

07-1069  
AUDIT  
TAX YEAR: 2003  
SIGNED: 06-08-2010  
COMMISSIONERS: R. JOHNSON, M. JOHNSON, D. DIXON, M. CRAGUN  
GUIDING DECISION

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BEFORE THE UTAH STATE TAX COMMISSION

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<p>PETITIONER 1 &amp; PETITIONER 2,  Petitioners,  v.  AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION,  Respondent.</p>	<p><b>FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION</b></p> <p>Appeal No.      07-1069</p> <p>Account No.     #####</p> <p>Tax Type:        Income Tax</p> <p>Tax Years:       2003</p> <p>Judge:           Chapman</p>
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**Presiding:**

D'Arcy Dixon Pignanelli, Commissioner  
Kerry R. Chapman, Administrative Law Judge

**Appearances:**

For Petitioner:      PETITIONER 1, Taxpayer  
For Respondent:    RESPONDENT REP 1, Assistant Attorney General  
                              RESPONDENT REP 2, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on March 23, 2010. The parties also submitted post-hearing information. Based upon the evidence and testimony presented by the parties, the Tax Commission hereby makes its:

FINDINGS OF FACT

1.        The tax at issue is individual income tax.
2.        The tax year at issue is 2003.
3.        PETITIONER 1 and PETITIONER 2 ("Petitioners" or "taxpayers") are appealing Auditing Division's ("Division") assessment of additional Utah individual income tax for the 2003 tax year. On August 22, 2007, the Division issued a Notice of Deficiency and Audit Change ("Statutory Notice") to the

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taxpayers. Exhibit R-1. In the Statutory Notice, the Division imposed additional tax and interest (calculated through September 21, 2007), as follows:

<u>Year</u>	<u>Tax</u>	<u>Penalties</u>	<u>Interest</u>	<u>Total</u>
2003	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$

4. An Initial Hearing was held in this matter on August 11, 2009, and the Commission issued its Initial Hearing Order on January 14, 2010. The taxpayers timely requested a Formal Hearing.

5. On October 15, 2004, the taxpayers filed a 2003 Utah return on which they claimed to be full-year Utah residents for the 2003 tax year. On the return, the taxpayers reported \$\$\$\$\$ of 2003 federal adjusted gross income (“FAGI”).

6. The Division’s assessment is based on the Internal Revenue Service (“IRS”) increasing the taxpayers’ 2003 FAGI from \$\$\$\$\$ to \$\$\$\$\$, an increase of \$\$\$\$\$. Exhibits R-1 and R-3.

7. The Division asserts that the majority of the IRS’s change in the taxpayers’ 2003 FAGI is related to a 1099-C on which COMPANY A (“COMPANY A”) reported that PETITIONER 1 had received debt cancellation income in the amount of \$\$\$\$\$ for 2003. Exhibit R-4.

8. The taxpayers agree with all portions of the Division’s assessment, except for its imposition of tax on the \$\$\$\$\$ of debt cancellation. The taxpayers argue that the debt cancellation amount is not subject to taxation for either of two reasons: 1) that the debt cancellation amount is not taxable because it is associated with a nonrecourse loan; and 2) even if the debt cancellation amount is taxable, it is excludable from FAGI because they were insolvent when the debt cancellation occurred.

9. The taxpayers explain that the \$\$\$\$\$ of debt cancellation is associated with a loan they obtained on a home they owned in STATE 1 (“STATE 1 home”). The taxpayers have been unable to locate any documents concerning the purchase of the STATE 1 home, but state that they purchased it around 2001 for approximately \$\$\$\$\$. They further explain that by 2003, they had suffered sufficient financial and

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professional setbacks so that they were required to “walk away” from the STATE 1 home. They indicate that they lost all of their savings and retirement and that they moved to CITY 1, Utah, where they owned a condominium.

10. In or around August 2003, the STATE 1 home was sold in a “short sale” to satisfy the taxpayers’ loan on the property. The taxpayers have been unable to locate any documents concerning the sale of the STATE 1 home. The taxpayers assert, however, that they were told at the time of the sale that there would be no tax ramifications from the sale of the home.

