STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
ROBERT AND ADELAIDE CHUCKROW	:	DECISION DTA No. 807745
for Redetermination of a Deficiency or for Refund of Personal Income Tax Under Article 22 of the Tax Law for the Years 1982 and 1983.	:	

Petitioners Robert and Adelaide Chuckrow, The Findings, Route 709, Box 351, The Plains, Virginia 22171, filed an exception to the determination of the Administrative Law Judge issued on July 9, 1992. Petitioners appeared by James H. Tully, Jr., Esq. The Division of Taxation appeared by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel).

Petitioners and the Division of Taxation each filed a brief on exception. Oral argument was heard on January 14, 1993 which began the six-month time period for the issuance of this decision.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUE

I. Whether petitioners can take a deduction in 1982 for a royalty payment under what they term a "minimum annual royalty" provision of a mineral lease.

II. Whether the Administrative Law Judge erred in considering a ground to support disallowing the deduction which was raised by the Division of Taxation for the first time in its post-hearing brief.

III. Whether petitioners are entitled to take certain miscellaneous business deductions for the year 1982.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Petitioners, Robert and Adelaide Chuckrow, timely filed 1982 and 1983 New York State personal income tax returns under the status "married filing jointly". Following a field audit of those returns, the Division of Taxation ("Division") issued to petitioners a Notice of Deficiency, dated March 25,1988, asserting a combined tax deficiency for both years of $60,631.31, plus penalty and interest.[1]

Following a conciliation conference, the Division issued a Conciliation Order, dated October 20, 1989, recomputing the amounts asserted on the notice of deficiency. The deficiency asserted for 1982 was reduced to $51,148.43. In addition, the Division determined that petitioner is entitled to a refund for 1983 in the amount of $5,101.17 plus interest. As a result, the issues raised in this proceeding relate only to petitioner's 1982 personal income tax return.

Following the conciliation conference, the Division issued to petitioner a Statement of Personal Income Tax Audit Changes, showing four adjustments to petitioner's 1982 return. The first was the disallowance of a minimum annual royalty deduction in the amount of $366,674.00. The Division also disallowed charitable contributions in the amount of $3,500.00 and miscellaneous deductions in the amount of $75,159.00. Finally, there was a depletion modification in the amount of $3,013.00. Petitioner did not challenge this last adjustment.

THE MINIMUM ANNUAL ROYALTY DEDUCTION

Petitioner is a private investor and businessman. In 1982 he was involved in the exploration, drilling and production of oil and natural gas, doing business as Glade Oil Company. During the course of these activities he entered into a sublease agreement with

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[1]Items of income, gain, loss and deduction reported on the returns pertain only to Mr. Chuckrow. Mrs. Chuckrow is a party to this proceeding only by virtue of having filed joint returns with her husband. Accordingly, subsequent references to petitioner may be deemed to refer only to Mr. Chuckrow.

Sherwood Guernsey, III, doing business as Sherwood Enterprises ("Sherwood"). Under the agreement, petitioner was entitled to drill for and produce oil and natural gas on 22 properties located in western Pennsylvania in return for a minimum annual royalty. The amount of the minimum annual royalty was $16,667.00 per site in the first year ($366,674.00 in total) and $14,245.00 per site in ensuing years (plus a cost of living adjustment after 1984). Under the terms of the sublease, petitioner was required to pay the first year minimum annual royalty on the effective date of the sublease, December 9, 1982, and to pay the second and subsequent years' minimum annual royalty one year from the effective date of the sublease (the anniversary date), and on each subsequent anniversary date.

Petitioner made the first minimum annual royalty payment by execution of a promissory note, also dated December 9, 1982. The promissory note states:

> "FOR VALUE RECEIVED, the undersigned ROBERT CHUCKROW hereby promises to pay to SHERWOOD ENTERPRISES, INC., Three Hundred Sixty-Six Thousand Six Hundred Seventy-Four ($366,674) Dollars, payable at Bedford, New Hampshire on December 9, 1994.
>
> "This Note is made and delivered in order to secure an obligation owing from Maker to Payee of even date herewith.
>
> "Presentment for payment, notice of dishonor, protest and notice of protest are hereby waived."

