UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In Re:

Samuel J. Chatman, Jr., **CASE NO. 96-21185**

Debtor.

Samuel J. Chatman, Jr.,

Plaintiff, **A.P. NO. 96-2225**

vs.

New York State Department of Taxation & Finance,

Defendant.

In re:

Dick T. VanManen, **CASE NO. 96-23980**

Debtor.

Dick T. VanManen,

Plaintiff,

vs. **A.P. NO. 97-2011**

New York State Tax Commission,

Defendant. **DECISION & ORDER**

BACKGROUND

I. Chatman Case

On April 30, 1996, Samuel J. Chatman, Jr. ("Chatman"), filed a petition initiating a Chapter

7 case. On the same day that he filed his petition, Chatman filed the lists, schedules, and statements required by Bankruptcy Rule 1007. On his Schedule F, Chatman listed as creditors holding unsecured nonpriority claims: (1) the New York State Department of Taxation and Finance (the "Department") as having a claim of $8,619.34, consisting of unpaid income taxes of $1,197.72 for the calendar year 1983, $653.32 for the calendar year 1985 and $6,768.30 for the calendar year 1986; and (2) the Internal Revenue Service (the "IRS") as having a claim of $21,614.75, consisting of unpaid income taxes of $7,328.61 for the calendar year 1985, $14,055.76 for the calendar year 1986 and $230.38 for the calendar year 1988.

On August 2, 1996, Chatman filed an Adversary Proceeding (the "Chatman Adversary Proceeding") to have the Court determine that the amounts due the Department were dischargeable because they did not fall within the exception to discharge set forth in Section 523(a)(1).[1]

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[1] Section 523(a)(1) provides:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
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> (1) for a tax or a customs duty—
>
> (A) of the kind and for the periods specified in section 507(a)(2) 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, if required—
>
> (i) was not filed; or
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> (ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or
>
> (C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

The Complaint in the Chatman Adversary Proceeding alleged that: (1) Chatman scheduled the Department as an unsecured creditor for taxes due for the calendar years 1983, 1985, and 1986; (2) Chatman filed original returns for those tax years more than two years prior to the filing of his petition; (3) the Department assessed the taxes due more than 240 days prior to the filing of Chatman's petition; (4) no portion of the taxes assessed and due was the result of a fraudulent return or an attempt by Chatman to evade or defeat the tax; (5) at no time prior to the filing of his petition did Chatman file an Offer in Compromise covering any of the taxes assessed and due; (6) no portion of the taxes assessed and due constituted a priority claim under Section 507(a)(8)[2]; and (7) no portion

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[2] Section 507(a)(8) provides:

> (a) The following expenses and claims have priority in the following order:
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> (8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for—
>
> (A) a tax on or measured by income or gross receipts—
>
> (i) for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;
>
> (ii) assessed within 240 days, plus any time plus 30 days during which an offer in compromise with respect to such tax that was made within 240 days after such assessment was pending, before the date of the filing of the petition; or
>
> (iii) other than a tax of a kind

of the taxes assessed and due was otherwise excepted from discharge under Section 523.

The Department in its Answer: (1) denied that no portion of the taxes due were entitled to treatment as a priority claim under Section 507(a)(8); (2) denied that no portion of the taxes due were otherwise excepted from discharge under Section 523; and (3) alleged that it lacked knowledge or information concerning whether the taxes due were the result of a fraudulent return or an attempt to evade or defeat the tax.

The Court conducted a pretrial conference in the Chatman Adversary Proceeding and the matter is now before the Court for decision upon Motions for Summary Judgment filed by both the Department and Chatman.[3]

The following material facts are not in dispute: (1) Chatman's 1983 New York State income tax return was postmarked August 24, 1984; (2) on November 18, 1988, Chatman was assessed additional income taxes by the Department for 1983 after the Department was notified by the IRS of specific changes that it had made to Chatman's federal tax liability as the result of an audit; (3) the audit changes were the result of Chatman's failure to include certain compensation income and

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> specified in section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case.

