

amended returns. The Petitioners paid \$257,354 of the proposed deficiency leaving a remaining amount of \$50,343.

The Petitioners dispute the remaining amount of the proposed deficiency because they disagree with the audit staff's determination of the reported net operating losses. This issue affects net operating loss carryovers for subsequent taxable years, as well as the losses incurred during certain taxable years.

The issue concerning the Net Operating Losses (NOLs) arises from a Chapter 11 bankruptcy the Petitioners filed after the [Redacted] was investigated by the United States Department of Justice. As a result of the investigation, [Redacted] was required to restate its financial reports. The Securities Exchange Commission and the Internal Revenue Service participated in the bankruptcy proceedings. Through the bankruptcy, [Redacted] cancelled a substantial amount of inter-company and third party debts.

For income tax purposes, the forgiveness of debt ordinarily is treated as income. However, when the debt is discharged through a bankruptcy, the discharge is not treated as income, at least to the extent that the forgiveness resulted from the insolvency of the company. The federal tax treatment is set forth in IRC section 108, which provides in pertinent part:

108. Income from discharge of indebtedness

(a) Exclusion from gross income.--

(1) In general.--Gross 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--

- (A)** the discharge occurs in a title 11 case,
- (B)** the discharge occurs when the taxpayer is insolvent,
- (C)** the indebtedness discharged is qualified farm indebtedness,

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or

(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2013.

Because the discharged debt is excluded from reported income, IRC § 108 further provides that certain tax attributes, including NOLs, are also reduced by the discharged amount.

(b) Reduction of tax attributes.--

(1) In general.--The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction.--Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL.--Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit.--Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) Minimum tax credit.--The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) Capital loss carryovers.--Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

The concept is that the discharge simply defers the tax rather than eliminates the tax. While potential income from the discharge is excluded in the current tax year, the reduced losses in subsequent years means that less loss will be used against available income and thus the taxpayer will pay more tax in subsequent years.

After the [REDACTED] entities emerged from the bankruptcy, the companies were purchased by [Redacted]. Essentially, [Redacted] assumed the debt in exchange for corporate shares of the Petitioners. The exchange of debt for stock also is specifically addressed in IRC § 108.

(e) General rules for discharge of indebtedness (including discharges not in Title 11 cases or insolvency).--For purposes of this title--

(8) Indebtedness satisfied by corporate stock or partnership interest.--For purposes of determining income of a debtor from discharge of indebtedness, if--

(A) a debtor corporation transfers stock, or

(B) a debtor partnership transfers a capital or profits interest in such partnership, to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

Under the terms of this section, the amount by which the NOL is reduced is the fair market value of the stock exchanged.

Following the bankruptcy and the exchange of indebtedness for stock, the Internal Revenue Service reduced the Petitioners' federal NOL by about 98 percent. The Audit Division followed the federal treatment and reduced the Petitioners' NOL for Idaho income tax purposes by the same percentage. The Petitioner does not dispute the federal treatment but asserts that Idaho tax law does not have the same provision as the Internal Revenue Code.

DISCUSSION

The starting point for determining Idaho taxable income is a taxpayer's federal taxable income. Idaho Code § 63-3002 declares:

It is the intent of the Legislature by the adoption of this act, insofar as possible to make the provisions of the Idaho act identical to the provisions of the federal internal revenue code relating to the measurement of taxable income, . . . to achieve this result by the application of the various provisions of the federal internal revenue code relating to the definition of income, exceptions therefrom, deductions, "personal and otherwise", . . .

By reference, the Idaho income tax incorporates the provisions of IRC § 108. Accordingly, the Petitioners correctly excluded the discharged debt in reporting its taxable income.

However, the Petitioners now claim that the provisions of IRC § 108, which reduce their federal NOLs, do not apply for Idaho purposes. The Petitioners note that their federal NOLs are "added back" when determining the company's Idaho taxable income pursuant to Idaho Code § 63-3022(b). Taxpayers compute their Idaho NOL differently from their federal NOL. After the federal NOL is added back to income, taxpayers compute the Idaho NOL under Idaho Code § 63-3021. The Petitioners contend that since Idaho Code § 63-3021 does not expressly adopt the IRC § 108 reductions, their Idaho NOL should not be reduced in the same manner as their federal NOL.

There are several reasons the Petitioners' interpretation of Idaho tax law is in error. First, it is true that the Idaho NOL statute is silent about the attribute reductions required by the federal statute, but Idaho Code § 63-3002 expressly provides that it is the Legislature's intent "insofar as possible to make the provisions of the Idaho act identical to the provisions of the federal internal revenue code relating to the measurement of taxable income, . . . to achieve this result by the

application of the various provisions of the federal internal revenue code relating to the definition of income, exceptions therefrom,” IRC § 108 is a statute that concerns the “definition of income” and an “exception” therefrom. Contrary to what the Petitioners assert, the Idaho tax code does adopt IRC § 108.

