STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
SAMIRA AHED	:	DETERMINATION DTA NO. 822462
for Redetermination of a Deficiency or for Refund of New York State and New York City Personal Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Year 2003.	:	

Petitioner, Samira Ahed, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income taxes under Article 22 of the Tax Law and the New York City Administrative Code for the year 2003.

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on May 11, 2010, at 10:30 A.M., with all briefs to be submitted by October 18, 2010, which date began the six-month period for the issuance of this determination. By a letter dated April 1, 2011, this six-month period was extended for an additional three-months (Tax Law § 2010[3]). Petitioner appeared by Kestenbaum & Mark (Bernard S. Mark, Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Nicholas Behuniak, Esq., of counsel).

ISSUE

Whether the Division of Taxation properly asserted a deficiency of personal income tax based upon income derived by petitioner from the forgiveness of indebtednes.

FINDINGS OF FACT

1. Petitioner, Samira Ahed, filed a New York State Resident Income Tax Return for the year 2003, which reported taxable income from wages, nonemployee compensation and interest.

2. On March 22, 2007, the Division of Taxation (Division) issued to petitioner a Notice of Deficiency, which asserted deficiencies of New York State and New York City personal income tax plus penalties and interest for the year 2003 as follows:

Jurisdiction	Tax	Interest	Penalty	Balance
NYS	$15,927.00	$3,870.75	$2,730.37	$22,528.12
NYC	9,041.00	2,196.67	1,549.83	1 2,787.50
Totals	$24,968.00	$6,067.42	$4,280.20	$35,315.62

3. The amounts asserted on the notice arose from two adjustments to petitioner's New York State adjusted gross income resulting in a total adjustment of $210,048.00. The adjustments were based upon (1) a return of capital in excess of basis from MP Partners resulting in additional gross income in the amount of $50,946.00 and (2) forgiveness of indebtedness by MP Partners resulting in additional gross income in the amount of $159,102.00. The penalties were imposed for negligence pursuant to Tax Law § 685(b)(1) and (2).

4. MP Partners (the partnership) was created in 1991. It engaged in oil and gas exploration and was formed in order to take advantage of drilling prospects in Tunisia. Permits were given to certain U.S. oil companies to drill exploratory wells, and the partnership was granted a working interest in the wells, which it subsequently syndicated to a number of partners including petitioner.

5. The partnership contracted with the Cardinal Drilling Company (the turnkey driller) to perform oil and gas drilling. The main agreement between MP Partners and the turnkey driller

was a turnkey drilling contract that defined the responsibilities of the parties. The partnership executed a note payable dated December 20, 1991 (partnership promissory note) to the turnkey driller in the amount of $6,815,645.00. The note provided that all interest and principal were due on or before December 30, 2006. The partnership promissory note did not provide for any extensions of the due date. The note was secured by the program assets including promissory notes from the individual partners. In addition to the promissory note, the partnership provided the turnkey driller a security agreement and a Uniform Commercial Code financing statement. The partnership promissory note was used to finance drilling costs of the turnkey driller.

6. On the same day the foregoing note was executed, the partnership executed an additional promissory note to the turnkey driller in the amount of $1,757,376.00 along with an additional security agreement and financing statement.

7. In 1991, petitioner invested $105,621.00 in the partnership and became a partner. The investment was made by providing a subscription note payable to MP Partners in the amount of $86,001.00 (the note) and paying the remaining amount in cash.

8. The note provided that it would bear interest at a rate of ten percent and that it was due and payable on December 31, 2006. It further provided that the initial due date could be extended from December 31, 2006 for an additional seven years by the payment of a five percent extension fee. The note provided for an additional extension of eight years with the payment of ten percent of the outstanding balance of the note.

9. The foregoing note, along with several similar notes from other partners, was assigned and physically handed over as security to the turnkey driller from the partnership.

10. The note did not require the periodic payment of principal over the term of the loan, and such payments were not made.

11. Petitioner did not provide any security interest or collateral guaranteeing repayment of the note. However, every partner was personally liable for his note and open to collection. The partners' notes collateralized the partnership's obligation to the driller.

12. In 1991, petitioner was allocated a loss of $106,044.00 from the partnership. Petitioner claimed a loss in the amount of $105,621.00 on her 1991 federal and New York State income tax returns. This was the same amount that petitioner invested earlier that year.

13. From 1991 through 1995, petitioner paid interest on the note. Each interest payment was immediately wired back to petitioner in full, on the same day that the interest payment was made, as a partnership distribution. After 1995, the notes were nonrecourse.