[3] The parties agreed that the Court should decide the Chatman Adversary Proceeding at the same time as the VanManen Adversary Proceeding when both became ready for decision.

the disallowance of certain deductions which Chatman had claimed; (4) Chatman himself never reported the 1983 audit changes to the Department; (5) the precise postmark date for Chatman's 1985 New York State income tax return in unknown, but the return was filed more than two years prior to the filing of his petition; (6) Chatman's 1986 New York State income tax return was postmarked March 17, 1988; (7) on January 25, 1991, Chatman was assessed additional income taxes by the Department for both 1985 and 1986 after the Department was once again notified by the IRS of audit changes; (8) the 1985 Chatman audit changes were the result of the disallowance of certain deductions which Chatman had claimed and the 1986 Chatman audit changes were the result of the disallowance of certain deductions and the failure to report certain income; and (9) Chatman himself never reported the 1985 or 1986 audit changes to the Department. (The 1983, 1985 and 1986 Chatman audit changes will sometimes be referred to collectively as the "Chatman Audit Changes")

Chatman and the Department have acknowledged that the specific issue before the Court for decision in these Motions for Summary Judgment is whether, since Chatman failed to file the reports required by New York Tax Law Section 659[4] (a "659 Report") after the Chatman Audit Changes

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[4] Section 659 of the New York Tax Law provides in part:

> If the amount of a taxpayer's federal income . . . for any taxable year . . . is changed or corrected by the United States internal revenue service . . ., the taxpayer . . . shall report such change, correction, renegotiation or disallowance , or as otherwise required by the commissioner, and shall concede the accuracy of such determination of state wherein it is erroneous . . . . Any taxpayer filing an amended federal income tax return . . . shall file within ninety days thereafter an amended return under this article, and shall give such information as the commissioner may require.

were made, the additional taxes assessed and due are nondischargeable under Section 523(a)(1)(B)(i) because, for purposes of that Section, an unfiled 659 Report is the equivalent of an unfiled return.

II. VanManen Case

On December 30, 1996, Dick T. VanManen ("VanManen") filed a petition initiating a Chapter 7 case. On the same day that he filed his petition, VanManen filed the lists, schedules and statements required by Rule 1007. On his Schedule F, VanManen listed the Department as a creditor holding unsecured nonpriority claims for unpaid income taxes of: (1) $12,980.00 for the calendar year 1981; and (2) $1,161.44 for the calendar year 1982.

On January 28, 1997, VanManen filed an Adversary Proceeding (the "VanManen Adversary Proceeding") to have the Court determine that the amounts due the Department were dischargeable because they did not fall within the exception to discharge under Section 523(a)(1)(B).

The Complaint in the VanManen Adversary Proceeding alleged in part that: (1) VanManen scheduled the Department for income taxes due for the calendar years 1981 and 1982; and (2) VanManen had filed returns on New York State Form 201 for those tax years more than two years prior to the filing of his petition.

The Department in its Answer once again denied that the taxes due were nondischargeable under Section 523(a)(1)(B) because VanManen had failed to file the required 659 Report after the federal audit changes had been made.

NY TAX §659 (McKinney 1997 Supp.).

For the years in question, this is accomplished by filing a Form IT-115 labeled as "Report of Federal Changes."

The following material facts are not in dispute: (1) VanManen timely filed his federal and New York State income tax returns for the calendar years 1981 and 1982; (2) on or about August 30, 1993, VanManen was assessed additional income taxes by the Department after the Department was notified by the IRS that it had made specific changes to VanManen's federal tax liability as the result of an audit (collectively the "VanManen Audit Changes"); (3) VanManen himself never reported the Audit Changes to the Department; and (4) the notices of assessment were dated September 13, 1993 and showed a due date of September 23, 1993.

