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Feature

BY STEVEN L. WALKER

Consequences of Failing to Report Federal Changes to the California FTB or Filing State Returns



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On Oct. 14, 2021, the Ninth Circuit Court of Appeals in *Berkovich*¹ affirmed the decision from the Bankruptcy Appellate Panel (BAP) that because a debtor failed to report Internal Revenue Service (IRS) tax assessments to the California Franchise Tax Board (FTB), the debtor's state tax liability was nondischargeable under § 523(a)(1)(B)(i). California law required the debtor to file a report under Cal. Rev. & Tax. Code § 18622(a), and the report was an "equivalent report" within the meaning of § 523(a)(1)(B). The court rejected the debtor's argument that the phrase "equivalent report" under § 523(a)(1)(B) is limited to a "return" and anything not expressly a "return" is excluded.

In a concurrently decided case, the Ninth Circuit Court of Appeals in *Sienege*² affirmed the BAP's decision holding that because a debtor failed to file "formal" state tax returns that complied with California law, the state taxes were nondischargeable under § 523(a)(1)(B)(i). The debtor's argument that he faxed reports of the federal changes to the FTB was insufficient because the faxes did not qualify as returns under the *Beard* test.

While both *Berkovich* and *Sienege* involve the California FTB, other states, such as Maryland,³ have similar statutes requiring the reporting of federal changes to a state's taxing agency. Debtor's counsel should be mindful of a state's tax-reporting regime to avoid the *Berkovich* trap of nondis-

chargeable state income taxes. A guiding principle is that whatever happens at the federal level should also be done at the state level, which means complying with state law notification requirements and filing tax returns and amended returns, as required by state law.

Calif. FTB's Notification Requirements

The California FTB generally follows the IRS's final determination in civil examinations. For example, suppose the IRS audits a taxpayer and any changes or corrections to the taxpayer's return. The FTB follows the federal determination and issues a notice of proposed assessment (NPA) to the taxpayer.⁴ The NPA sets forth adjustments to the taxpayer's state income tax return, and those adjustments flow from the IRS's determination. There is no need for the FTB to start from scratch and re-audit the taxpayer when it can simply follow in the footsteps of the IRS revenue agent who has already examined the taxpayer. It comes down to agency efficiency. If a taxpayer fails to file a protest, the amount of the proposed deficiency assessment becomes final upon the expiration of 60 days.⁵ This generally is the procedure that occurs after an IRS audit.

Taxpayers have notification responsibilities to California if the IRS examines a return and makes adjustments that increase the tax for any year. Under California law, if the IRS makes a change or correction to a return, the taxpayer must report each federal change or correction.⁶ The "final federal

¹ *Cal. Franchise Tax Bd. v. Berkovich* (In re *Berkovich*), 610 B.R. 893 (Bankr. C.D. Cal. 2020), *aff'd*, 619 B.R. 397 (B.A.P. 9th Cir. 2020), *aff'd*, 15 F.4th 997 (9th Cir. 2021).

² *Sienege v. Cal. Franchise Tax Bd.* (In re *Sienege*), 619 B.R. 405 (B.A.P. 9th Cir. 2020), *aff'd*, 18 F.4th 1164 (9th Cir. 2021).

³ *Maryland v. Ciotti* (In re *Ciotti*), 638 F.3d 276 (4th Cir. 2011) (Maryland state tax debt was nondischargeable where debtor failed to give report to Maryland comptroller).

⁴ Cal. Rev. & Tax. Code § 19033.

⁵ Cal. Rev. & Tax. Code § 19042 (finality of assessed deficiency).

