BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ORVILLE H. and JEANNE K. HAAG)

For Appellants: Marvin G. Giometti
Attorney at Law

For Respondent: Bruce W. Walker
Chief Counsel

Steven S. Bronson
Counsel

O P I N I O N

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 Orville H. and Jeanne K. Haag against a proposed assessment of additional personal income tax in the amount of $6,752.75 for the year 1968.

The sole issue for determination is whether the statute of limitations for the assessment of the deficiency was extended to six years due to appellants' omission from their gross income of an amount in excess of 25 percent of the gross income actually reported on their return.

During 1968 appellants were the controlling shareholders and officers of Haag Photo Service, Inc., a closely held California corporation. For federal tax purposes the corporation elected to be taxed as a tax option or subchapter S corporation. The corporation distributed cash dividends in the amount of $67,527.50 to appellants during 1968.

Appellants' 1968 California personal income tax return did not report the cash distributions received from the corporation as gross income. The omitted dividend income exceeded 25 percent of the gross income reported on the 1968 return. In the portion of their return entitled "Reconciliation to Federal Return," appellants explained the difference between the total income reported on their federal return ($109,561.33) and that shown on their California return ($55,965.29) as follows:

Total income shown on federal return		$109,561.33
Federal dividend exclusion	$ - 100.00	
Subchapter S Income -		
Haag Photo Service	$53,696.04	
		$ 53,596.04

During an audit of appellants' personal income tax returns for later taxable years which are not before us, respondent discovered the omission of gross income on appellants' 1968 return. Although more than four years had elapsed since the 1968 return was filed, respondent, nevertheless, issued a notice of proposed assessment on March 28, 1974, relying on section 18586.1 of the Revenue and Taxation Code. That section extends the limitations period from four years to six years if the taxpayer has omitted from gross income an amount in excess of 25 percent of the amount of gross income stated in the return.

Appellants protested the notice of proposed assessment and were granted a hearing. At the hearing appellants agreed that the correct amount of unreported

cash dividends received during, 1968 was $67,527.50 which was in excess of 25 percent of the amount of gross income stated in the return. While appellants agreed that the amount should have been reported in their 1968 return, they maintained that the omitted income was adequately disclosed in the federal reconciliation section of their return. Therefore, appellants concluded that the deficiency assessment was barred by the four year statute of limitations. Respondent denied appellant's protest and this appeal followed.

Section 18586.1 of the Revenue and Taxation Code extends the general four year statute of limitations for issuing deficiency assessments to six years as follows:

> (a) If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, a notice of a proposed deficiency assessment may be mailed to the taxpayer within six years after the return was filed.

Appellants argue, however, that their 1968 return satisfied the disclosure exception to the six-year limitation period contained in subsection (b)(2) of section 18586.1 which states:

> (b) For purposes of this section--
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> * * *
>
> (2) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Franchise Tax Board of the nature and amount of such item.

The critical inquiry, therefore, is whether appellants disclosed the amount of the cash dividends in their 1968 return, or in a statement attached to the return, in a manner adequate to apprise respondent of the nature and amount of such dividends.

Before considering the adequacy of the disclosure it is necessary to recognize a fundamental difference between California franchise tax law and the federal corporate income tax. California has no equivalent of the subchapter S corporation recognized under federal tax law. For federal purposes the distinctive feature of a subchapter S corporation is that earnings and profits of the corporation are not subject to the corporate income tax. The corporate income is, in effect, passed through and taxed to the stockholders at the federal level, even though the -income is not distributed. (See Benderoff v. United States, 398 F.2d 132 (8th Cir. 1968).) Thus, a shareholder in a subchapter S corporation would not be required to report current undistributed income of a subchapter S corporation on his California personal income tax return, but would be required to include such income in his gross income for federal income tax purposes.

With this distinction in mind we turn to the consideration of the adequacy of the disclosure contained in appellants' 1968 return. In order to prevail, the burden is on respondent to show that the amount was not adequately disclosed on the return or in a statement attached to the return. (Walker v. Commissioner, 46 T.C. 630, 637 (1966); Roschuni v. Commissioner, 44 T.C. 80, 85 (1965); Rose v. Commissioner, 24 T.C. 755, 767 (1955).)

The federal counterpart to section 18586.1 is contained in section 6501 of the Internal Revenue Code of 1954. The congressional purpose behind that statute was merely to give the taxing agency an additional two years to investigate a tax return where the taxpayer's omission of a taxable item has placed the taxing agency at a special disadvantage in detecting errors. In that situation the return on its face provides no clue to the existence of the omitted item. However, where the understatement is disclosed somewhere on the return the taxing agency is not similarly disadvantaged and the statute of limitations is not extended. (Colony Inc. v. Commissioner, 357 U.S. 28, 36 [2 L. Ed. 2d 1119] (1958).) Or, as the rule has been stated by the Tax Court in George Edward Quick Trust v. Commissioner, 54 T.C. 1336, 1347 (1970):

> The touchstone in cases of this type is whether respondent has been furnished with a "clue" to the existence of the error. [Citations omitted.] Concededly, this does not mean simply a "clue"

which would be sufficient to intrigue a Sherlock Holmes. But neither does it mean a detailed revelation of each and every underlying fact.

Here, appellants identified a discrepancy between the gross income figures as they appeared on their federal return and on their state return. The item was clearly labeled as subchapter S income. The amount and nature of the omitted income was clearly disclosed on the face of appellants' return.

Respondent argues that because of the special treatment accorded a subchapter S corporation at the federal level and the fact that such corporations are not recognized for California franchise tax purposes, the disclosure on appellants' return was not sufficient to provide a clue as to the omission. It is respondent's position that, under these circumstances, a state auditor examining the return would logically conclude that the subchapter S income was not distributed to the shareholders, thus, accounting for the difference between the amount of gross income reported on the California and the federal return. We do not agree.

The language of appellants' disclosure, "Sub Chap. S Income" gave respondent clear notice of the existence of such income. There was no indication whether the income was distributed or not. Where it is equally tenable to conclude that the dividends were paid as to conclude that they were not, the prudent conclusion would be that they were paid. Thus, appellants' disclosure was sufficient to put respondent on inquiry.

Respondent also argues that appellants cannot prevail because they inadequately disclosed the amount of the cash dividends. We do not find this argument persuasive. Nothing in the statute requires disclosure of the exact amount. (George Edward Quick Trust v. Commissioner, supra; Lyta J. Morris, T.C. Memo., Oct. 31, 1966.)

We conclude that appellants disclosed the amount of the dividends in their 1968 return in a manner adequate to apprise respondent of the nature and amount of such dividends. Therefore, the six-year statute of limitations contained in section 18586.1 of the Revenue and Taxation Code is inapplicable. Since respondent's notice of proposed assessment was untimely, its action in this matter must be reversed.

In view of our determination in this matter, it is not necessary to resolve the question whether respondent has a duty to cross-reference a taxpayer's return with the return of his closely held corporation in order to supplement a disclosure of income omitted from the taxpayer's personal income tax return.

O R D E R

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 Orville H. and Jeanne K. Haag against a proposed assessment of additional personal income tax in the amount of $6,752.75 for the year 1968, be and the same is hereby reversed.

Done at Sacramento, California, this 26th day of July, 1977, by the State Board of Equalization.

Chairman

, Member

, Member

, Member

, Member