As in the Summary Judgment Motions in the Chatman Adversary Proceeding, the parties in their submissions on their Motions for Summary Judgment have agreed that there are no disputed issues of material fact and that the issue of law for the Court to decide is whether the failure of VanManen to file a 659 Report after the VanManen Audit Changes were made, and within the 90 days required by Section 659, was a failure to file a required return within the meaning and intent of Section 523(a)(1)(B)(i) so that the additional taxes assessed and due are nondischargeable.

DISCUSSION

Although counsel for VanManen disagrees, counsel for the Department and Chatman agree that if the Department had never assessed Chatman or VanManen additional taxes based on the federal Audit Changes, even though the Department had received detailed information regarding the Changes from the IRS, those additional taxes would be nondischargeable in these Chapter 7 cases. They reason that: (1) those additional taxes would be assessable before and after the filing of the petition and, therefore, entitled to priority treatment under Section 507(a)(8)(A)(iii); and (2) as such, would be nondischargeable under Section 523(a)(1)(A). For the purposes of this Decision & Order,

I accept this as true.

I agree with the proposition cited by Chief Judge Tina L. Brozman in *In re Blutter,* 177 B.R. 209 (Bankr. S.D.N.Y. 1995), that the dischargeability exceptions set forth in Section 523(a) demonstrate the decision of Congress to allow certain competing public interests to override the Bankruptcy Code's fresh start policy. I also agree with the proposition cited by Chief Judge Michael J. Kaplan in *In re Dyer,* 158 B.R. 904 (Bankr. W.D.N.Y. 1995), that generally, exceptions to discharge should be liberally construed in favor of the debtor, and thus strictly construed against the party objecting to discharge. This requires the Court, as it often must, to balance the competing policies of fresh start and exceptions to discharge based upon the facts and circumstances of the particular case before it.

Unlike most, if not all, of the exceptions to discharge set forth in Section 523(a)[5], where once the obligation is incurred by a debtor's "misconduct", assuming that it is not otherwise unenforceable because of an applicable statute of limitations, it is forever nondischargeable in a Chapter 7 case, not all income taxes due and unpaid by a debtor are forever nondischargeable. By the enactment of Sections 523(a)(1) and 507(a)(8), Congress has allowed a Chapter 7 debtor to discharge certain "older" income tax obligations where: (a) an original tax return was due more than three years before the filing of the petition; (2) a required return was filed within two years of the filing of the petition; (3) any additional taxes which could be assessed were assessed for more than 240 days before the

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[5] Such exceptions to discharge include obligations: (1) incurred by fraud (Section 523(a)(2)(A)); (2) incurred as the result of embezzlement or larceny while acting in a fiduciary capacity (Section 523(a)(4)); (3) for alimony, maintenance or support of a spouse or child (Section 523(a)(5)); (4) for willful and malicious injury (Section 523(a)(6)); and (5) for death or personal injury caused by debtor's operation of a motor vehicle intoxicated (Section 523(a)(9)).

filing of the petition, or a longer period if there was an offer in compromise made; and (4) the debtor did not file a fraudulent return or wilfully attempt to evade or defeat the taxes.

The IRS has agreed that the additional taxes due to the federal government based on the federal Chatman and VanManen Audit Changes, which were utilized by the Department to make its assessments, are dischargeable in these Chapter 7 cases because they fall outside the dischargeability exception of Section 523(a)(1) and within this category of dischargeable "older income taxes", in that: (1) original returns were due more than three years before the filing of the petitions and were in fact filed within two years of the filing of the petitions; (2) the IRS had assessed additional taxes based on its audits of Chatman and VanManen and their returns, and the assessments had been outstanding for more than 240 days before the filing of the petitions; and (3) neither Chatman nor VanManen had made a fraudulent return or willfully attempted to evade or defeat the applicable taxes.