Second, Idaho Code § 63-3002 also states, “the taxable income reported each taxable year by a taxpayer to the internal revenue service shall be the identical sum reported to this state, **subject only to modifications contained in the Idaho law, . . .**” [Emphasis added.] The Idaho NOL statute does not contain any modification to the income exclusion and attribute reductions of IRC § 108.

Third, the Petitioners’ interpretation would frustrate the intent of both federal and Idaho tax law. As stated above, the purpose of IRC § 108 is to exclude the forgiven debt from current income in exchange for reducing the NOL that can be carried forward and used to reduce future income. It reduces the NOL simply to ensure that future taxable income includes a portion of the discharged debt. The Petitioners seek to exclude the forgiven debt from their current income and carry forward their NOLs to reduce future income. In essence, the Petitioners seek a double deduction.

In recognition of the legislative policies discussed above, the Tax Commission specifically incorporated the net operating loss provisions of IRC § 108 in its administrative rules. Income Tax Rule 210 provides:

210. REDUCTION OF IDAHO TAX ATTRIBUTES AND BASIS WHEN INCOME FROM INDEBTEDNESS DISCHARGE IN BANKRUPTCY IS EXCLUDED FROM GROSS INCOME (RULE 210).

01. In General. Any taxpayer excluding from taxable income an amount resulting from the discharge of indebtedness in bankruptcy under Section 108(b) of the Internal Revenue Code,

shall reduce Idaho net operating loss and basis in accordance with Section 346 of the Bankruptcy Code of the United States. If the discharge occurs outside of bankruptcy, the provisions of these rules shall not apply.

02. Order of Reduction. The reduction referred to in Subsection 210.01 shall be made to the following tax attributes in the following order:

a. Any net operating loss deduction, as defined in Rule 201 of these rules, shall be reduced by the amount of the indebtedness forgiven or discharged in bankruptcy except as follows:

i. A deduction with respect to the liability which is disallowed for any taxable period during or after the liability is forgiven or discharged. A deduction with respect to the liability includes a capital loss incurred on the disposition of a capital asset with respect to a liability that was incurred in connection with the acquisition of such asset.

ii. To the extent that the indebtedness forgiven or discharged consisted of items of a deductible nature that were not deducted by the taxpayer, or resulted in an expired net operating loss deduction or carryover that did not offset income for any taxable period and did not contribute to a net operating loss in or a net operating loss carryover to the taxable period during or after the indebtedness was discharged.

* * * *

04. Discharge Not Treated as Discharged Indebtedness. The following provisions exclude from this rule indebtedness that is discharged and treat the debtor as if it had originally issued stock instead of debt. No reduction to the Idaho net operating loss or basis is required if one (1) or more of these provisions are satisfied.

a. The indebtedness did not consist of items of a deductible nature and is exchanged for an equity security, other than a limited partnership interest, issued by the debtor or is forgiven as a contribution to capital; or

b. The indebtedness consisted of items of a deductible nature, and the exchange of stock for debt has the same effect as a cash payment equal to the fair market value of the equity security that is issued.

IDAPA 35.01.01.210. Pursuant to this rule, the audit staff properly reduced the Petitioners' Idaho NOL in the same proportion that the Internal Revenue Service reduced the Petitioners' federal NOL.

CONCLUSION

For the reasons stated above, the Commission finds the Audit Division correctly reduced the Net Operating Losses reported by the Petitioners. The Commission upholds the audit adjustment.

WHEREFORE, the Notice of Deficiency Determination issued on August 3, 2007, is hereby APPROVED and MADE FINAL.

IT IS ORDERED and THIS DECISION DOES ORDER that the Petitioners pay the following tax and interest:

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
3/31/1995	\$ 9,199	\$ 9,180	\$ 18,379
3/31/1996	(941)	(860)	(1,801)
3/31/1997	6,090	5,045	11,135
3/31/1998	0	0	0
9/14/1998	90,015	63,930	153,945
12/31/1998	46,629	32,014	78,643
12/31/1999	199,969	92,372	292,341
12/31/2000	(158,700)	(84,663)	(243,363)
12/31/2001	0	0	0
12/31/2002	0	0	0
12/31/2003	0	0	0
12/31/2004	0	0	0
12/31/2005	0	0	0
		Subtotal	\$309,279
		Less Payments Received 12/26/06	(257,354)
		TOTAL AMOUNT DUE	<u>\$ 51,925</u>

Interest is calculated through September 25, 2009, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given. An explanation of the Petitioners' right to appeal this decision is enclosed. As set forth in the enclosed explanation, the Petitioners must deposit with the Tax Commission 20 percent (20%) of the total amount due in order to appeal this decision. The 20 percent deposit in this case is \$10,385 and will be held as security for the payment of taxes until the appeal is resolved.

DATED this _____ day of _____, 2009.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2009, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED]

Receipt No.