⁶ Cal. Rev. & Tax. Code § 18622(a) (report of federal change or correction or amended return).

determination” is when the IRS examination adjustment is assessed on the account transcript as described in IRC § 6203.⁷ California law prescribes how the taxpayer must report the changes or corrections.⁸

A strategic move is that a taxpayer should timely notify the FTB instead of leaving it up to the IRS to report the change through the IRS information-sharing program with the state. By informing the FTB, the taxpayer proactively triggers a special limitation period that shortens the amount of time that the FTB has to issue an NPA. Here are some examples:

- Suppose that a taxpayer reports the change or correction within the six months after the final federal determination (or the IRS reports that change within six months). In that case, the FTB has *two years* from the date that it receives a report of the federal change to apply the federal change to a taxpayer’s California income tax return.⁹
- If a taxpayer fails to report a change made by the IRS, the FTB can mail an NPA resulting from the adjustment to the taxpayer *at any time*.¹⁰
- However, if the FTB receives the change or correction after six months, the FTB has a much longer time — four years — to issue an NPA to a taxpayer.¹¹

FTB Publication 1008¹² explains the procedural rules for notifying the FTB and is a must-read so as not to run afoul of the detailed notification responsibilities in California. Publication 1008 prescribes how a taxpayer must report to the FTB the changes or corrections and how to submit the information.

A similar set of rules applies concerning amended tax returns. For example, if a taxpayer files an amended return with the IRS, California law requires the taxpayer to file within six months after that an amended return with the FTB.¹³ The FTB then has two years to issue a notice of proposed deficiency assessment.¹⁴ Suppose a taxpayer fails to file an amended return as required by Cal. Rev. & Tax. Code § 18822. The FTB can then mail a notice of proposed deficiency assessment to the taxpayer at any time.¹⁵ Most California tax professionals are well-versed in the FTB reporting rules and use them to the taxpayer’s advantage outside of bankruptcy to promptly start the clock on the FTB’s time for adjusting a taxpayer’s California income tax return.

The *Berkowitz* case illustrates the application of the notification rules in a chapter 13 case. It underscores the importance of timely reporting the changes to discharge state income taxes. The *Sieneaga* case reminds debtors to file formal state tax returns that comply with Cal. Rev. & Tax. Code § 18501 before considering bankruptcy.

Berkovich: Failure to Notify FTB of Federal Adjustments

Dennis Berkovich filed his California state tax returns for 2003, 2004 and 2005. The IRS assessed additional taxes for those years, but Berkovich failed to notify the FTB of the changes or corrections required by Cal. Rev. & Tax. Code § 18622(a). Instead, the IRS reported the changes or corrections, and the FTB assessed additional taxes.

Berkovich and his wife subsequently filed a chapter 13 petition. Their proposed plan treated the balance due to the FTB as a general unsecured claim to be paid *pro rata* with other unsecured claims. The bankruptcy court confirmed the plan, and the Berkoviches completed all required plan payments and obtained a discharge under § 1328(a). The FTB filed a nondischargeability complaint, alleging that the state tax debts were nondischargeable under § 523(a)(1)(B)(i) because Berkovich failed to report the increased federal tax assessments to the FTB.

The bankruptcy court granted summary judgment in the FTB’s favor. On appeal, the BAP ruled that the reporting requirement under Rev. & Tax. Code § 18622 was an “equivalent report” within the meaning of § 523(a)(1)(B) and that Berkovich did not dispute that he failed to file such report with the FTB following the IRS’s assessment.

Sieneaga: Unfiled State Tax Returns

Rudolf Sieneaga failed to file required California state income tax returns for the 1990, 1991, 1992 and 1996 tax years. The IRS adjusted his federal tax liability for those years, and the U.S. Tax Court upheld the IRS’s determination. Sieneaga notified the FTB of the adjustments via fax following the Tax Court’s decision. Debtor’s counsel faxed a cover sheet and IRS Form 4549-A that listed Sieneaga’s income adjustments. In response to the faxes, the FTB issued an NPA to Sieneaga for each of the four tax years and assessed the additional tax and interest due.

Sieneaga filed a voluntary chapter 13 petition, which he later converted to a chapter 7 petition. In November 2018, the FTB filed a timely adversary complaint seeking to have Sieneaga’s tax debts declared nondischargeable under § 523(a)(1)(B) because he failed to file a state tax return in any of the relevant years. The BAP agreed, holding that the debtor’s faxes did not constitute a return because they failed the definition of a “return” under the “hanging paragraph” at the end of § 523(a). The faxes sent to the FTB were not signed under penalty of perjury and failed the first two prongs of the *Beard* test.