The Department, like the IRS, had original tax returns filed with it more than two years before the filing of the petitions for the applicable tax years where a return was due more than three years before the filing of the petitions, and it assessed Chatman and VanManen additional taxes based on the federal Audit Changes and those assessments were outstanding for more than 240 days. In addition, the Department has conceded that there has been no attempt by Chatman or VanManen to wilfully evade or defeat the taxes. As pointed out by Chief Judge Kaplan in *Dyer*, if this Court were to determine that the additional taxes due to the Department, which were actually assessed based on the federal Audit Changes, are nondischargeable, it would put the Department in a better position than the IRS when the only basis for affording the Department this advantage would be that

Chatman and VanManen failed to file the 659 Report within 90 days after the federal Audit Changes were finalized.[6]

The purpose of the Department requiring the filing of a 659 Report after federal audit changes have been made can only be to insure that it obtains the specific, detailed and necessary information concerning those changes which will allow it to assess and collect the additional taxes due. Once the Department has: (1) received detailed information from the IRS concerning federal Audit Changes; (2) accepted it and utilized it to make an assessment; and (3) attempted to collect the additional taxes assessed and due without taking steps to further audit the taxpayer or determine if even more additional taxes may be due, there is no longer a reason for the taxpayer to file the 659 Report. The taxpayer, having failed to file the Report as required, has clearly waived the right to contest the accuracy of the information received by the Department or the Department's assessment, and there is no other detriment to the Department from a continuing failure to file a 659 Report.[7]

Based upon the facts and circumstances of the Chatman and VanManen cases, I find that the

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[6] Although the Department in its submissions has argued that once a taxpayer fails to file a 659 Report within 90 days after federal audit changes have been made, the taxpayer can never cure this failure by filing the Report after the 90-day period, and thus the additional taxes will always be nondischargeable for failure to file a required return, this appears to be inconsistent with Section 523(a)(1)(B)(ii) which, if the Report were to be deemed to be a return, would allow a taxpayer to file a late Report and have the additional taxes discharged, provided that the Report was filed more than two years before the filing of the Chapter 7 petition. The net effect then of deeming the 659 Report to be a return for purposes of Section 523(a)(1)(B)(i) would be to give the Department, even if it has made an assessment, an additional time of from two years, if a Report is later filed, to forever, if a Report is never filed.

[7] As Chief Judge Kaplan stated in *Dyer*, "dischargeable taxes are not converted into nondischargeable taxes . . . by a state's labeling all 'amendments' or 'notifications' as 'returns'". 158 B.R. at 906.

659 Reports that these Debtors failed to file are not returns within in the meaning and intent of Section 523(a)(1)(B)(i), for the following reasons: (1) the New York State Legislature when it enacted Section 659 demonstrated that it knew the difference between a report and a return, including and amended return, and it required the filing of a report, not a return[8]; (2) once the Department assessed additional taxes based upon the federal Audit Changes, all of the material purposes for requiring a 659 Report were satisfied, and the Report could no longer be considered to be a return for purposes of Section 523(a)(1)(B)(i); and (3) once the Department assessed additional taxes based upon the federal Audit Changes, any distinction between Changes based upon the disallowance of deductions and those based upon the underreporting of income became irrelevant for purposes of Section 523(a)(1)(B)(i).[9]

CONCLUSION

The taxes due to the department from Chatman for the calendar years 1983, 1985 and 1986, as well as the taxes due to the department from VanManen for the calendar years 1981 and 1982, are determined to be dischargeable.

IT IS SO ORDERED.

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[8] One of the Department's principal arguments is that taxpayers are presumed to know the law. It is equally presumed that a state legislature, if it wished to bring itself within the discharge exception of Section 523(a)(1)(B)(i), would at least have referred to something it considered to be a return as a return.

[9] In *Dyer*, the Court expressed a concern about the sufficiency of an original return which underreported income as opposed to one where there was a claim to a deduction which was subsequently disallowed.

_____/s/_____
HON. JOHN C. NINFO, II
U.S. BANKRUPTCY JUDGE

Dated: September 5, 1997