BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GEORGE E. AND)
DELORES WILLETT)

For Appellants: George E. Willett, in pro. per.

For Respondent: James W. Hamilton
Acting Chief Counsel

Kathleen M. Morris
Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of George E. and Delores Willett against proposed assessments of additional personal income tax in the amounts of $3,114.27 and $251.57 for the years 1963 and 1965, respectively.

George E. Willett (hereafter appellant) and his spouse, Delores Willett, filed timely joint California personal income tax returns for the years 1963 and 1965. Thereafter, the Internal Revenue Service audited appellant's federal returns for the years 1962 through 196.5, and determined that appellant had understated his taxable income for the years 1963 and 1965. On September 15, 1970, respondent issued notices of proposed assessment of additional personal income tax for the years 1963 and 196.5 on the basis of the Internal Revenue Service audit reports. Appellant immediately filed a protest against the proposed assessments. Appellant also informed respondent that he was contesting the federal action, and that he would notify respondent of the final federal determination relative to his taxable income for the years in question. On January 18, 1971, while these administrative proceedings were pending, appellant filed a petition for an arrangement of his unsecured debts pursuant to Chapter XI of the Bankruptcy Act (11 U. S. C. § 701 et seq.). Appellant's spouse was not a party to the bankruptcy proceedings.

Appellant's Chapter XI plan of arrangement was confirmed on August 13, 1973. The record on appeal indicates that respondent did not participate in the Chapter XI proceedings with respect to the proposed assessments of additional tax for the years 1963 and 1965. Following several unanswered requests for information from appellant regarding the status of his protest against the Internal Revenue Service audit determination, respondent affirmed the proposed assessments on February 4, 1975.

The primary issues presented for resolution are whether respondent's action in assessing additional taxes for the years 1963 and 1965 solely on the basis of the federal audit reports was proper, and, if so, whether the Chapter XI arrangement resulted in the discharge of appellant's liability for the additional taxes. 1/

1/ A collateral issue raised by this appeal concerns the liability of appellant's spouse, Delores Willett, for the deficiencies in question. Specifically, since Mrs. Willett did not participate as a party to the Chapter XI arrangement, the question is presented whether she remains liable for the deficiencies regardless of her husband's bankruptcy status. However, due to our conclusions with respect to the effect of appellant's Chapter XI arrangement upon his liability for the additional taxes, we find it unnecessary to address this collateral issue.

The lnternal Revenue Service audit of appellant's federal returns for the years in question was apparently conducted in conjunction with its audit of the corresponding tax returns of appellant's closely held corporation, Willett Flying Service, Inc. However, while respondent relied solely upon the federal audit reports as the basis for assessing deficiencies against appellant, it conducted an independent audit and investigation with respect to the corporation's California tax liability for the years in issue. Appellant contends that respondent, in relying upon the federal audit reports to assess the deficiencies against him, failed to consider the relationship between the federal determinations relative to the respective corporate and individual returns. Therefore, appellant argues, respondent's action in assessing additional taxes for the years 1963 and 1965 was improper.

It is well established that a deficiency assessment issued by respondent on the basis of a federal audit report is presumed to be correct, and that the burden is upon the taxpayer to establish that it is erroneous. (Appeal of Robert-J. and Evelyn A. Johnston, Cal. St. Bd. of Equal., April 22 1975; Appeal of Sidney and De Daun Buegeleisen, Cal. St. Bd. of Equal., 'April 9, 1973.) Appellant has not presented any evidence to show specifically wherein respondent's determination based upon the federal audit reports was erroneous. Accordingly, we must conclude that appellant has failed to meet his burden of establishing error in respondent's action.

The remaining issue presented by this appeal raises a question concerning the power of this board to determine the effect of a bankruptcy decree upon a taxpayer's liability for a deficiency assessment. Respondent asserts that only federal bankruptcy courts have jurisdiction to determine whether a particular debt is dischargeable in bankruptcy. Therefore, respondent concludes, this board is not the proper forum to determine whether appellant's liability for the deficiencies in issue was dischargeable in the Chapter XI proceeding. However, respondent's conclusion appears to be based upon a misinterpretation of the precise issue before the board in this matter.