Observations

Considering the recent consecutive wins before the Ninth Circuit Court of Appeals in late 2021, expect the FTB to be extra vigilant with enforcing the exception to discharge under § 523 in bankruptcy court. An important takeaway is that the FTB can successfully establish that state tax debts are nondischargeable on *three* separate grounds under § 523(a)(1)(B):

- State taxes are nondischargeable if the IRS examined the debtor’s return and made adjustments,

7 Cal. Rev. & Tax. Code § 18622(d); see also 18 C.C.R. § 19059(e) (“A final determination is an irrevocable determination or adjustment of a taxpayer’s federal tax liability from which there exists no further right of appeal either administrative or judicial.”)

8 Cal. Rev. & Tax. Code § 18622(a) prescribes the manner in which a taxpayer must report changes or corrections; Cal. Rev. & Tax. Code § 18622(c) requires that a taxpayer mail the information to the FTB.

9 Cal. Rev. & Tax. Code § 19059(a) (federal change or correction; amended return).

10 Cal. Rev. & Tax. Code § 19060(a) (failure to report federal change or correction).

11 Cal. Rev. & Tax. Code § 19060(b).

12 Publication 1008, “Federal Tax Adjustments and Your Notification Responsibilities to California,” State of Calif. Franchise Tax Board, available at ftb.ca.gov/forms/misc/1008.html#Method-of-Notification (last visited Jan. 18, 2022).

13 Cal. Rev. & Tax. Code § 18622(b).

14 Cal. Rev. & Tax. Code § 19059(b).

15 Cal. Rev. & Tax. Code § 19060(a).

but the debtor failed to notify the FTB as required under Cal. Rev. & Tax. Code § 18622(a) (this is the *Berkovich* case);

- State taxes are nondischargeable if the debtor has unfiled California income tax returns, and meeting the reporting requirements under California law does not satisfy the tax-return filing requirement (this is the *Sienea* case); and
- State taxes are nondischargeable if the taxpayer filed an amended tax return with the IRS and failed to file an amended return with the Franchise Tax Board as required under Cal. Rev. & Tax. Code § 18622(b).

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Common-Sense Due Diligence

In light of *Berkovich* and *Sienea*, debtor's counsel should consider taking the following steps to ensure that any balance owed to the California FTB is not excepted from discharge under § 523(a)(1)(B).

1. Ask the client whether the IRS has examined a prior tax return, and if so, what happened. Was there a balance due, and for what years? Did the client file a petition in Tax Court? How was the case resolved?
2. Request copies of IRS correspondence and Tax Court pleadings from the client if they exist. Search for the final determination, which is a defined term under 18 CCR § 19059. For example, look for an executed Form 4549, an IRS closing agreement made under IRC § 7121, a 90-day deficiency notice under IRC § 6213(a) or a Tax Court decision, and obtain assistance from tax counsel to help wade through the maze of documents.
3. Order IRS account transcripts for the past six years. These transcripts can be obtained electronically from the IRS with a valid Form 2848 (power of attorney and declaration of representative). Review the transcripts for Transaction Code 299 (additional tax assessment), which means that the IRS assessed additional taxes after the taxpayer filed a return.
4. Read FTB Publication 1008, which sets forth the notification requirements, method of notification and mailing information.
5. File a Freedom of Information Act (FOIA) request seeking a copy of the IRS administrative file, but be forewarned that the wait can be up to a year or longer to obtain the documents. The IRS's website contains instructions on filing a FOIA request.
6. Contact the FTB through the Tax Practitioner Hotline to determine whether the client has any unfiled state tax returns. If so, work with a tax professional to file the returns as required by law. The FTB is authorized to speak with a tax professional with a valid Form 3520 (power of attorney).

The Bottom Line

Debtors who have delinquent state tax returns or who fail to report changes to the state taxing agencies run the risk of the debts not being discharged in bankruptcy. Clients who have been the subject of a civil examination would be wise to seek the advice of competent tax counsel, who can help evaluate the case, explain the options and develop a defensible strategy. **abi**