11. The taxpayers assert that the loan on their STATE 1 home was a nonrecourse loan where any debt cancellation associated with it is nontaxable under STATE 1 law. COMPANY A, however, reported the \$\$\$\$\$ of debt cancellation as taxable income on a 2003 1099-C, which suggests that the loan was a recourse, not a nonrecourse, loan. The taxpayers claim that COMPANY A erroneously issued the 1099-C. The taxpayers claim that they have tried, without success, to contact COMPANY A to have it issue corrected tax information.

12. The taxpayers admit that they have asked the IRS to reconsider its determination that the \$\$\$\$\$ of debt cancellation is taxable income, but without success.

13. The Division asks the Commission to sustain its assessment for several reasons. First, the Division admits that STATE 1 is a “nonrecourse” state and that debt cancellation on a nonrecourse loan is not subject to taxation. They also explain that an initial loan obtained to purchase property in STATE 1 is a nonrecourse loan, whereas refinancing and equity loans on the same home are recourse loans. The Division contends that COMPANY A filed tax documents that suggest that the taxpayers’ loan is a recourse loan. Because the IRS has not accepted the taxpayers’ argument that COMPANY A incorrectly filed the 1099-C and because the taxpayers have submitted no documentation to show that the loan was a nonrecourse loan, the Division asks the Commission to sustain its assessment.

14. Second, the Division claims that even if the Commission believes that the taxpayers' loan was nonrecourse, it is possible that the taxpayers may have recognized a gain for federal income tax purposes. The Division further states that any such gain may or may not be offset by the residential exclusion available in 2003, depending on whether the taxpayers qualified for the exclusion. The Division admitted that the taxpayers probably did not incur a gain on the sale of the home. However, the Division claims that there is no way to know for certain how the short sale would impact the taxpayers' 2003 FAGI without them filing an amended federal return on which they report the sale and, if there is a gain, report whether any portion of the gain is offset by the residential exclusion. Because the taxpayers have provided no documentation concerning the loan or the purchase and sale of the home, the Division claims that it cannot be determined whether the taxpayers owe tax on the sale of the home and that its assessment should be sustained.

15. As an alternative argument, the taxpayers contend that even if COMPANY A correctly reported the \$\$\$\$ of debt cancellation as taxable income, it should, nevertheless, be excluded from their 2003 FAGI because they were insolvent. The taxpayers point out that Internal Revenue Code ("IRC") §108(a)(1)(B) provides that "[g]ross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if . . . the discharge occurs when the taxpayer is insolvent[.]" The taxpayers claim that they were insolvent when the debt cancellation at issue occurred and, as a result, assert that the \$\$\$\$ of income reported by COMPANY A is to be excluded from FAGI.

16. The taxpayers explain that they had professional and financial setbacks in 2001 and 2002 that necessitated them walking away from the STATE 1 home. They also claim that they had borrowed a significant amount of money and were in debt over \$\$\$\$ in 2003 when they sold the STATE 1 home and moved to CITY 1, Utah, where they owned a condominium. They assert that they lost their down payment and

all payments made on the STATE 1 home. Given these circumstances, they assert that they were insolvent when the STATE 1 home was sold and the debt cancellation occurred.

17. The Division contends that the taxpayers have not proven that they were insolvent when the debt cancellation occurred. The Division states that the taxpayers have provided no documentation to support an insolvency claim and have not filed an amended federal return evidencing this assertion. On this basis, the Division asks the Commission to deny the taxpayers' claim that the income is not subject to taxation due to their insolvency.

APPLICABLE LAW

1. Utah Code Ann. §59-10-104(1) (2003)<sup>1</sup> provides that “a tax is imposed on the state taxable income, as defined in Section 59-10-112, of every resident individual. . . .”

2. In the case of a resident individual, Utah Code Ann. §59-10-112 defines “state taxable income” to mean “federal taxable income (as defined by Section 59-10-111) with the modifications, subtractions, and adjustments provided in Section 59-10-114.”