Appellant has properly asserted on appeal to this board the personal defense of discharge which is provided pursuant to the confirmation of his Chapter XI arrangement. (See Argonaut Ins. Co. v. United States, 434 F. 2d 1362, 1364.) Accordingly, our inquiry

in this matter is directed to the effect of the confirmation of appellant's Chapter XI plan of arrangement upon his liability for the deficiencies in question. Our exercise of jurisdiction in this manner is necessary for proper disposition of this appeal, and does not constitute a usurpation of the exclusive jurisdiction conferred upon the bankruptcy court to determine the dischargeability of particular debts during a bankruptcy proceeding. (Cf. Ciavarella v. Salituri, 153 F. 2d 343, 344; United States Credit Bureau v. Manning, 147 Cal. App. 2d 558, 561 [305 P. 2d 970].)

The confirmation of an arrangement under Chapter XI of the Bankruptcy Act discharges the debtor "from all his unsecured debts and liabilities provided for by the arrangement.. excluding such debts as, [under section 17 of the act], are not dischargeable." (11 U. S. C. § 771.) Conversely, the confirmation of a Chapter XI arrangement does not discharge the debtor from any debts or liabilities which are not provided for by the arrangement or which are not dischargeable pursuant to section 17 of the Bankruptcy Act. (See generally 9 Collier on Bankruptcy ¶ 9.32.)

Although the record on appeal does not include a description of appellant's Chapter XI plan of arrangement, it does contain copies of several documents which were filed during the arrangement proceedings. These documents, which include appellant's schedule of priority tax claims, the court order of confirmation, and the final decree of discharge, indicate that respondent's claim for additional taxes for the years 1963 and 1965 was neither listed by appellant in his schedule of priority tax claims nor filed by respondent in the arrangement proceedings. Under the circumstances, we must assume that appellant's Chapter XI arrangement did not provide for the tax liability here in question. Accordingly, we conclude that the confirmation of the arrangement did not discharge appellant's liability for payment of the additional taxes.

Additional support for our conclusion that appellant's Chapter XI arrangement did not discharge his liability for the additional taxes may be drawn from the fact that, by virtue of section 17 of the Bankruptcy Act, the taxes were not dischargeable.

Prior to 1966, section 17 of the Bankruptcy Act provided that federal, state, and local taxes were not dischargeable in bankruptcy. On July 5, 1966, section 17 was amended to provide, in pertinent part:

> (a) A discharge in bankruptcy shall release a bankrupt from all his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy; Provided, however, that a discharge shall not release a bankrupt from any taxes ... (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt.. .. (11 U. S. C. § 35(a).)

Thus, in determining whether appellant's liability for payment of the additional taxes for the years: 1963 and 1965 was dischargeable under section 17, our inquiry is directed initially to whether the taxes became "legally due and owing" more than three years prior to the date of appellant's Chapter XI petition.

There is no unanimous agreement as to the appropriate construction and application to be given the phrase "legally due and owing" as it is used in section 17. (See 1 Collier on Bankruptcy ¶ 17.14.) Depending upon the circumstances of a particular case, the phrase might be construed to mean the date of the close of the taxpayer's taxable or income year, the due date of the return, or the date of assessment. (See generally Plumb, Federal Tax Liens and Priorities in Bankruptcy - Recent Developments, (1969) 74 Corn. L. J. 225 232.) However, it is our opinion that, for purposes of determining' the applicability of section 17 to a case involving California income taxes, the taxes must be considered "legally due and owing" as of the due date of the taxpayer's return.

Pursuant to California tax law, income taxes are payable, and must be paid, on or before the due date of the taxpayer's return. (Rev. & Tax. Code, §§ 18432, 18551, 25401, 25551.) Thus, such taxes clearly are not "legally due and owing" as of the close of the taxpayer's taxable or income year, since that event occurs prior to the due date of the return.

With respect to a deficiency assessment it might be argued that the deficiency is not "legally due and owing" until the date of assessment, or until the taxpayer's liability is finally adjudicated. However, construction of the phrase in this manner would frustrate the legislative intent which motivated enactment of the 1966 amendment to section 17. The evident purpose of Congress in enacting the amendment was to assure the financial rehabilitation of a bankrupt by providing for the elimination of his stale tax debts. (Vol. 2, 1966 U. S. Code Cong. & Rd. News 2468.') Respondent generally has four years from the due date of a taxpayer's return to issue a deficiency assessment for a particular year. (Rev. & Tax. Code, §§ 18586, 25663.) However, in certain cases, the limitation period may be considerably longer. (See, e.g. , Rev. & Tax. Code, §§ 18586.1, 18586.2, 25663c, 25673.) Thus, if the phrase "legally due and owing" is construed to mean the date of a deficiency assessment, a bankrupt taxpayer might still be liable for California tax debts which refer to a taxable or income year which closed at least seven years prior to his bankruptcy. We believe that with the enactment of the 1966 amendment of section 17 Congress intended to allow a taxing agency only three years from the due date of the taxpayer's return to determine and assess tax deficiencies without subjecting its claim thereto to discharge in bankruptcy. (See In re Kopf, 299 F. Supp. 182.)