As material here, the sublease also contains the following provision with respect to payment of a production royalty:

> "Sublessor [Sherwood] shall be entitled to fifty percent (50%) of all oil and gas at the wellhead (the "Production Royalty"). The Production Royalty may be taken in kind or in cash, and if taken in cash, payable monthly. Aggregate Minimum Annual Royalties paid or incurred by Sublessee...shall be applied against the Production Royalty, such that no Production Royalty shall be payable or accrued by Sublessee until it shall have recouped all Minimum Annual Royalties incurred by it."

The sublease also contained a provision which allowed for deferment of the cash payment of the minimum annual royalty on the anniversary date. As pertinent, this provision states:

> "In lieu of the cash payment on the Anniversary Date, the Sublessee, in its sole discretion, may elect to defer all or any part of the Minimum Annual Royalty due. As a condition of such deferral, the Sublessee shall pay to the Sublessor fifty percent (50%) of all Production Revenues. The term "Production Revenues" shall mean the gross revenues of the Sublessee from the sale of oil and gas produced from any of the properties.... Any amount so paid shall reduce the deferred amount of the Minimum Annual Royalty.
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> "All deferred amounts remaining unpaid as of the 1993 Anniversary Date of the Sublease shall be due and payable without interest at such time. The election to defer granted in this Article shall be deemed to have been made in the event that the Sublessee shall fail to pay a Minimum Annual Royalty when due."

In a sworn and notarized affidavit, petitioner states:

> "I had no discretion to pay the MAR or not. My failure to make MAR payments would be a substantial breach of the sublease, and among other things, would result in a loss of all mineral rights."

The sublease allowed petitioner to surrender or abandon any or all of the drilling sites at any time by executing a notice of surrender. Upon abandonment, petitioner's obligation under the sublease ceased with respect to the abandoned drilling site, "except those obligations previously incurred." Petitioner was also entitled to purchase all of Sherwood's right, title and interest to individual drilling sites, so long as the sublease was in effect.

The sublease agreement was prepared by James M. Russell. At petitioner's behest, Mr. Russell evaluated the oil reserves and recoverable reserves on the property which was the subject of the sublease. He obtained a written opinion from a geologist who estimated that the drilling sites would produce taxable income in excess of one million dollars between 1982 and 1994. Mr. Russell also evaluated a number of other potential drilling sites for petitioner. He was paid for his services as well as his expenses in carrying out these activities.

It was petitioner's intention to actively explore the sites, drill wells and produce oil and natural gas. However, shortly after he entered into the Sherwood sublease, the price of oil began dropping and drilling became unprofitable. Petitioner abandoned or purchased from Sherwood all drilling sites covered under the sublease before the first year anniversary date.

Petitioner made a series of payments on the promissory note after its execution. The payments included the assignment to Sherwood of amounts payable to Glade Oil by oil drillers and the assignment of the proceeds from the settlement of a lawsuit brought by petitioner. The aggregate amount of the payments is $59,443.41. Petitioner remains obligated to pay the full balance of the promissory note on December 9, 1994.

Attached to petitioner's 1982 New York return was a Federal schedule C for Glade Oil Company on which petitioner reported a net loss of $561,074.00 comprised of intangible drilling costs of $194,400.00 and a minimum royalty payment of $366,674.00. Petitioner reported no gross receipts or sales from this business. Petitioner is an accrual method taxpayer. The Internal Revenue Service commenced an audit of petitioner's 1982 Federal return which resulted in that return being accepted as filed.

The Division disallowed petitioner's deduction of the minimum annual royalty payment. At hearing, the Division's auditor, Dominick A. Grasso, testified that the deduction was disallowed on audit because petitioner had failed to prove actual payment of the minimum annual royalty or to provide much information pertaining to the payment. On cross-examination by petitioner's attorney, the following exchange took place regarding the Division's disallowance of the minimum annual royalty:

Mr. Tully: "...You had a copy of the note?"

Mr. Grasso: "A copy of the note was presented to me."

Mr. Tully: "And you disallowed that as a deduction?"

Mr. Grasso: "Yes. That's correct."

Mr. Tully: "Why?"

Mr. Grasso: "It was never paid to my satisfaction or to my knowledge."