3. UCA §59-10-111 defines “federal taxable income” to mean “taxable income as currently defined in Section 63, Internal Revenue Code of 1986.”

4. UCA §59-1-1417 (2009) provides that the burden of proof is upon the petitioner in proceedings before the Commission, with limited exceptions as follows:

In a proceeding before the commission, the burden of proof is on the petitioner except for determining the following, in which the burden of proof is on the commission:

- (1) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;

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<sup>1</sup> The Utah Individual Income Tax Act has been revised and provisions renumbered subsequent to the audit period. The Commission cites to and applies the provisions that were in effect during the 2003 tax year at issue, unless otherwise indicated.

- (2) whether the petitioner is obligated as the transferee of property of the person that originally owes a liability or a preceding transferee, but not to show that the person that originally owes a liability is obligated for the liability; and
- (3) whether the petitioner is liable for an increase in a deficiency if the increase is asserted initially after a notice of deficiency is mailed in accordance with Section 59-1-1405 and a petition under Part 5, Petitions for Redetermination of Deficiencies, is filed, unless the increase in the deficiency is the result of a change or correction of federal taxable income;
  - (a) required to be reported; and
  - (b) of which the commission has no notice at the time the commission mails the notice of deficiency.

CONCLUSIONS OF LAW

1. The taxpayers provided insufficient documentation to show that they did not incur taxable income from the short sale of their STATE 1 home. First, they have provided no documentation to show that the loan on the STATE 1 home was a nonrecourse loan. COMPANY A has reported the \$\$\$\$ of debt cancellation as taxable income, which suggests that the loan was a recourse loan. The IRS has determined that the debt cancellation is taxable, as well. As a result, the loan that gave rise to the debt cancellation income is not found to be a nonrecourse loan.

2. Second, even if the loan were a nonrecourse loan, the taxpayers have not provided documentation to show whether they would be subject to other taxable income, specifically gains, on the short sale of the STATE 1 home. In addition, they have not provided sufficient documentation to show whether a portion of any such gains would be offset with the residential exclusion. Without such documentation, the taxpayers have not shown that they would have no Utah tax liability on the short sale of the STATE 1 home, regardless of whether the loan was a nonrecourse loan.

3. The taxpayers have not shown that they were insolvent when the debt cancellation occurred. IRC §108(1)(d)(3) defines “insolvent” to mean “the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer’s assets and liabilities immediately

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before the discharge.” Although the taxpayers may have had other debts at the time of the debt cancellation, it appears that they also owned real estate in CITY 1, Utah at this time. They have not provided documentation of their total assets and liabilities at the time of the debt cancellation so that it can be determined whether they were insolvent. They have not filed a federal tax return on which they claimed to be insolvent. Because the taxpayers have not shown that they were insolvent, they have not shown that the debt cancellation income is excluded from FAGI under IRC §108(a)(1)(B).

It is noted that the taxpayers filed a letter with the Commission on May 28, 2010, in which they stated their intent to file a 2003 Form 982 with the IRS to show that they were insolvent when the debt cancellation occurred. If the IRS approves the Form 982 and reduces the taxpayers’ 2003 FAGI, the taxpayers may file an amended Utah return to reflect the IRS changes, which would result in a corresponding refund of Utah tax.

4. The taxpayers have the burden of proof in this matter. They have not shown that any portion of the Division’s assessment should be reversed. Accordingly, the Division’s assessment should be sustained in its entirety.

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Kerry R. Chapman  
Administrative Law Judge

DECISION AND ORDER

Based upon the foregoing, the Commission finds that the contested debt cancellation income is subject to Utah taxation. Accordingly, the Commission sustains the Division’s assessment in its entirety. It is so ordered.

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DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2010.

R. Bruce Johnson  
Commission Chair

Marc B. Johnson  
Commissioner

D'Arcy Dixon Pignanelli  
Commissioner

Michael J. Cragun  
Commissioner

**Notice of Appeal Rights:** You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. §63G-4-302. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. §§59-1-601et seq. and 63G-4-401 et seq.

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