Respondent proposed the assessment of additional taxes here in question on September 15, 1970, about four months prior to appellant's petition for the Chapter XI arrangement. However, the additional taxes became "legally due and owing" on April 15, 1964, and April 15, 1966, the respective due dates for appellant's returns for the years 1963 and 1965. (Rev. & Tax. Code, § 18551.) Therefore, since the additional taxes became "legally due and owing" more than three years prior to appellant's Chapter XI petition, the taxes were dischargeable in bankruptcy unless they "were not reported" on the returns made by appellant and "were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies" available to appellant. (11. U. S. C. § 35(a), supra.)

The record on appeal does not indicate the specific reasons either for respondent's assessment of the additional taxes or for the corresponding action of the Internal Revenue Service. However, it is clear that the deficiency assessments were for the difference in tax

between the amounts shown by appellant on his returns and the amounts calculated as correct by respondent. (See Rev. & Tax. Code, § 18591. 1.) The term "reported" as used in section 17 refers to the taxpayer's representation of taxes due, whether the deficiency arises out of the disallowance of deductions or out of the taxpayer's failure to report income. (In re Ferwerda, 36 Am. Fed. Tax R. 2d 5413.) Therefore, we conclude that appellant did not "report" on his respective returns for the years 1963 and 1965 the amount of additional taxes which constitute the deficiency assessments in question, (See In re Michaud, 458 F. 2d 953, 957, cert. denied, 409 U. S. 876 [34 L. Ed.. 2d 129]; In re Indian Lake Estates, Inc. , 428 F. 2d 319, 324, cert. denied, 400 U. S. 964 [27 L. Ed. 2d 383]. But see, In *re* Wukelic, 396 F. Supp. 141.)

With respect to whether the additional taxes in question "were not assessed prior to bankruptcy . . . ", we interpret the term "assessed" to mean final assessment under section 18591 of the Revenue and Taxation Code. (Cf. In re Indian Lake Estates, Inc., supra; In re Laytan Jewelers, Inc. , 332 F. Supp. 1153; see generally, Plumb, Federal Liens and Priorities - Agenda for the Next Decade (I 967) 77 Yale L. J. 228 266) Final assessment of the additional taxes against appellant 'was postponed pending the,, outcome of appellant's protest action against the proposed assessments. Therefore, we conclude that the additional taxes were not assessed prior to appellant's Chapter XI arrangement "by reason of a prohibition on assessment pending the exhaustion of administrative ... remedies available to [appellant]. "

In summary, although the additional taxes in question became legally due and owing to the state more than three years prior to appellant's Chapter XT arrangement, it is our opinion that pursuant to the above stated exception to discharge found in section 17 of the Bankruptcy Act, the taxes were not dischargeable. Therefore, appellant's Chapter XI arrangement had no effect upon his liability for payment of the deficiencies.

Appellant also contends that since respondent failed to file a proof of claim for the additional taxes in the Chapter XI proceeding, respondent is estopped from further attempts to assess and collect the taxes. However, appellant cites no authority in support of the contention. Furthermore, the failure of respondent to file proof of a nondischargeable claim in a bankruptcy proceeding

does not constitute grounds for application of estoppel in this manner. (Cf. Newberg v. United States, 296 F. 2d 152, aff'g 187 F. Supp. 158; Cal. St. Bd. of Equal. v. Coast Radio Prod., 228 F. 2d 520, 525.)

Accordingly, for the reasons stated above, we conclude that respondent's action in this matter must be sustained.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue, and Taxation Code, that the action of the Franchise Tax Board on the protest of George E. and Delores Willett against proposed assessments of additional personal income tax in the amounts of $3,114.27 and $251.57 for the years 1963 and 1965, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 22nd day of June, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____. Member

ATTEST: _____, Executive Secretary