Mr. Tully: "But it seemed on its face a note, a bonafide note?"

Mr. Grasso: "I don't believe so. I would probably categorize it as a nonrecourse note. There was never a payment made on it." (Transcript at 26.)

MISCELLANEOUS EXPENSE DEDUCTIONS

Petitioner's accountant during the audit years was Gerald Reich. Mr. Reich was critically ill during the audit period and unable to provide documents necessary to substantiate petitioner's claimed business deductions. In 1989, petitioner turned to an accountant named Earl Kriger for help in responding to the Division's audit. At Mr. Kriger's urging, petitioner went to the home of Mr. Reich and retrieved whatever personal and business records he could locate. Among the items recovered were expense memorandums prepared by Mr. Russell, showing expenses incurred by petitioner or Glade Oil with respect to investments in the oil and gas business. These included payments to Mr. Russell and a second individual for reimbursement of expenses. Mr. Chuckrow also recovered cancelled checks, bank statements, and statements of accounts. These documents established payments to various persons for legal fees; payments to Mr. Reich for accounting fees; management fees to different individuals overseeing properties for petitioner; and charitable contributions. From these documents and conversations with petitioner, Mr. Kriger prepared a summary of 1982 business expenses totalling $107,826.00 and a summary of charitable contributions in the amount of $10,020.00. Explanations of the expenses were included on the summary schedule and were prepared from information provided by petitioner.[2]

Several of the expenses shown on the summary schedule contained only cursory explanations or indicated that the expenses were claimed in connection with property in which petitioner neither had nor ever acquired a property interest. Those items are as follows:

(a) "Richard Goldwater, Attorney. August 10, 1982 business leases were sought but not culminated"	$ 2,000.00
(b) "Sherwood Guernsey - business legal fees"	1,200.00
(c) "James E. Conway - legal fee re: Apple Hill - to look after partnership interest which was not	

[2]Petitioner submitted an affidavit in his own behalf stating, among other things, that he now lives in Virginia and was recuperating from surgery at the time of the hearing, making it impossible for him to travel to New York to testify.

acquired"[3]	1,000.00
(d) "Lawrence Williams - legal fees re: Apex - 3 units that became worthless"	1,800.00
(e) "Christian Clode - for supervision of oil interests, fee - $1,000; expenses - $349"	1,349.00

Petitioner had a partnership interest in a hotel named the Sportsmen's Lodge, located in California. His 1982 California income tax return shows gross income from this source of $701,356.00. The summary schedule shows an expense in the amount of $13,200.00 for management fees paid to petitioner's brother in connection with this investment. Petitioner submitted invoices to substantiate the monthly payments; the March 1982 bill was missing. Workpapers prepared by the auditor show property management fees of $14,300.00 paid in connection with the Sportsmen's Lodge.

In calculating his income for 1982, petitioner claimed a bad debt loss of $20,000.00. The Division apparently allowed this deduction since no mention was made of it in the audit report or the auditor's testimony. In connection with attempts to collect that debt, petitioner incurred two expenditures: (1) legal fees to Richard Goldwater in the amount of $783.00 and (2) legal fees to Richard S. Perles in the amount of $385.00.

Petitioner paid Mr. Reich $20,000.00 for accounting fees connected with the preparation of his 1982 tax returns and paid Mr. Sherwood Guernsey $252.00 for legal fees in connection with a brief filed with the Internal Revenue Service.

The remainder of the expenses delineated by petitioner were explained through the testimony of Michael Neustadt and the affidavit of Mr. Russell. Mr. Neustadt met petitioner in 1979. In 1981, petitioner hired Mr. Neustadt

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[3] The field audit report contains the following notation with regard to an Apple Hill Partnership:

> "Taxpayer was involved in this shelter promotion from 1976 - 1978. Issue was reviewed by the Internal Revenue Service. Based on a decision made by the Internal Revenue Service taxpayer was required to pick up $68200 [sic] of income on his 1983 return. Decision was made in November 1983."

to investigate a hotel business in which petitioner had an investment. Mr. Neustadt performed a management audit of that business and made recommendations to petitioner for operating the business. Mr. Neustadt later became involved in petitioner's oil and gas businesses. Petitioner had an interest in a number of mineral leases in Louisiana in association with an individual named Austin Speed. Petitioner suspected Mr. Speed of dishonesty with respect to his oversight of the oil and gas operations. Mr. Neustadt was engaged to investigate. He traveled to the site of the operations to determine whether wells were in fact being drilled and to study the operations of the drilling and production business. In carrying out these activities, Mr. Neustadt reported to Richard Goldwater, an attorney representing petitioner in a lawsuit which was brought against Mr. Speed. Among the deductions claimed by petitioner were payments totalling $18,760.00 to Mr. Goldwater "for legal action against Austin Speed, who sold an interest in an oil partnership which he did not own." Copies of cancelled checks substantiate the payments to Mr. Goldwater, but there is no further information in the record describing the legal action brought against Mr. Speed or the nature of petitioner's business dealings with Mr. Speed.

Mr. Neustadt later became involved in investigating other potential business opportunities for petitioner, travelling to Pennsylvania, Ohio, West Virginia and Jamestown, New York on petitioner's behalf. Petitioner chose not to invest in most of the properties investigated by Mr. Neustadt. In 1982, approximately 90 percent of Mr. Neustadt's time was spent on projects for petitioner.

In carrying out his activities for petitioner, Mr. Neustadt sometimes travelled with Mr. Russell who was also engaged in investigating oil and gas investment opportunities for petitioner. Petitioner submitted a sworn affidavit from Mr. Russell which states, as pertinent here:

> "For the tax year 1982, J.M.R. Oil & Gas, a company I was a principal of, evaluated a number of...drilling sites for Robert Chuckrow. In addition, J.M.R. Oil and Gas entered into contracts with Robert Chuckrow pertaining to management of various sites. Upon information and belief, my handwritten memoranda to Robert Chuckrow pertaining to the expenses incurred with regard to the evaluation and operation of various drilling sites have been submitted to the Tax Department.

> They represent a true and accurate statement of payments made to me by Mr. Chuckrow for the work I performed regarding these operations. Each of these operations...were undertaken for purposes of earning a profit. Evaluations, prepared with regard to the various projects and submitted to Robert Chuckrow, anticipated taxable income from such operations."

Expense memorandums prepared by Mr. Russell show expenses incurred by him and Mr. Neustadt for various trips to Louisiana, Ohio, Oklahoma, Pennsylvania and Kansas, among others. Bank statements substantiate the expenditures. Some of the expenditures appear to have been made in connection with property in which petitioner had an ownership interest. For example, expenses are shown in connection with an entity identified as "Mariner", and petitioner's tax return shows a partnership loss from Mariner Drilling Associates in the amount of $21,553.00. However, petitioner did not offer a detailed explanation of the numerous items shown in Mr. Russell's memorandum.

At the time of the audit, petitioner attempted to substantiate the claimed business deductions by providing the Division with cancelled checks. At hearing, Mr. Grasso testified that the majority of petitioner's claimed business deductions were disallowed because the cancelled checks did not adequately establish that the expenses qualified as ordinary and necessary business expenses and the Division was not provided with other information relative to the claimed expenses. Mr. Grasso testified:

> "It appeared from the cancelled checks that these were just investigation expenses to try to obtain investment type property or something that would be of a capital nature." (Transcript at 23.)

Petitioner claimed miscellaneous business deductions in 1982 in the amount of $95,809.00, and the Division disallowed $75,159.00 of this amount. Included in the miscellaneous deductions allowed by the Division was a payment of $20,000.00 for tax return preparation.

CHARITABLE CONTRIBUTIONS

Petitioner claimed a deduction for charitable contributions in the amount of $11,001.00. The Division disallowed $3,500.00 of the total contribution claimed. On audit, petitioner claimed that a portion of this amount represented a donation made to the Metropolitan Opera

Association (the "MET") in the form of a contribution of artwork to a MET raffle. With regard to the disallowance of charitable contributions, the audit report states:

> "1982 - taxpayer submitted partial documentation relative to Cash Contributions. Amount unsubstantiated was $1,000.00. In addition taxpayer donated 2 gifts to the Met for use in a raffale [sic]. Taxpayer retained possession of the gifts. Based on Code Section 170(a)3, a taxpayer received no Charitable Deduction while he has the right of possession and enjoyment of the property."

The Division based its finding that petitioner did not relinquish control of the artwork on a letter, dated December 3, 1982, from the MET to petitioner. The letter indicates that the artwork was to be raffled in 1983 or 1984 and that petitioner would not lose possession of the artwork until that time. The letter also indicates that the artwork consisted of two paintings, a seascape and a painting with a martial theme, valued at $1,600.00 and $900.00 respectively.

At hearing, petitioner introduced a second letter, also from the MET to petitioner, dated November 6, 1981. It states, in relevant part:

> "I was delighted to learn that you will donate a gift to the 1982 MET Raffle. Your generosity is greatly appreciated by the Metropolitan Opera.
>
> "Our drawing will be held in July. As soon as we have the name and address of the lucky winner, we will forward that information to you so you can dispatch the prize."

The letter, as completed by petitioner, indicates that the item to be donated was an oil painting of James Joyce by Gladys McCabe. Attached to the MET's letter is a letter to petitioner from an art appraiser, valuing the painting at $1,500.00 "more or less."

Mr. Kriger prepared a summary of petitioner's claimed charitable contributions, showing substantiated contributions of $10,120.00. Of this amount, cash contributions of $7,620.00 were substantiated with copies of cancelled checks and other documents. Based upon the first MET letter, dated December 3, 1982, Mr. Kriger included an additional contribution of $2,500.00. Mr. Kriger did not include the contribution evidenced by the second MET letter of November 6, 1981 in his calculations.

OPINION

The Administrative Law Judge determined that petitioner's right to the deductions at issue rests upon Federal statute and case law. Applying this authority, the Administrative Law Judge concluded that petitioner was not entitled to deduct the royalty payment in the amount of $366,674.00 because the payment did not satisfy the conditions of Treasury Regulation § 1.612-3(b)(3). To be deductible under this regulation, the Administrative Law Judge found that the royalty had to be paid or accrued in the year in which the mineral product to which it related was sold, or the royalty had to be an "advanced minimum royalty." The Administrative Law Judge noted that petitioner never claimed entitlement to the deduction on the first ground and decided that the instant royalty was not an advanced minimum royalty because, as a result of a deferral provision, the sublease agreement did not require annual and uniform payment of such royalties. The Administrative Law Judge addressed the latter point even though the Division had not raised it until its post-hearing brief. The Administrative Law Judge concluded that petitioner had not been prejudiced by the delay in raising the issue and that petitioner bore the burden to show that the payment satisfies the requirements of the regulation. The Administrative Law Judge rejected the only reason advanced by the Division for denying the deduction for the royalty prior to the post-hearing brief, i.e., that the payment was a nonrecourse note, finding that petitioner had proved that the note was a recourse note.

With respect to the miscellaneous deductions denied by the Division for 1982, the Administrative Law Judge found that petitioner had substantiated a total of $34,620.00 but had failed to substantiate the remainder. The Administrative Law Judge stated that a majority of the disallowed expenses were not deductible because they related to property or investments in which petitioner had no ownership interest in 1982. The Administrative Law Judge stated that other deductions were disallowed because they were sought for expenses that were never fully explained. Finally, the Administrative Law Judge concluded that petitioner was not entitled to an additional deduction for charitable contributions because petitioner had not proved that he

actually donated certain artwork and because petitioner's evidence was insufficient to establish the fair market value of the artwork.

On exception, petitioner argues that the Administrative Law Judge erred in considering the new ground for disallowing the deduction for the royalty payment advanced by the Division for the first time in its post-hearing brief because this new ground created an unfair surprise to petitioner and was prejudicial to him. Petitioner requests that we dismiss the Division's late position or, at the least, remand this case to the Administrative Law Judge so that petitioner may present additional evidence as to the provisions of the sublease. With respect to the deductibility of the royalty payment, petitioner asserts that it is deductible because Glade Oil was an accrual base taxpayer and all of the events that established liability on the obligation occurred in 1982, i.e., the execution of the sublease requiring the royalty payment and the issuance of a recourse note as payment of the initial royalty. Petitioner also states that the Division "should defer to the IRS' expertise as to the requirements of Federal tax law and permit the Chuckrows to claim the MAR deduction in dispute" (Petitioner's brief on exception, p. 14). With respect to the claimed miscellaneous expenses, petitioner argues that, contrary to the Administrative Law Judge's statement, under section 212 of the Internal Revenue Code, a taxpayer may deduct expenses incurred to investigate a particular investment or to buy income producing property, whether or not the investment is ultimately made or the property purchased. Finally, petitioner claims that he did establish reasonable cause for his actions and that the penalties imposed should be abated.

In response, the Division argues that the royalty was not deductible because, pursuant to Treasury Regulation § 1.612-3(b)(3), no mineral product was sold in 1983 and the royalty was not an advanced minimum royalty as defined in the regulation. Next, with respect to the 1982 miscellaneous business deductions, the Division contends that the Administrative Law Judge correctly held that "the majority of the expenses claimed by the petitioners were shown to relate to property or investments in which the petitioners had no ownership interest in 1982 and, therefore, the expenses were not allowable pursuant to IRC section 212" (Division's brief on

exception, p. 8). The Division argues, with respect to the 1983 deductions, that it properly disallowed a total of $23,573.00. Finally, the Division asserts that petitioner has not previously raised the penalty issue in this proceeding and that the record fails to establish reasonable cause to support abatement.

We affirm the determination of the Administrative Law Judge.

We first address whether the Administrative Law Judge properly allowed the Division to raise a new ground for disallowing the royalty deduction in its post-hearing brief. We have consistently held that new legal issues can be raised on exception (see, Matter of Standard Mfg. Co., Tax Appeals Tribunal, July 11, 1991; Matter of Small, Tax Appeals Tribunal, August 11, 1988). We have not, however, allowed new factual issues to be raised after the hearing which would disadvantage the party who had the burden of establishing the disputed fact (see, Matter of Sandrich, Inc., Tax Appeals Tribunal, April 15, 1993; Matter of Clark, Tax Appeals Tribunal, September 14, 1992; Matter of Consolidated Edison Co. of New York, Tax Appeals Tribunal, May 28, 1992). By arguing that, at the least, he should have an additional opportunity to present evidence on whether the lease required minimum, uniform payments, petitioner seeks to characterize the instant issue in the latter category. However, petitioner has not specified what type of additional evidence he would have introduced in support of his position that the lease did require minimum, uniform payments. Further, petitioner has not argued that the lease provisions are in any way ambiguous, and our own reading of the sublease reveals no ambiguity. Therefore, it cannot be claimed that resort to evidence external to the sublease is necessary in order to interpret its terms (see, Matter of Emery Air Freight Corp. v. New York State Tax Appeals Tribunal, ___AD2d___, 591 NYS2d 264). As a result, we fail to perceive what type of evidence would have been relevant to determine the meaning of the sublease terms, other than the sublease itself. Thus, we conclude that any response petitioner had to the Division's assertion that the sublease did not require uniform, minimum payments would be in the nature of argument and could have been made in petitioner's reply to the Division's post-hearing brief, or in petitioner's brief on exception, and that petitioner was not

prejudiced by the Division's failure to raise the additional ground while the record was still open.[4]

Turning to the substantive question, petitioner argues that the Administrative Law Judge erred because she based her decision on the premise that payment in the form of a note could not satisfy the Federal regulations, i.e., that payment always has to be in cash (Oral Argument Tr., p. 13).

The Administrative Law Judge clearly and separately considered the method of payment in this case and concluded that the note was not a nonrecourse note and that petitioner has overcome the Division's only articulated basis (up to the time of the hearing) for disallowing the deduction (Determination, p. 15). As an entirely independent issue, the Administrative Law Judge considered whether the sublease agreement satisfied the requirement of Treasury Regulation § 1.612-3(b)(2) that "a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years in the absence of mineral production requiring payment of aggregate royalties in a greater amount" (Determination, pp. 18-20). Relying on Walden v. Commissioner (T.C. Memo 1988-98, 55 TCM 332), Oneal v. Commissioner (84 T.C. 1235) and Vastola v. Commissioner (84 T.C. 969), the Administrative Law Judge determined that the sublease did not satisfy this condition because of the deferral provision which allowed petitioner to defer all, or a part, of the payment of the royalty. Because this portion of the Administrative Law Judge's determination focused exclusively on the deferral provision in the sublease, and not on the form of the payment, we see no basis for petitioner's