14. The well in Tunisia was drilled to a depth of about 5,000 feet without any production. The turnkey driller then decided to drill in a different formation. However, this formation also did not yield oil. In 1997, the turnkey driller determined that it did not have any viable options for oil and gas drilling relating to the partnership. Therefore, in 1997, the wells were closed and there was no further production or other activity carried out by the turnkey driller with regard to the partnership or petitioner. During this period of time, the partnership followed its normal operations and reporting requirements by preparing schedules K-1 and filing tax returns with the federal government and the state.

15. The original December 31, 2006 due date for the payment of the note was extended. However, petitioner did not pay the extension fee as required under terms of the note. No legal action was ever taken against petitioner for nonpayment of the note including the nonpayment of the required extension fee. It was agreed between Mr. Valeri, a representative of the turnkey driller, and Mr. Karlik, the managing partner of the partnership, that the note would be examined

at the end of these proceedings regarding whether the partners have a tax liability arising from the forgiving of indebtedness.

16. After 1996, there was no partnership activity. On December 31, 2003, the partnership was terminated due to a lack of any viable operations. The partnership did not make a distribution to any of its partners at the time of its termination. The partnership's 2003 New York State tax return was its final return and the final partnership schedule K-1 was filed in 2003. The dissolution of the partnership led the Division to conclude that the note executed by petitioner would not be repaid and that she had income from the forgiving of indebtedness.

17. At the time of its termination in 2003, the partnership had $81.00 in assets but approximately $1,622,000.00 in liabilities, which included interest that had accrued on the partnership promissory note.

18. Neither the partnership nor the partners ever received any gains from the turnkey drilling oil and gas arrangement.

19. In accordance with State Administrative Procedure Act § 307(1), the Division's proposed findings of fact have been generally accepted and incorporated herein. However, proposed findings of fact 3, 5, 7 and 12 were modified to reflect the record. Additional findings of fact were also made.

SUMMARY OF THE PARTIES' POSITIONS

20. Petitioner argues that there cannot be forgiveness of indebtedness in 2003 because the note was not due and payable until December 31, 2006. In this regard, petitioner claims that by the terms of the note, she was not required to pay the turnkey driller in 2003. Petitioner also submits that the termination of MP Partners is irrelevant because she remained personally liable on the note until December 31, 2006. According to petitioner, the Division has not presented any

evidence that, in 2003, the note would not be paid on its due date. It is further argued that no penalties are due because no tax is due. In the alternative, petitioner submits that the issue is technical and there is no rational basis for imposing a penalty.

21. In its brief, the Division argues that the amount due under the note should be treated as forgiveness of debt income. The Division also asserts that the note was not a bona fide debt. Further, the Division regards it as unreasonable to wait for the expiration of the note and any extension periods before determining that the note should be treated as forgiven debt.

22. In her reply brief, petitioner contends that the Division's position fails to recognize that the debt did not become worthless in 2003 and that there was no event in 2003 that would have rendered the debt worthless.

23. As noted in the findings of fact, the Notice of Deficiency was premised, in part, on the Division's conclusion that there was a return of capital in excess of basis resulting in additional gross income in the amount of $50,946.00. In the course of the hearing, this amount was reduced by the Division to $35,260.00. Thereafter, the Division's position, with respect to this adjustment, became ambiguous. At one point in the hearing, the Division appeared to acknowledge that this adjustment should not have been made because the distributions were offset by interest expense (Transcript p. 74). Later, the Division was reticent to take a firm position on whether this adjustment was appropriate without additional research (Transcript, p. 94). In their briefs, neither party addressed this adjustment. Under the circumstances, the adjustment issue is considered abandoned by the Division.

CONCLUSIONS OF LAW

A. In ***Cozzi v. Commissioner*** (88 TC 435 [1987]), the Tax Court summarized the applicable principles concerning income from the discharge of indebtedness as follows:

> It is well settled that gross income includes income from the discharge of indebtedness. Sec. 61(a)(12). The general theory is that to the extent that a taxpayer has been released from indebtedness, he has realized an accession to income because the cancellation effects a freeing of assets previously offset by the liability arising from such indebtedness. ***United States v. Kirby Lumber Co.*** [2 ustc ¶814], 284 U.S. 1 (1931). Whether a debt has been discharged is dependent on the substance of the transactions. Mere formalisms arranged by the parties are not binding in the application of the tax laws. ***Commissioner v. Court Holding Co.*** [45-1 ustc ¶9215], 324 U.S. 331 (1945). Consequently, the surrender or failure to surrender a note is not determinative of the release of liability. ***Seay v. Commissioner*** [Dec. 32,869(M)], T.C. Memo. 1974-305.
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> The moment it becomes clear that a debt will never have to be paid, such debt must be viewed as having been discharged. The test for determining such moment requires a practical assessment of the facts and circumstances relating to the likelihood of payment. ***Brountas v. Commissioner*** [Dec. 37,151], 74 T.C. 1062, 1074 (1980), supp. opinion to [Dec. 36,506] 73 T.C. 491 (1979), vacated and remanded on other grounds [82-2 ustc ¶9626] 692 F.2d 152 (1st Cir. 1982), affd. in part and revd. in part on other grounds sub nom. ***CRC Corp. v. Commissioner*** [86-2 ustc ¶9677], 693 F.2d 281 (3d Cir. 1982); see ***Bickerstaff v. Commissioner*** [42-2 ustc ¶9504], 128 F.2d 366, 367 (5th Cir. 1942); ***Kent Homes, Inc. v. Commissioner*** [Dec. 30,664], 55 T.C. 820, 828-831 (1971), revd. on other grounds [72-1 ustc ¶9250] 455 F.2d 316 (10th Cir. 1972); ***Cotton v. Commissioner*** [Dec. 7527], 25 B.T.A. 1158 (1932). Any "identifiable event" which fixes the loss with certainty may be taken into consideration. ***United States v. S.S. White Dental Mfg. Co.*** [1 ustc ¶235], 274 U.S. 398 (1927).

B. As set forth above, the theory employed by the Division states that the release of an indebtedness results in an addition of income. In order to utilize this theory, one must ask when it became clear that the debt would never have to be paid. This, in turn, requires the recognition of an "identifiable event." There may be more than one identifiable event and, therefore, the question presented is whether the particular event chosen by the Division to determine when there was a release of indebtedness was reasonable (***id***).

C. In the course of the hearing, the Division's witness candidly explained that the year 2003 was chosen as the year in which the Division would assert that there was forgiveness of the indebtedness because that was the year that the partnership was dissolved. The difficulty with this approach is that there is no rational basis for the conclusion that the dissolution of the partnership in 2003 would result in the release of the indebtedness. The debt had been assigned to the turnkey driller and was not payable until 2006. On the record presented, there was no identifiable event in 2003 that would provide a basis for the Division to conclude that either petitioner did not intend to repay the note or the turnkey driller would forgive the indebtedness. Under the circumstances, it was it was unreasonable for the Division to conclude that petitioner had income from forgiveness of indebtedness in 2003.

D. In its brief, the Division argues that this analysis is infirm because it is unreasonable to wait for the expiration of the note and extension periods before determining that the note should be treated as a forgiven debt. This argument is rejected because it misstates the controlling principle for determining when to conclude that a debt will never be repaid, namely, that there must be an "identifiable event" (Conclusions of Law A and B). Since there may be more than one identifiable event, there is no requirement that the Division wait until the expiration of the periods of extension before assessing a deficiency.

E. The question that remains concerns the outcome of issuing a notice of deficiency of personal income tax for the wrong year. It is clear that not all defects in the notice render the notice invalid. Thus, for example, a reference to an incorrect tax year does not invalidate the notice when the taxpayer is not misled and the correct tax year is stated in other places on the notice and is correctly referenced in supporting schedules (***see e.g. Anderten v. Commissioner***, 65 TCM 1697 [1993]; ***see also Donoghue v. Commissioner***, 36 TCM 1112 [1977]). On the

other hand, in ***Rose v. Gibbs*** (90-1 US Tax Cas ¶ 50,282 [D Mass 1990]), the Internal Revenue Service did not correct an error involving an assessment of an incorrect tax period and, as a result, the Tax Court, relying, in part, upon ***United States v. Lehigh*** (201 F Supp 224 [D Ark 1961], ***appeal dismissed*** 305 F2d 377 [8th Cir 1962]) held that the assessment was invalid for that quarter.

F. Here, the Division intentionally issued an assessment for 2003 because that was the year that the partnership terminated. Since the termination of the partnership had no bearing upon whether the debt would be repaid, the Division assessed the wrong year and the assessment must be cancelled. In view of the defect in the notice, it is impossible to reach the Division's argument that the note was not bona fide and that the amount of the debt should be treated as forgiveness of debt income.

G. Since the notice is infirm, the assertion of penalties is cancelled.

H. The petition of Samira Ahed is granted and the Notice of Deficiency dated March 22, 2007 is cancelled.

DATED: Troy, New York
May 26, 2011

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE