaning of the foregoing bankruptcy code section.

Under Iowa Code 422.22, the director of the Department may require a supplementary return if a taxpayer fails to

include in his or her return items of taxable income. The Iowa Administrative Code requires taxpayers to file an amended return if they learn that the amount of income reported on their return was erroneous. Iowa Administrative Code 701-39.3(4). No time limit for the filing is specified.

The IDOR learned of the embezzlement charges against Janis Dangler from a newspaper article in February, 1992. In April, 1992, the IDOR assessed taxes on the Danglers' unreported income from embezzlement. The Danglers filed amended returns for tax years 1986 through 1989 in July 1992. The IDOR argues that the Danglers should not have the benefit of discharge of their tax debt because they filed amended returns only in response to the assessment. The IDOR cites Bergstrom v. United States (In re Bergstrom), 949 F.2d 341 (10th Cir. 1991), and Haywood v. Illinois Dept. of Revenue (In re Haywood), 62 B.R. 482 (Bankr. N.D. Ill. 1986), in support of its argument. In Bergstrom, the court held that a substitute return prepared by the IRS does not constitute a filed return for purposes of 523(a)(1)(B)(i). In Haywood, the State of Illinois learned that the IRS had audited the debtor and assessed a tax deficiency of nearly $1.5 million. Illinois law required the debtor in this situation to file a signed amended return. The State prepared a "pro forma" return to estimate additional state tax owed, but the debtor did not file his own amended return. The court said that "[m]erely because the State caught up to the taxpayer through its diligence does not free that person from the consequences of 523(a)(1)(B)(i)." Haywood, 62 B.R. at 485.

Bergstrom and Haywood are distinguishable because both cases involve a debtor who failed ever to file a required return. In each case, the taxing authority had prepared a substitute return in order to calculate the tax. Iowa law required the Danglers to file amended returns, and they have done so. It is questionable that IDOR proved that Danglers filed amended returns only as responses to the state's assessments. Assuming they did, and even assuming that the policy underlying 523(a)(1)(B)(i) is meant to encourage taxpayers to file voluntary returns rather than to file only after "getting caught," it seems to me to be an impermissible expansion of 523(a)(1)(B)(i) to use such a policy to ignore returns which in fact have been filed.

It is the point of Haywood that a taxpayer cannot ignore a duty to file an amended return, leaving it to the taxing authority to discover the additional tax, and then escape the consequences of ignoring the duty by relying on the government's substituted return or assessment. A substituted return does not count as the debtor's fulfillment of his obligation to file an amended return under appropriate tax law. But in Craig Dangler's case, he filed amended returns. I do not find it relevant that they were filed only after the embezzlement was made public. Dangler filed the amended returns for 1986 and 1987 and more than two years went by before the bankruptcy was filed. During this period, the state had ample time to attempt collection of the taxes. This is not a case where the debtor filed bankruptcy without any notice to the state of taxes due. A determination of nondischargeability under 11 U.S.C. 523(a)(1)(B)(i) is not appropriate to these facts.

ORDER

IT IS ORDERED that the Danglers' complaint is dismissed in part and granted in part. The tax liability of Janis L. Dangler to the IDOR for tax years 1986, 1987, 1988, and 1989 is not discharged pursuant to 11 U.S.C. 523(a)(1)(C).

IT IS FURTHER ORDERED that the tax liability of Craig A. Dangler to the IDOR for tax years 1988 and 1989 is not discharged pursuant to 11 U.S.C. 523(a)(1)(C).

IT IS FURTHER ORDERED that the tax liability of Craig A. Dangler to the IDOR for tax years 1986 and 1987 is discharged. Judgment shall enter accordingly.

SO ORDERED THIS 2nd DAY OF OCTOBER 1995.

William L. Edmonds
Chief Bankruptcy Judge

I certify that on _____ I mailed a copy of this order and a judgment by U.S. mail to: Donald Molstad, Dale Baker and U. S. Trustee.