[4]In reaching this conclusion, we have not considered a letter dated January 29, 1991 that was submitted by the Division on exception because, as we have consistently ruled, evidence submitted after the closing of the record will not be considered (see, Matter of Schoonover, Tax Appeals Tribunal, August 15, 1991).

assertion that the Administrative Law Judge relied on the premise that payment by a note could not satisfy the regulation.[5]

With respect to petitioner's claim that we should defer to the Internal Revenue Service's expertise and permit the royalty deduction because the Internal Revenue Service did, we see absolutely no basis for such a contention where we are not informed of the scope and subject matter of the audit (cf., Matter of USV Pharmaceutical Corp., Tax Appeals Tribunal, July 16, 1992 [where we held that detailed proof of specific IRS adjustments under section 482 of the IRC was sufficient to prove that the adjustments resulted in arm's-length pricing between petitioner and its wholly owned subsidiary]).

As petitioner has advanced no other argument on exception concerning the merits of the Administrative Law Judge's holding that due to the deferral provision, the sublease did not require annual, uniform royalty payments, we affirm the Administrative Law Judge's disallowance of the royalty deduction for the reasons stated in the determination.

Next, we address whether the Administrative Law Judge properly disallowed miscellaneous deductions in the amount of $73,206.00 for the year 1982. Contrary to petitioner's assertion, expenses incurred for investigating investments that are never acquired cannot be deducted, as an expense incurred for the production of income, under section 212 of the Internal Revenue Code. The rationale for this rule is that without the acquisition of the asset, there can be no production of income for the taxpayer's benefit (Domenie v. Commissioner, T.C. Memo 1975-094, 34 TCM 469; Price v. Commissioner, T.C. Memo 1971-323, 30 TCM 1405-3).

The cases cited by petitioner do hold that a taxpayer may be allowed a deduction, as a nonbusiness loss, under section 165(c)(2) of the Internal Revenue Code for investigatory expenses for certain abandoned projects; however, these cases establish the loss is only available if the taxpayer can show that the search proceeded beyond preliminary investigation to

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[5]Although it was not a basis of the Administrative Law Judge's determination (because this point was not raised by the parties before the Administrative Law Judge), a conclusion that the annual payment required by section 1.612-3(b)(3) of the regulation has to be in cash would appear to be correct (see, Heitzman v. Commissioner, 859 F2d 783, 88-2 USTC ¶ 9565; Capek v. Commissioner, 86 T.C. 14, 47).

reach the "transaction" stage (Seed v. Commissioner, 52 T.C. 880; Domenie v. Commissioner, supra). As petitioner has not shown that his search for assets advanced beyond the preliminary investigation stage, a loss under section 165(c)(2) is not available.

In its brief on exception, petitioner presents his argument with respect to the miscellaneous deductions as if the deductions for 1983 are also in issue. The Administrative Law Judge did not specifically address the disallowance of the miscellaneous deductions in 1983, but upheld the Division's disallowance by sustaining the conciliation order with respect to 1983 (Determination, p. 23). As petitioner introduced no evidence with respect to the miscellaneous deductions for 1983, the Administrative Law Judge's determination was appropriate.

Similarly, the Administrative Law Judge sustained the imposition of penalties without any discussion because petitioner never raised this as an issue before the Administrative Law Judge. Further, there is no evidence in the record to support abatement of the penalties; therefore, we sustain the Administrative Law Judge's determination imposing the penalties.

Accordingly it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioners Robert and Adelaide Chuckrow is denied;

2. The determination of the Administrative Law Judge is sustained;

3. The petition of Robert and Adelaide Chuckrow is granted to the extent indicated in conclusions of law "D," "G," and "H," but is otherwise denied; and

4. The Division of Taxation is directed to modify the Notice of Deficiency dated March 25, 1988 in accordance with paragraph "3" above, but such Notice is otherwise sustained.

DATED: Troy, New York
July 1, 1993

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner