STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
MARC S. SZNAJDERMAN AND JEANNETTE SZNAJDERMAN	:	DECISION
	:	DTA NO. 824235
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law and the New York City Administrative Code for the Year 2001.	:	

Petitioners, Marc S. Sznajderman and Jeannette Sznajderman, and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on March 6, 2014. Petitioners appeared by Latham & Watkins, LLP (Miriam L. Fisher, Esq., Brian C. McManus, Esq. and Joshua Wu, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller Esq. (Kathleen O'Connell, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in support of its exception and in opposition to petitioners' exception. Petitioners filed a brief in opposition to the Division of Taxation's exception and in reply to the Division of Taxation's brief in opposition. The Division of Taxation filed a brief in reply to petitioners' brief in opposition. Oral argument was heard in New York, New York on March 19, 2015. At the Tribunal's request, the parties also filed supplemental briefs seriatum. The six-month period for the issuance of this decision began on January 11, 2016, the date petitioner's supplemental reply brief was received.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision. Commissioner Scozzafava took no part in the consideration of this matter.

ISSUES

I. Whether the issuance of the notice of deficiency is barred pursuant to the three-year statute of limitations set forth in Tax Law § 683 (a) or is valid pursuant to the exception thereto set forth in Tax Law former § 683 (c) (11) (B), by which tax may be assessed at any time within six years after the return was filed if the deficiency is attributable to an abusive tax avoidance transaction, thereby justifying the Division's denial of petitioner's deductions.

II. Whether, if the notice of deficiency is sustained, petitioner has demonstrated reasonable cause for the abatement of the penalties asserted by the Division of Taxation pursuant to Tax Law § 685 (b) (1), (2) and former (p) and a penalty for failure to participate in the voluntary compliance initiative under Chapter 61 of the Laws of 2005, Part N, section 11 (1).

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge, except for findings of fact 1, 2, 6, 7, 9, 10, 21, 23, 26 through 30, 37, 38, 42, 47, 49, 51, 67, 70, 85, and 88, which we have modified to more fully reflect the record. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

1. Petitioners, Marc S. Sznajderman and Jeannette Sznajderman,[1] filed a joint resident personal income tax return for the year 2001, pursuant to an extension, on June 19, 2002.

2. During the year 2001, Marc Sznajderman became a general partner in Belle Isle Drilling Company (Belle Isle), a New York general partnership that was formed in 2001. As indicated in its certificate of partnership, Belle Isle was formed for the purpose of investing in the acquisition, development, and drilling of oil and gas wells. As indicated in its investment proposal and by its

[1] Petitioner Jeannette Sznajderman's name appears in this matter because she filed a joint return with petitioner Marc S. Sznajderman for the year at issue. Since she was not involved in the transaction that is at the center of this proceeding, references to petitioner herein shall be to Marc S. Sznajderman, unless otherwise indicated.

investment structure, Belle Isle had the concurrent purpose of taking advantage of the Internal Revenue Code's allowance of expense deductions for intangible drilling and development costs (IDCs) incurred in connection with the wells in which it invested.

3. Petitioner was an experienced and intelligent investor. He received his undergraduate education at Syracuse University and then received a masters degree in business management from the Kellogg Graduate School of Management at Northwestern University. During his career, he was employed by Goldman Sachs as a real estate investment banker, working on raising capital for developers in financing large assets, and also working on the real estate components of mergers and acquisitions and other corporate finance transactions. Mr. Sznajderman later worked at Bear Stearns, the Carlton Group and RM Capital Management, where he assisted in real estate investment transactions and raising capital for real estate owners. At the Carlton Group, these transactions ranged from 10 million to a billion dollars.

4. Petitioner has also demonstrated that he is a sophisticated investor in his own right, having invested in stocks, bonds, real estate, private equity, small companies and hedge funds. It was with this financial and business background that petitioner approached his investment in Belle Isle.

5. In 2000, petitioner was introduced to Richard Siegal,[2] who had been involved in the oil and gas business since the 1970s, by one of Mr. Siegal's sons, Bippy, with whom petitioner had previously worked. Mr. Sznajderman frequently made investments with people with whom he had a social and trusting relationship because it provided a basis for the confidence and trust he liked to have with business associates.

[2] Richard Siegal died on February 9, 2010.

6. Petitioner met with Mr. Siegal numerous times, learning more about the deals that Mr. Siegal made with drillers and other players in the industry. On one such occasion, Mr. Siegal explained that his business either explored and drilled for oil and gas itself or partnered with others in the industry. To make investment in these ventures available to individuals, Mr. Siegal created partnerships to participate in oil and gas drilling ventures. These partnerships were designed to be eligible to deduct IDCs in the first year of operation and were therefore vested with working interests in the wells in which they were invested. Additionally, the investors were required to be general partners, exposing investors to greater risks than those in limited partnerships, which had previously been the investment vehicle generally used in oil and gas ventures. Petitioner was aware of the greater risks involved due to his role as a general partner in other business ventures.

7. Prior to making his decision to invest in Belle Isle, Mr. Siegal provided petitioner with copies of key investment documents, including an investment proposal and a partnership agreement.

The investment proposal suggests Bell Isle as a means to address the problem of "confiscatory" tax rates for high income earners. It further states that investors in the partnership would receive a deduction equal to 2.5 times their cash investment in the first year. The proposal also informs prospective investors that they could expect an annual cash flow of approximately 10 to 15% of the cash funds invested, which would have required Belle Isle to generate annual income of $29,400.00 per unit (where one unit was valued at $280,000.00). Additionally, the investment proposal outlines the structure of the investment, including the subscription note, the turnkey note, the 20-year extension of such notes, the payment and accrual of interest, the collateral agreement for the purchase of bonds, and the cash flow waterfall with respect to revenue earned by the partnership. These features of petitioner's investment are more fully described hereinafter.

The partnership agreement explained the purpose of the partnership, the duties of the managing partner, and set forth the value of each unit, which would be paid for by a cash contribution of $100,000.00, and the partner's execution of a full recourse promissory note with a face value of $180,000.00 to Belle Isle at an interest rate of 8% per annum.

8. Mr. Sznajderman's initial investigation of the prospective investment also revealed that Mr. Siegal established numerous partnerships each year and had set up several companies to perform different functions to effectuate these investments. Petitioner was also aware that the wells he would be investing in were located in Texas and Oklahoma and that the Belle Isle venture would be a very small part of Mr. Siegal's overall business. However, petitioner knew that he would be relying on Mr. Siegal to provide the expertise related to choice of wells and actual drilling. After numerous conversations with Mr. Siegal, petitioner was confident enough in Mr. Siegal's business operations that he decided to pursue the next level of due diligence.

9. Petitioner may not have been aware that the well locations were mostly developmental sites, that is, located near proven wells, a fact that would enhance the chances of finding oil. However, because Belle Isle's wells would then be offsetting wells to other producing wells, the abundance of oil and gas to be harvested as well as the financial returns most likely would be greatly diminished. Despite this fact, David Plastino, petitioner's expert in finance and economics, believed that petitioner had a reasonable opportunity to both make and lose money in Belle Isle at the time he entered into the investment in 2001.

10. Petitioner researched oil and gas investments on the internet, confirming that investors in oil and gas wells could gain significant tax deductions for a portion of their initial investment,

including deductions for depletion. He also reviewed a tax opinion prepared by Stuart Becker and Company, a certified public accounting firm that had done work with Mr. Siegal previously. The opinion concerned a drilling partnership called Tiger Bay Drilling Company, which petitioner read as supportive of the Belle Isle investment proposal, even though he understood that he could not rely on it for purposes of his investment in Belle Isle. The Stuart Becker and Company opinion made no reference to an option for the partners to pay the partnership 15% of the face value of the subscription note for the purchase of bonds under the terms described in finding of fact 26.

11. Petitioner did not obtain his own tax opinion because of the expense, but did have his own accounting firm, Sidney and Green, review all the documentation provided to him by Mr. Siegal. Although not specialists in oil and gas, Sidney and Green advised petitioner that the documents did not appear to them to be out of the ordinary or raise any undue concern.

12. Petitioner reviewed the names of other investors provided to him by Mr. Siegal, including one whom he knew to be a certified public accountant and spoke with prior to investing. He also had several conversations with Mr. Siegal when questions arose concerning the investment. Based on the documents provided by Mr. Siegal and his own research, petitioner came up with his own rough estimate of potential returns and tax benefits.

13. One of petitioner's objectives in investing in oil and gas was to diversify his investment portfolio, especially since oil and gas investments are defensive and counter-cyclical, that is, there is a negative price correlation between common investments like stocks and bonds and oil and gas investments.

14. Another objective was to make money on his investment, and Mr. Siegal had told him some partnerships had done very well and others did not perform to the average, but that there

was the possibility of making in excess of 10% on his equity investment, and that he could see returns on his investment for a number of years.

15. Mr. Sznajderman viewed the investment as analogous to a mutual fund, where he would own interests in numerous wells, thereby minimizing his risk and optimizing his chances for success, since it was not uncommon for wells to underproduce or not produce at all. To him, the hope was that the average performance of all the wells in which Belle Isle had an interest would generate a profit and positive cash flow to the investors.

16. With respect to this oil and gas investment, another of petitioner's objectives was to reap the tax benefits, which amplified the economic returns by increasing the returns overall and enhancing the entire transaction.

17. Petitioner had no expectation that he would take an active role in the management of the partnership, leaving the decisions concerning the choice of wells and drilling protocol to experts like Richard Siegal and his company, Palace Exploration (Palace). Although Belle Isle's managing partner was George Coleman, a person petitioner did not meet prior to his investment in the partnership, who was legally vested with the authority to run the partnership, he believed that Richard Siegal would actually manage Belle Isle and confer with Mr. Coleman on all decisions. This belief was confirmed by Mr. Coleman.

18. In December 2001, petitioner executed various documents consistent with his investment in the Belle Isle partnership and its unique funding structure. He received back from the partnership countersigned copies of the documents on or about January 17, 2002.

19. The partnership agreement, dated August 1, 2001, stated that it was created to invest in the acquisition and development of oil and gas prospects, set forth operational details and established the price of a partnership unit as $280,000.00, payable $100,000.00 in cash and

$180,000.00 in a promissory note. The agreement also set forth the mechanics of how economic benefits would be distributed to partners. The partnership term was defined in the agreement as beginning on the date of the agreement and terminating on December 31, 2034.

20. Petitioner purchased three units in Belle Isle and made an initial cash commitment of $300,000.00, of which he paid $100,000.00 from personal funds on December 20, 2001 and borrowed the balance of $200,000.00 from Tierra Resources, a Richard Siegal-controlled entity, signing an interest-free note therefor that he repaid in July 24, 2002. He believed that the courtesy of extending the credit was Mr. Siegal's way of providing additional incentive for participating in the partnership.

21. In all, the general partners in Belle Isle contributed capital in the stated amount of $10,985,800.00, of which $3,923,500.00 was cash and $7,062,300.00 consisted of promissory or subscription notes.

22. In furtherance of his participation in the partnership, petitioner signed a subscription agreement whereby he agreed to purchase three units for $840,000.00, payable in cash of $300,000.00 and a full recourse promissory note of $540,000.00 bearing interest of 8% per annum and due December 31, 2009. The agreement placed restrictions on the transfer of the units as well as required petitioner to state that his net worth was in excess of one million dollars and that his income for two years prior to the agreement was in excess of $200,000.00 and was expected to remain so in the then-current year (2001).

23. On December 13, 2001, petitioner executed a full recourse subscription note in the face amount of $540,000.00 as described in the above paragraph. The note provided for an interest rate of 8% per year. Interest for the first year, that is, from January 1, 2002 through December 31, 2002, was payable quarterly, and thereafter said interest was payable from

petitioner's share of Belle Isle's net operating revenue, and to the extent these revenues were not available or insufficient, interest accrued. According to the note, all accrued and unpaid interest was due and payable on December 31, 2009. The note also provided that 50% of petitioner's share of Belle Isle's revenues, after the payment of interest, was to be applied to the outstanding principal balance of the note. The note was to be assigned by Belle Isle to SS&T Oil Co., Inc. (SS&T), a Richard Siegal-controlled entity, as security of partnership indebtedness, and petitioner would pledge, transfer and assign as collateral a security interest in his share of the partnership and the production and proceeds from Belle Isle's wells.

24. The total financial commitment made by Belle Isle's partners was considerably more significant when the annual interest was taken into account. These amounts of the notes and the interest due were duly reflected on Belle Isle's books and records as assets and interest income, respectively, as well as on schedule K-1 of Belle Isle's federal partnership returns denoting the distributive share of interest income to partners.

As of July 2012, Belle Isle's partners had paid $885,387.00 in interest on their subscription notes. During 2002 and 2003, pursuant to the terms of the subscription notes, Belle Isle's partners each made "first year" quarterly interest payments on their subscription notes directly to Belle Isle totaling $622,978.00. Beginning in 2003, an additional $262,409.00 was withheld from the partners' distributions and credited to interest due on the partners' subscriptions notes as of July 2012.

Beginning in 2002, petitioner received four quarterly invoices from SS&T for interest due on his subscription obligation, each in the amount of $10,800.00, dated March 11, June 11, September 10 and December 10, 2002. All were timely paid and petitioner was current on his interest obligation as of December 31, 2002.

As of 2011, petitioner had paid $60,552.00 in interest on his subscription note. He made four payments in the amount of $10,800.00 in 2002; payments of interest from partnership distributions from 2003 through 2010 totaled $12,952.00; and he made interest payments in 2011 from partnership distributions of $4,400.00. As of 2011, petitioner's accrued but unpaid subscription note interest balance due was $371,402.00.

25. Evident from the terms of the subscription agreement and note were the standard creditor protections, as well as additional and less common protection devices, such as the requirement that 50% of petitioner's share of the net operating revenue be applied to payment of the outstanding principal balance on the note.

26. Petitioner was also required to execute a separate additional collateral agreement with SS&T that required him to purchase municipal bonds that would be used towards the repayment of his subscription note on maturity. The bonds, to be registered in the name of SS&T, were to be of at least an "A" rating, have a maturity date of no more than 25 years and a face value at maturity of not less than the original principal amount of the subscription note. Alternatively, the additional collateral agreement gave petitioner the option to pay the partnership 15% of the face value of the subscription note, payable from his partnership distributions, which sum "SS&T will guarantee to invest at 7.88% compounded so that at the end of 25 years the sum would be equal to the principal amount of the Note."[3] Like nearly all investors in Belle Isle, petitioner chose this option.[4]

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[3] In an email dated December 11, 2003, related to another Siegal oil drilling venture, Mr. Siegal stated:

> "Since 1981 when we began structuring these ventures, no one has ever been required to pay any portion of their notes. If . . . the investor assigns part of his income from the venture to the driller to be used to purchase securities to secure the note, there is no event other than the failure of the issuer of the securities to pay the securities at maturity, that would require the investor to pay any part of the note."

[4] All but four of the 35 investors in Belle Isle chose this guaranteed sinking fund option. Of the four who did not, three were clearly insiders (Richard Siegal, Michael Siegal [Richard Seigal's son], and George Coleman).

27. The 8% interest rate provided for in the note was reasonable for such debt instruments in 2001. It was also reasonable to expect, in 2001, that municipal bonds meeting the 7.88% rate specification could be found when the time came for the municipal bond purchases.

28. Petitioner's choice to pay the partnership 15% of the face value of his subscription note for the purchase of bonds pursuant to the additional collateral agreement is reflected in a letter dated December 13, 2001, from Richard Siegal to petitioner, which provides that petitioner would assign 60% of his distributions from Belle Isle for a period of up to five years or until such assigned income equaled 15% of the face value of his subscription note. The letter indicates that SS&T would make up any shortfall in the bonds by reinvesting the proceeds until such time as the bond fund equals the note principal. At that point, the letter states, the bond proceeds would be used to "pay off the Note in full." The letter also indicates that the note would be extended so as to be coextensive with the maturity date of the bonds. The letter notes that petitioner's "personal guaranty" remains on the note to insure that the bonds are redeemed in full and that petitioner agrees to make good on any loss due to the failure of the issuing authority.

29. In a memo from Mr. Siegal to Mr. Sznajderman, dated July 29, 2004, Mr. Siegal recounted an agreement with petitioner in which Mr. Sznajderman's assignment a portion of his distribution from Belle Isle to SS&T for purposes of purchasing the municipal bonds in accordance with the additional collateral agreement would not commence until after he had received cash distributions from Belle Isle equal to or greater than the money he expended on interest due on the subscription note in 2002. In contrast to the December 13, 2001 letter, the memo indicates that petitioner agreed to assign 75% of his cash distributions for the bond purchases. All of the Belle Isle investors who opted to assign distributions to fund bond purchases assigned 75% of such distributions for such purchases.

Petitioner has reviewed statements prepared by an investment firm that included the bonds. In fact, petitioner's and the other Belle Isle partners' bonds (including those of other partnerships) were accounted for and held in an account at Morgan Stanley by SS&T Holding Co. Petitioner paid SS&T $81,000.00 (or 15% of $540,000.00) for the purchase of bonds under the additional collateral agreement. In total, Belle Isle's partners paid $873,395.00 out of their partnership distributions to SS&T for the purchase of bonds to collateralize the subscription and turnkey notes.

30. Petitioner understood that the bonds provided collateral for his repayment of the subscription note and the turnkey note issued by Belle Isle for drilling. He appreciated the importance of both the collateral agreement and the bond fund, knowing that they were designed to satisfy the principal due under the notes, which were his ultimate responsibility. Petitioner understood that by assigning his distribution to SS&T for the purchase of bonds, he had satisfied his obligation for the principal due on the notes.

31. Many parties are assembled to perform all the tasks necessary for drilling a well. The operator is the party that acquires the lease and assumes the working, or cost, interest, and also determines whether to add partners, in which case those partners would receive a proportionate share of the working interest. The operator provides an estimate of the costs of drilling and completing the well, also known as the authority for expenditure (AFE), often gleaned from price quotations from providers of specific drilling activities, including line item detail of all the intangible drilling costs (IDC) and tangible drilling costs (TDC), based on the operator's best estimate of costs, which could have been adversely affected by unexpected complexities and other drilling risks.

32. The primary service provider that the operator engages is the drilling contractor, who is responsible for providing the drilling rig and personnel. Drilling contractors are usually hired on a

day rate basis, footage basis or turnkey basis. The day rate contract pays for services based on the driller's billing rate for rig and crew. In day rate contracts, the operator bears all the cost and time risks of the drilling operation should trouble be encountered. That said, the day rate contract method is the least expensive if the drilling operation is managed effectively by an experienced and capable operator.

33. Turnkey drilling contracts, common in the industry, provide that the driller accept a fixed fee for developing wells up to the point at which they enter production. The turnkey driller is obligated to cover all costs, including cost overruns and delays, incurred prior to commencement of production. A key benefit for turnkey participants is the protection it gives against cost inflation.

34. The turnkey arrangement passes risks and uncertainties to the drilling contractor while protecting working interest owners, which is why turnkey drilling contracts are well suited for drilling partnerships, where partners often prefer to pay their fixed costs at one time prior to commencement of a project.

35. Belle Isle entered into a turnkey drilling contract with SS&T to avoid the risks and potential expenses that may be associated with any drilling venture, like failure to achieve commercial quantities of oil and gas (hydrocarbons), known as dry holes, or low post-completion production rates. By doing so, Belle Isle could avoid costs of environmental damage and accidents and the wide variation in drilling completion costs, even when wells are drilled in close proximity to each other. Wells that are close in distance and drilled to similar depths may encounter different geological impediments such as subterranean pressures, fault blocks, and the different drilling protocols of different operators. For assuming these risks, the turnkey drillers are able to demand a higher rate than day rate drillers.

36. Factors considered by drilling contractors when pricing a turnkey contract might include the estimated cost of the drilling rig and crew; project management and supervision; required drilling and support services; the depth of the well; anticipated bottom pressures; potential technical risks; opportunities for unexpected cost overruns; overhead; insurance; and target profit margins.

37. Since the Belle Isle wells were drilled in varied formations, to various depths in many locations, each project had to be considered separately to determine a contract price. In addition, drilling costs could vary widely even for specific target formations for the reasons stated above.

Richard Siegal alone determined the price of the turnkey contract between Belle Isle and SS&T, and there is no evidence of how he established his pricing.

The Division's expert petroleum engineer, Mikel Morris, established that, based on his substantial experience in the petroleum and gas industry, the standard markup on a turnkey contract was 10 to 25% over the cost of a day rate contract. The turnkey contract between Belle Isle and SS&T was approximately five times that cost, comparing the contract price of $10,836,000.00 to the actual expenses incurred in the drilling of the subject wells of approximately $2,050,000.00.[5] Mr. Morris was able to obtain actual drilling costs from public information for most of Belle Isle's wells, using a depth estimation methodology and a Massachusetts Institute of Technology study to estimate the few he could not obtain.[6]

The Division's investigation into the wells yielded an estimate of $1.77 million. The auditor, James Fahrenkopf, used AFE's for 75% of the 37 wells (only ones available) and used the average of the known AFE's for the remaining 25%.

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[5] Based upon a review of the records of the Palace Group, Mr. Plastino, petitioner's expert in economics and finance, determined that the direct drilling expenses related to Belle Isle's working interest totaled $2,172,622.00, consisting of $1,787,449.00 in IDCs and $385,173.00 in tangible drilling costs.

[6] Augustine, A Comparison of Geothermal With Oil and Gas Well Drilling Costs, Thirty-First Workshop on Geothermal Reservoir Engineering, Stanford University, Stanford, CA, January 30-February 1, 2006.

Although Michael Krehel, an expert petroleum engineer called by petitioner, stated that the turnkey contract “appears reasonable relative to standard industry practice” and that it insured against unforeseen cost overruns and well problems, he conceded that given the lack of specific cost detail for each well, it would not have been possible for an investor to discern the cost for each well, which wells were projected to be more costly or which represented the most technical risk. Thus, in Mr. Krehel’s opinion, the investors could not reach an opinion on the markup on the turnkey contract and whether it was reasonable. He further testified that he did not have an opinion on the average markup on a turnkey contract because he did not negotiate them. Although he did know that approximately two thirds of Belle Isle’s wells ultimately produced oil or gas in commercial quantities, he conceded that a built-in profit margin would diminish any investor profitability.

Petitioner knew that a turnkey contract limited his liability and that the price reflected “costs associated with the drilling and then some.” But he had no idea how the price was determined and testified that he did not know that Richard Siegal set the price, even though he knew that Mr. Siegal controlled SS&T and was behind the decisions made on behalf of Belle Isle. Petitioner did not question the turnkey price or make any attempt to investigate it on his own.

38. The Belle Isle turnkey contract with SS&T included many usual, generally accepted features such as end point, fees to be paid, and a description of the activities the driller was required to provide associated with the complete manufacturing of the well. The turnkey contract, however, did not contain any information regarding the location or target depth of the wells, two customary features of such contracts.

39. Some of the more important terms included in the turnkey contract between Belle Isle and SS&T were:

a. Belle Isle agreed to pay SS&T $10,836,000.00: $3,773,700.00 in cash and a note for the remaining $7,062,300.00, due on December 31, 2009, bearing interest at a rate of 8% (turnkey note);

b. Belle Isle pledged its right, title and interest in the production, wells, and subscription notes to SS&T as collateral for the turnkey note;

c. SS&T agreed to assume the costs of drilling a portfolio of oil and gas wells on behalf of Belle Isle;

d. SS&T agreed to provide management and supervision of the drilling operation to explore for oil and gas by drilling (or causing to be drilled) one well on each site;

e. SS&T agreed to commence or cause to be commenced the drilling and payment or prepayment of each well identified in the exhibit provided on legal locations following the agreement date, but in no event later than December 31, 2001;

f. SS&T agreed to provide, at its sole cost, risk and expense, curative work on titles; staking of well locations; well access roads; a complete drilling rig and accessories to drill to total depth; cement and cementing services; drilling mud, weighting materials and chemicals; electrical induction log of hole to desired depth; plug and abandonment per applicable regulatory requirements; all labor and third-party services; and the necessary liability and property insurance;

g. the turnkey point was defined, for purposes of the agreement, to be the point in time at which the well had been drilled to the objective depth and to be either plugged and abandoned or completed up to the tank battery or meter, after which all costs were borne by the owner;

h. SS&T agreed to bear all of Belle Isle's obligations up to the turnkey point per the applicable leases and assignment agreements;

i. SS&T agreed to maintain daily drilling reports, records of borehole tests and analyses, and certified copies of plugging records in the case of plug or abandonment;

j. Belle Isle was not responsible for any cost overruns except those caused by extraordinary problems in the well;

k. SS&T was given the right to subcontract or assign any of the work required under the terms of the turnkey contract at its own expense, without the written consent of Belle Isle;

l. SS&T agreed to indemnify and hold Belle Isle harmless for losses resulting from any subcontractor's failure to perform contracted services in an adequate and workmanlike manner.

40. The turnkey note referred to in finding of fact 39 (a), given in part payment to SS&T for its services under the turnkey contract, was drafted with identical terms and amounts as the subscription note, particularly with respect to the interest rate, amount and maturity date (***see*** finding of fact 23).

41. The turnkey note provided that the principal amount was $7,062,300.00, with interest accruing at a rate of 1% from August 1, 2001 through December 31, 2001 and at 8% thereafter. The accrued interest and 50% of the principal were to be paid from net operating revenues of Belle Isle. The full balance due on the note, both principal and interest, were due in full on December 31, 2009, with the possibility of an extension until December 31, 2026 as alluded to in the collateral agreement referred to above in finding of fact 26. In addition, prepayment of the note was not to be penalized.

42. Also integrated into the turnkey note were added security provisions intended to further ensure payment under the turnkey and subscription notes, such as the assumption by the partners of their pro rata share of the turnkey note; collateralization features (e.g., the turnkey note was secured by the subscription notes); provisions that privileged early payments of principal and interest over cash distributions to investors; and the opportunity to set aside money from Belle Isle's distributable cash in the years 2003 through 2007 that would be used to establish the equivalent of a sinking fund through the purchase of municipal bonds, which would be used to

repay the full amount of the principal amount owed to Belle Isle at the maturity of the subscription and turnkey notes.

43. The turnkey note was reflected as a long-term liability on Belle Isle's federal partnership returns for the years 2001 through 2011 and in its books and records. Additionally, the interest accrued by Belle Isle on the turnkey note was reflected in its books and records.

44. For additional creditor security, petitioner also entered into an assumption agreement with Belle Isle and SS&T, dated August 1, 2001, whereby petitioner agreed to assume personal liability for his pro rata share of the turnkey note up to the amount of his subscription note obligation.

45. The assumption agreement provided that SS&T could enter into agreements with Belle Isle with respect to the subscription notes, including granting extensions or renewal, or forbearance with respect to any part of the subscription notes without notice. The agreement also granted SS&T the right to enter into any agreement of forbearance with respect to all or any part of the partner subscription notes or with respect to the indebtedness.

46. By the very terms of the assumption agreement, petitioner assumed responsibility for a portion of the loan that the partnership had taken from SS&T.

47. The agreements and notes described above created an anticipated cash flow that emanated from the subscription agreement, which provided that cash flows for the Belle Isle investors would first be used to pay current and accrued interest on the subscription note, with 50% of the remaining cash flow designated for payment of the principal balance of the note and 50% paid to the investors. As indicated, petitioner agreed to assign 60% (subsequently modified and increased to 75%) of his distributions to SS&T to fund the purchase of municipal bonds that were to be used to pay the remaining principal balance due on the subscription note and his share

of the turnkey note. SS&T subordinated its right to interest payments on the turnkey note to a priority cash distribution to the Belle Isle partners equal to 2.5% of the cash invested.

Mr. Plastino, petitioner's expert in economics and finance, believed the investment was structured in a manner consistent with arrangements in the oil and gas industry and that the portion of petitioner's investment funded by debt was subject to standard creditor protections, given the documentation presented at hearing. Further, Mr. Plastino believed the BiState Oil Management (BOM) record keeping system accurately allocated the revenue and expenses incurred by Belle Isle wells consistent with its net revenue interest and working interest in the wells. BOM was another Richard Siegal-controlled entity.

48. Petitioner understood that he was ultimately responsible for the repayment of the accrued interest on the subscription note and his share of the turnkey note. He believed that he had the financial capacity to repay the amounts due on the notes at the time he signed them and thereafter, and made such a representation of his net worth in the subscription agreement.

49. Petitioner had a clear understanding of his investment with Belle Isle and the risks and responsibilities that accompanied the investment, including his obligation to pay the subscription note by its maturity date and his personal responsibility for his share of the turnkey note. Although his current principal obligation on the subscription note was $540,000.00 as of the hearing date, he did not believe he would have to pay the balance because he believed the bond fund would satisfy that obligation. However, in the event of a default with respect to the bonds, petitioner understood that he was personally liable.

50. Palace Exploration Company (Palace) was an Oklahoma company whose business it was to acquire interests in oil and gas properties and to assign portions of those interests to partnerships. As discussed above, SS&T was a company that contracted with the partnerships to actually drill oil and gas wells. Bistate Oil Distribution Corporation (Bistate) was a New York

corporation that was engaged in the business of receiving proceeds and paying expenses associated with the sale of oil and gas on behalf of the drilling partnerships and distributing revenue among the various stakeholders of the partnerships in proportion to their respective interests. BOM provided general administrative services, including accounting services for Palace, Bistate and the drilling partnerships. BOM maintained a financial database on behalf of the Palace-related companies and the partnerships.

51. Richard Siegal owned and controlled Palace, Bistate and BOM. While his wife and three sons owned SS&T, Mr. Seigal controlled it. Mr. Siegal had extensive experience in the oil and gas industry, selecting potential properties for development and negotiating drilling contracts and other financial agreements. He also had numerous oil and gas executives on whom he relied for second opinions on well prospects.

52. Oil and gas exploration is a risky endeavor, despite professional geologic and engineering consultations, and some operators seek out partners to reduce their exposure to the risk. Therefore, it is typical for oil and gas prospects to be funded by multiple investors, who fund their operations in different and diverse manners from the large companies that finance drilling from cash flow, investors, private equity and drilling partnerships.

53. It is not uncommon for investors without oil and gas knowledge and experience to participate in drilling projects, but do so with the expertise of others to evaluate projects, review the AFE's and joint interest billing statements, and ensure that bills are paid and revenues are received and accounted for correctly.

54. Petitioner entered the field through Belle Isle, an investment partnership, to acquire an interest in wells. A lease is typically used to convey rights of an oil and gas developer to pursue oil and gas exploration and production, and the lease rights are generally acquired by a party known as the operator, giving him the working interest in the well. If the operator chooses to take

on partners in exploration and production, these partners receive a proportionate share of the working interest and the new partners are known as working interest owners. The operator also proposes the activities for developing the prospect, such as drilling, completion, workover, and recompletion, and seeks the approval of the other working interest owners.

55. Drillers and operators allocate and distribute revenue to investors in accordance with their percentage of the well's net revenue interest and allocate and bill investors for drilling expenses in proportion to their working interest percentage. The working interest is the cost interest, where one's percentage of the working interest determines his percentage of the cost. As mentioned, Belle Isle acquired a working interest in the wells it developed. Net revenue interest and working interest are often distinguished because certain stakeholders may receive a percentage of the revenues but are not liable for expenses, a common circumstance for property lessors.

56. Of particular importance to Palace, whose business it was to acquire interests in oil and gas properties, was the evaluation of prospects that were offered to it by industry participants like Crest Resources. Richard Siegal worked with many industry experts with localized expertise like Zinke & Trumbo before deciding to invest in a well. Mr. Siegel frequently consulted independent geophysicists to interpret seismic data that was critical information in well selection and an area in which he lacked technical expertise. Likewise, Palace would frequently double check the work of drillers and prospect generators to insure the validity and value of its own selection process. Out of this process, Mr. Siegal amassed a large number of wells for which he created a timeline for drilling and then allocated the wells to partnerships according to the money each partnership had raised.

57. Exemplifying this process was the selection of a Texas well known as Chapman 34-2, which was a prospect in which Belle Isle had an interest in 2001. As explained by Glen Hudgens,

a geological engineer and president of Crest Resources, a prospect generating firm, Chapman 34-2 was known as an exploratory well because it was drilled into a fault block with no prior penetrations. The decision to drill this well was made by Crest Resources and Palace. Initially, Crest put together a package of scientific information for Palace that included a detailed geological analysis; a material balance analysis to determine the volume of gas in place; a log of other wells nearby (Chapman 34-2 was in an area where Texaco and Mobil were active); seismic and various engineering analyses; and a financial analysis. Based on its evaluation of the data, Crest believed Chapman 34-2 had the potential to return $150 million in product and only cost $1.6 million to drill. On this projection, Palace would have received $90 million and Belle Isle's 1.51% net revenue interest would have garnered $2.265 million. The data on Chapman 34-2 also indicated a large volume of recoverable gas.

58. Crest also met with independent experts from Zinke & Trumbo to discuss the data on the Chapman 34-2 well. Zinke & Trumbo were also hired by Mr. Siegal to analyze the data as a confirmation of the conclusions reached by Crest. Despite the research and analysis, the Chapman 34-2 well was not successful, underscoring the uncertainty and risks involved in oil and gas investment.

59. Palace maintained a file on each of its wells, and the one maintained for Chapman 34-2 contained all of the important geological, engineering and economic information that was required to make a decision on whether to participate in the drilling of the well.

60. Belle Isle entered into a prospect agreement with Palace Exploration, under which Belle Isle was assigned working interests in 37 prospect well sites in consideration of cash and an overriding royalty interest. Through this agreement, Belle Isle obtained working interest ownership of the wells. Derivatively, petitioner acquired a working interest in the wells also.

61. The prospect agreement, dated August 1, 2001, between Palace (assignor), Belle Isle (assignee), Oil and Gas Title Holding Company (nominee title holder) and Bistate (designated distributor), provided that, in consideration of $135,000.00, Palace assigned a net revenue interest of 60% in certain oil and gas leases to Belle Isle; Palace transferred to Belle Isle a proportionate share in the working interests in 37 oil and gas leasehold drilling opportunities; Palace delivered to Belle Isle a 60% net revenue interest on each drill site assigned to Belle Isle, reserving an overriding royalty equal to the difference between the actual net revenue interest purchased by Palace and the 60% conveyed to Belle Isle. In the oil and gas industry, a royalty interest is a percent of production, before allowance for expenses, paid from a production well. Bistate was appointed by Belle Isle to accept all distributions on its behalf, make quarterly distributions to Belle Isle and provided a complete history of receipts and disbursements by well and by month.

62. The prospect agreement also provided that Palace would convey legal title to the prospects to Belle Isle, but record title was held in the name of the nominee, Oil and Gas Title Holding Corp., on behalf of Belle Isle. This arrangement was common in the industry because directly holding title in an oil and gas well is very expensive. However, it was not uncommon for an investor to own a working interest in a well without holding record title.

63. The number and type of prospects in the Belle Isle portfolio was not unusual. They were located in states and areas known to produce oil and gas, and the target zones being pursued were in zones known to produce oil and gas ("best place to look for oil and gas is where it is"); the wells contemplated were located offshore on the continental shelf, in coastal waters and included a more complex horizontal well; and Belle Isle's prospect list also demonstrated that it would acquire a relatively small working interest in the wells, ranging from less than 1% to 3.8%, helping to further diversify the portfolio. Belle Isle's wells were usually located near other

producing wells, which improved chances of finding oil and gas. Such wells are referred to as development wells.

64. Petitioner was well aware of the risks of the Belle Isle investment, and knew that there was both a reasonable expectation of making money (even if all the tax benefits were excluded from his economic analysis) and a reasonable risk of losing it (notwithstanding the tax benefits). However, the chance of making a profit, diversifying his portfolio and receiving the tax benefits associated with oil and gas investments balanced his concerns with the risk of loss.

65. Belle Isle reported intangible drilling costs (IDC) of $9,906,715.00 on its 2001 federal and state partnership returns. This amount represented the turnkey contract price less the costs allocated to geological and drilling expenses, prepaid drilling expenses and capital equipment. Petitioner's share of the IDC was $749,916.00. The partnership return was prepared by Richard Guralnick, CPA, of the firm of Schain, Leifer & Guralnick.

66. Petitioner filed a timely New York State personal income tax return for the year 2001 pursuant to an extension, claiming corresponding deductions on the federal and state returns.

67. During the year at issue, as well as all subsequent years, Palace fully paid all drilling-related costs for Belle Isle. The total amount of expenses paid by Palace to third-party drillers to drill Belle Isle's portfolio of wells exceeded $50 million and the portion of that amount allocable to Belle Isle's working interest was $2,172,622.00, which did not include overhead costs incurred by Palace attributable to drilling operations, monitoring and decision-making.

68. Palace maintained substantial well file data for the prospect wells, including AFE's, well logs, drilling and completion reports, well test data, plug and abandonment reports and third party reports. It also received drilling reports directly from drillers and operators on a daily basis that were reviewed by Richard Siegal or other Palace executives.

69. Of the 37 wells that Belle Isle participated in drilling, 22 have produced oil and gas in commercial quantities. The wells were drilled by well known, reputable and, in some cases, publicly traded industry operators. The wells were drilled to a range of depths, some a medium depth of 7,000 feet and some deep wells that exceeded 20,000 feet. Deep wells required the services of experienced drillers.

70. Several of the Belle Isle wells have and will continue to generate revenues in the future, although BOM records indicate that, as of September 19, 2012, petitioner had not received a distribution from Bell Isle since October 29, 2010.

In accordance with the analysis of David T. Plastino, CPA, one of petitioner's experts, Belle Isle's wells generated approximately 2.7 million barrels of oil and 66 billion cubic feet of natural gas. The total dollar value of the oil and gas produced through 2012 by the Belle Isle wells alone was about $533 million before taxes.

71. Between 2002 and 2012, Belle Isle's share of gross revenue from the sale of oil and gas from the wells was $3,076,389.00, while its net revenue (gross revenue less operation costs and taxes) was $2,340,188.00. Net revenue was reported as income annually on Belle Isle's partnership tax returns.

In sum, for the years 2002 through 2011, Belle Isle reported substantial income from oil and gas production and accrued and reported interest income due on the partners' subscription notes, while also continuing to accrue and deduct interest due on the turnkey note.

72. The foundation for accounting for the revenues and expenses was the Bistate database operated by BOM, owned and controlled by Richard Siegal. As stated above, it provided general administrative services, including accounting services for Palace, Bistate and the drilling partnerships. It received the invoices for drilling and production expenses, paid them and input the detail into the Bistate database. The database also allocated revenue and expenses incurred by

Belle Isle to the partnership in accordance with its working interest and net revenue interest in its wells.

73. From 2002 through July 2012, Belle Isle made quarterly cash distributions to its partners totaling $2,343,499.00. Of this amount, $1,235,384.00 was distributed directly to Belle Isle's partners as cash payments. The balance of the partners' distributions were withheld for interest payments and the purchase of bonds.

74. For the years 2002 through 2011, Belle Isle made quarterly cash distributions to petitioner of $177,058.00. From this amount, $78,707.00 was distributed directly to petitioner as cash payments.

75. Belle Isle partners, including petitioner, received and continue to receive quarterly reports in connection with their investment that typically included a cover letter and pages that list the oil wells and gross revenue from the wells. Occasionally, these reports included more detailed updates regarding issues that arose with particular wells.

76. The reports would sometimes prompt Mr. Sznajderman to call Mr. Siegal or an associate for further information or questions, leading him to conclude that Mr. Siegal was always current with Belle Isle's operations and ready to update petitioner or discuss Belle Isle's performance. In one conversation, Mr Siegal explained that falling gas prices were having a negative impact on Belle Isle's return.

77. Belle Isle was managed by George Coleman, who worked with Richard Siegal since 1980 and has been associated with Palace for more than 30 years. In 1984, Mr. Coleman established his own oil and gas exploration company, Coleman Oil and Gas, which he managed for 12 years.

78. Mr. Coleman had certain fiduciary duties and obligations, but chose to delegate those responsibilities to persons capable of executing them. As the managing partner, Mr. Coleman was

responsible for ensuring that persons with appropriate expertise selected prospects, maintained Belle Isle's books and records, allocated funds and made distributions properly; ensuring that notes and interest payments were properly reflected; receiving regular updates and informing the partners of same; and reviewing and executing tax filings.

79. Mr. Coleman relied on Richard Siegal and Palace to manage the day-to-day business of Belle Isle. In fact, Palace did provide complete administration for Belle Isle, with the exception of preparing tax returns.

80. Mr. Coleman did monitor the progress of wells as they were drilled and verified production figures provided by Bistate on a periodic basis. He reviewed and verified the accuracy of the oil and gas revenue received by Belle Isle and the distributions allocated to its partners. He also assisted in the preparation of quarterly reports sent to Belle Isle's partners.

81. In or about the spring of 2006, the Division of Taxation's (Division) desk audit unit identified two New York State audit cases involving intangible drilling costs that the Division believed might be questionable. Further investigation of the tax preparer, Richard Guralnick, led to the discovery of approximately 200 oil and gas partnerships, including Belle Isle, all of whom used the firm of Schain, Leifer and Guralnick to prepare their partnership returns.

82. Between 2007 and 2008, the desk audit shelter unit, Division field auditors and the Internal Revenue Service (IRS) in Houston, Texas, cooperated on their respective audits of the partnerships. The Division was provided with copies of many partnership documents and transcripts of interviews with principals and investors in Richard Siegal-run oil and gas partnerships.

83. On January 8, 2008, the Division sent an information document request (IDR) to Belle Isle requesting specific documents that formed the underpinnings of the IDCs claimed by

petitioner herein. A similar IDR was sent to petitioner on January 15, 2008. Documentation was not provided by either Belle Isle or petitioner in response to the IDRs.

84. The Division's audit technicians from the shelter unit met with the IRS in Houston to confirm the shelter unit's analysis with respect to Belle Isle and other Richard Siegal partnerships. The shelter unit also worked with taxing authorities in California to gather information on the structure of the partnerships designed by Richard Siegal. The unit's conclusion was that the partnerships constituted abusive tax avoidance transactions.

85. In order to avoid the six-year statute of limitations, the Division issued to Marc S. and Jeannette Sznajderman a notice of deficiency, dated March 14, 2008, for the year 2001, asserting additional New York State and New York City personal income tax of $78,427.35, penalties pursuant to Tax Law § 685 (b) (1), (2) and former (p) and a penalty for failure to participate in the voluntary compliance initiative (VCI) at Laws of 2005 (ch 61, part N, § 11 [1]) in the total sum of $73,796.17, plus interest of $41,389.62.

The deficiency of tax in the statutory notice resulted from the Division's disallowance of petitioner's claimed federal schedule E loss of $751,076.00 arising from his partnership interest in Belle Isle. Nearly all of the total claimed loss, i.e., $749,916.00, consisted of petitioner's share of Belle Isle's claimed IDCs for the year at issue.

86. On or about June 1, 2008, petitioner timely protested the notice of deficiency by filing a request for a conference in the Bureau of Conciliation and Mediation Services.

87. On January 29, 2009, petitioner filed a form DTF-672, election to participate in the tax shelter voluntary compliance initiative (VCI) with respect to the year 2001. On the form, petitioner elected option 2, which allowed him to participate in the VCI and also retain the right to file a claim for credit or refund for any amounts paid under the option. At the time petitioner made the VCI election he paid $98,035.00.

88. The amount of petitioner's deficiency was subsequently reduced to $47,100.82 in tax and $4,710.10 in penalty under the voluntary compliance initiative based on the Division's determination that it had received sufficient information that drilling had occurred and expenses incurred. This reduction resulted from the Division's allowance of petitioner's claimed Belle Isle loss to the extent of his $300,000.00 cash investment.

The Division continued to disallow the remaining $451,076.00 of the claimed loss, which the Division attributes to the note or debt portion of petitioner's investment.

While it stands by its adjustment to the deficiency, the Division takes the position that it would not have allowed $200,000.00 of petitioner's cash contribution, that is, the amount attributable to the interest free loan from Tierra Resources to petitioner (***see*** finding of fact 20) because Belle Isle's cash receipts journal shows that petitioner contributed cash to the partnership in the amount of $100,000.00 only as of December 31, 2001.

89. Pursuant to petitioner's participation in the VCI, and the Division's allowance for his cash investment in Belle Isle, petitioner's adjusted tax, penalties and interest due were recalculated to be $98,072.00 ($0.08 abatement adjustment), which was paid in full by petitioner on January 29, 2009 and March 18, 2009 in personal checks of $98,035.00 and $37.00.

90. On July 28, 2009, petitioner filed a petition with the Division of Tax Appeals seeking a review of the March 14, 2008 notice of deficiency. On January 6, 2011, Administrative Law Judge Joseph W. Pinto, Jr., held that the petition was premature and that the Division of Tax Appeals lacked jurisdiction over the subject matter since no refund claim had been filed. To remedy this error, petitioner filed an amended personal income tax return for the year 2001, which constituted a valid claim for refund. The Division of Taxation promptly disallowed the refund claim by letter dated January 18, 2011 and petitioner filed a petition in the Division of Tax Appeals, dated March 15, 2011, seeking a refund in the amount of $98,035.00, plus interest.

91. An answer was filed in response to the petition on April 13, 2011, after which petitioner filed a motion for summary determination, which was denied in a written opinion, dated April 12, 2012.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge first noted that, while notices of deficiency asserting personal income tax liability generally are subject to a three-year statute of limitations (Tax Law § 683 [a]), there is a six-year limitations period where the tax deficiency is "attributable to an abusive tax avoidance transaction" (Tax Law former § 683 [c] [11] [B]). As the subject notice of deficiency was issued beyond the standard three-year limitations period, but within the six-year period, the Administrative Law Judge observed that the issue of whether such notice was time-barred depends upon whether petitioner's investment in Belle Isle was an abusive tax avoidance transaction with the meaning of Tax Law former § 683 (c) (11) (B). The Administrative Law Judge determined that petitioner bore the burden of proof to show that his Belle Isle investment was not such an abusive tax avoidance transaction.

In analyzing whether petitioner met his burden, the Administrative Law Judge focused on the economic substance of the Belle Isle transaction. He concluded that the partnership was validly formed; that it acquired fractional interests in oil and gas wells; and that it contracted with drillers pursuant to the turnkey contract with SS&T.

Such conclusions notwithstanding, the Administrative Law Judge noted that a finding of economic substance in the Belle Isle transaction also required a finding that the notes used to finance the transaction were genuine debt. On this point, the Administrative Law Judge relied on ***Zeluck v Commr.*** (TC Memo 2012-98 [2012]), a case involving a Siegal oil and gas partnership similar in structure to Belle Isle. He specifically analyzed the facts herein in light of the Tax Court's well-established test to determine the existence of genuine debt for federal income tax purposes, the same test that provided the basis of the ***Zeluck*** decision. The Administrative Law Judge found that the subscription and turnkey notes in the present matter did create genuine debt and thus supported petitioner's claim that his investment in Belle Isle was not an abusive tax avoidance transaction.

The Administrative Law Judge also determined that a finding of economic substance in the Belle Isle transaction required a finding that the terms of turnkey contract between Belle Isle and SS&T (the source of petitioner's disallowed IDC deduction) were reasonable and grounded in tangible values. Upon review of the record, the Administrative Law Judge concluded that petitioner failed to establish the reasonableness of the turnkey contract price. He further concluded, accordingly, that the Belle Isle transaction had tax avoidance as its primary motive and had no economic substance apart from the tax benefits conferred. In reaching these conclusions, the Administrative Law Judge noted the lack of any evidence in the record as to how the turnkey contract price was set, other than that it was set unilaterally by Richard Siegal. The Administrative Law Judge further noted the significant difference between the turnkey price and the AFEs for the wells; the strong incentive to overstate the drilling costs to maximize IDC; petitioner's failure to ascribe values to items that he claimed added substantial value to the turnkey contract; and petitioner's failure to address the impact of liability and property insurance, which the driller was required to provide.

The Administrative Law Judge also sustained the imposition of penalties against petitioner. Given Mr. Siegal's control of both parties to the turnkey contract, the Administrative Law Judge found that petitioner acted negligently in this matter by failing to question the price of the contract; failing to sufficiently investigate the turnkey contract; and failing to seek the advice of an independent expert. He thus concluded that petitioner did not act with ordinary care and prudence in entering into the Belle Isle transaction.

SUMMARY OF ARGUMENTS ON EXCEPTION

As a threshold issue, petitioner asserts that the six-year limitations period under Tax Law former § 683 (c) (11) (B) is not properly applicable to transactions involving IDC deductions. In support, petitioner cites Treas Reg [26 CFR] 1.6662-4 (g) (2) (C) (ii). According to petitioner, this regulation provides that a transaction does not have federal income tax avoidance or evasion as its principal purpose solely as a result of claiming an accelerated deduction, such as IDC. Petitioner argues that the term principal purpose as used in Tax Law former § 683 (c) (11) (B) should be read consistently with this federal regulation.

As a second threshold issue, petitioner contends that the burden of proof to establish the applicability of the six-year limitations period under Tax Law former § 683 (c) (11) (B) should fall on the Division. Petitioner thus contends that the Division should be required to prove that petitioner's Belle Isle investment was an abusive tax avoidance transaction. Petitioner reasons that the extension of the regular three-year limitations period is an extraordinary measure and that the term "abusive" as used in Tax Law former § 683 (c) (11) (B) indicates a high standard of proof. Petitioner thus contends that fundamental considerations of fairness and due process are implicated in this matter such that the burden should be placed on the Division.

Assuming that the six-year statute of limitations is applicable to transactions involving IDC deductions, petitioner contends that the six-year statute applies only if the most important purpose of his Belle Isle investment was tax avoidance. Petitioner asserts that the record shows that his most important purpose was profit, and that accordingly, the six-year statute does not apply.

With respect to the question of whether the Belle Isle transaction had economic substance, petitioner first questions whether the economic substance doctrine is applicable, asserting that such doctrine has not been applied in cases where a transaction pursued tax incentives, such as IDC, enacted to encourage such investments.

Assuming the application of the economic substance doctrine, petitioner contends that the record and the Administrative Law Judge's findings of fact show that petitioner's Belle Isle investment satisfies both prongs of the economic substance doctrine test. Specifically, petitioner asserts that the subjective non-tax business purpose prong of the test is met by the Administrative Law Judge's finding that, in entering into the transaction, petitioner was "aware of the risks" in the investment and he "knew that there was both a reasonable chance of making money and a reasonable chance of losing money." Petitioner also cites his investment diversification goal as a non-tax business purpose.

Petitioner also asserts that his Belle Isle investment met the objective economic substance prong of the test because the record shows that a reasonable possibility of profit existed apart from the tax benefits. Petitioner contends that the testimony and evidence presented by his expert in finance and economics demonstrated several alternate return scenarios under which petitioner's investment could have resulted in significantly greater profits or losses. As such an additional alternate return scenario, petitioner cites the evidence indicating that the Chapman 34-2 well alone could have made the investment profitable, had it produced as anticipated.

Petitioner contends that the Administrative Law Judge properly determined that the subscription and turnkey notes created genuine debt. Given this finding of genuine debt, petitioner notes that the tax benefit in the present matter thus arose from a deduction of expenses that were actually incurred, as distinguished from non-economic losses common in tax shelters.

Petitioner also argues that he faced true economic risks with his investment consistent with an economically substantive transaction. Specifically, petitioner contends that he faced the risk that the wells would not produce enough gas or oil to make the investment profitable. Second, as a general partner in Belle Isle, he faced liability for damages arising during the production process.

Additionally, petitioner contends that his conduct, and the conduct of Richard Siegal and Palace organization, objectively establishes that the principal motivation of the Belle Isle partnership was profit. Petitioner asserts that his research before making his investment, including his conversations with Mr. Siegal, focused on the economics of the transaction. Petitioner also asserts that Palace's diligence in well selection reflects an economic purpose. Petitioner further argues that, while he considered the tax consequences of his Belle Isle investment, such consideration does not transform the investment into an abusive tax avoidance transaction.

Petitioner asserts that the Administrative Law Judge's conclusion that the turnkey contract price was unreasonable and that, therefore, the transaction lacked economic substance wrongly conflates proof of economic substance with the proper allocation and deduction of IDCs in connection with the contract. Petitioner contends that the principal purpose test to determine an abusive tax avoidance transaction does not apply to misallocations of expenses.

Related to this point, petitioner disagrees with the Administrative Law Judge's finding that the turnkey contract was marked by the absence of arm's length negotiations. To the contrary, petitioner asserts that he and Richard Siegal were unrelated parties and that he was free to accept or decline the investment. Petitioner contends that he entered into the transaction because it had a reasonable potential for profit. He further contends that the objective evidence supports his position. Under such circumstances, petitioner argues that it is not for the taxing authority to determine whether the price was reasonable.

Petitioner also takes issue with the Administrative Law Judge's concern with the lack of transparency with respect to how the turnkey contract price was determined. What is relevant, according to petitioner, is the potential return on his investment, rather than any concern with the cost or value of the services provided under the contract. Under such an income approach, petitioner asserts, the cost of the turnkey contract was reasonable.

Finally, petitioner asserts that, even if the statute of limitations is open, and even if he wrongly claimed IDCs during the year at issue, he was not negligent. That is, petitioner contends that he had substantial authority for the IDC deduction claimed on his 2001 return, and that he acted with reasonable cause and in good faith. Accordingly, petitioner contends that penalties imposed herein are properly abated.

In opposition to petitioner's exception, the Division contends that, contrary to petitioner's assertion, the claim of IDC deductions does not insulate an entity from the principal purpose test. The Division asserts that petitioner's assertion is inconsistent with the language of the relevant Treasury regulation.

Next, the Division contends that petitioner's Belle Isle investment was an abusive tax avoidance transaction subject to the six-year statute of limitations for assessment. Specifically, the Division contends that the investment fails to meet the test for economic substance, as it lacks both objective economic substance and a subjective non-tax business purpose. More specifically, the Division takes the position that no reasonable possibility of profit existed in the Bell Isle investment because of the "exorbitant" turnkey contract price. As to petitioner's motivation for entering into the transaction, the Division asserts that his asserted desire to make money is outweighed by his failure to make, in the Division's estimation, sufficient inquiry into the turnkey price, as well as his statement that the transaction was untenable without the tax benefits. The Division thus claims that petitioner failed to establish a non-tax business purpose for investing in Belle Isle.

Additionally, the Division asserts that the turnkey contract was a sham. That is, the Division claims that there was no performance under the contract and that SS&T had no contractual relationship with Palace or any actual drillers. The Division thus contends that the turnkey contract had no purpose beyond creating an opportunity to claim a large amount of IDCs.

The Division's exception challenges the Administrative Law Judge's conclusion that the subscription and turnkey notes created genuine debt. It contends that the instant matter is distinguishable from ***Zeluck v Commr.***, the case upon which the Administrative Law Judge relied in reaching his conclusion on this issue.

Finally, the Division asserts that petitioner has not established that he acted in good faith and with reasonable cause such that penalties should be abated.

OPINION

For the reasons that follow, we affirm the determination of the Administrative Law Judge.

We first review the fundamentals underlying this matter. The income tax deficiency results from the Division's denial of petitioner's distributive share of Belle Isle's claimed 2001 loss. Such loss consists almost entirely of Bell Isle's claimed IDC expense deduction (***see*** findings of fact 85 and 88). IDCs are payments for non-salvageable capital expenditures incurred in connection with oil and gas drilling (***see*** Treas Reg [26 CFR] 1.612-4 [a]). Examples of IDCs include expenditures for labor, fuel, repairs, hauling, and supplies "incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas" (***id.***). Generally, of course, a capital expenditure may not be deducted as an expense (Internal Revenue Code [IRC] [26 USCA] § 263 [a]), but may be recovered through depreciation, amortization or depletion (***see e.g.***, IRC [26 USCA] §§ 167, 195, 611). In apparent recognition of the risks inherent in oil and gas exploration, and in order to encourage investment in such activities, the Internal Revenue Code allows operators of oil or gas wells to elect to treat IDCs as expenses, and thereby deduct such costs in the year incurred (***see Exxon Corp. v United States***, 547 F2d 548, 554, 555 [1976]); IRC [26 USCA] § 263 [c]; Treas Reg [26 CFR] § 1.612-4 [a]). An operator of a well includes a working interest owner for purposes of the IDC expense election (Treas Reg [26 CFR] § 1.612-4 [a]).

The record establishes that Belle Isle acquired a share of the working interest in 37 well sites pursuant to the prospect agreement (***see*** findings of fact 60 and 61).[7] Accordingly, Belle Isle was an operator eligible to claim its share of the IDCs associated with the drilling of those wells, and petitioner, as a partner in Belle Isle, was eligible to claim his proportionate share of Belle Isle's IDC expense.[8]

As to the period of limitations on assessment, a notice of deficiency of personal income tax generally must be issued within three years after the filing of the return (Tax Law § 683 [a]). One exception to this rule extends the limitations period to six years "if the deficiency is attributable to an abusive tax avoidance transaction" (Tax Law former § 683 [c] [11] [B]).[9] As noted, the Division contends that petitioner's investment in Belle Isle was such an abusive tax avoidance transaction, and accordingly, asserts that the six-year period under Tax Law former § 683 (c) (11) (B) is applicable herein. As the notice of deficiency in this matter was issued within six years after the relevant return was filed, but later than three years (***see*** findings of fact 1 and 85), the notice would be time-barred unless the exception applies.

We next address petitioner's threshold assertion that the six-year limitations period under Tax Law former § 683 (c) (11) (B) is not properly applicable to transactions that are structured for

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[7] We note that the copy of the prospect agreement in evidence is unexecuted. The same is true of the copies of other documents related to petitioner's Belle Isle investment that were received in evidence. We defer to the Administrative Law Judge's finding, based on what he determined to be credible testimony, that the documents received in evidence were true copies of properly executed documents (***see Matter of MediaBuss Systems, Inc.***, Tax Appeals Tribunal, March 18, 2014 [Tribunal generally follows Administrative Law Judge's credibility findings unless there is some basis in the record to differ]). The Administrative Law Judge also found that a conscientious search had failed to discover the originals.

[8] We do not comment at this point on the validity of the amounts claimed as IDCs by Belle Isle; we merely find that, as an operator, Belle Isle was eligible to claim IDCs.

[9] Tax Law former § 683 (c) (11) was effective until July 1, 2015 (see L 2005 c 61, pt N. § 12 [iii]).

the "principal purpose" of claiming IDC expense deductions. The federal regulation upon which petitioner's argument is premised involves the proper application of a penalty for the substantial understatement of income tax (Treas Reg [26 CFR] 1.6662-4). Specifically, the regulation provides that "the principal purpose of an entity, plan or arrangement is not to avoid or evade Federal income tax if the entity, plan or arrangement has as its purpose the claiming of . . . tax benefits in a manner consistent with the statute and Congressional purpose" (Treas Reg [26 CFR] 1.6662-4 [g] [2] [C] [ii]). The regulation cites "deducting intangible drilling and development costs as expenses under [IRC] [26 USCA] section 263 (c)" as an example of the "tax benefits" to which it refers. Petitioner seeks to tie the federal regulation to the Tax Law via Tax Law § 607 (a), which provides that "any term used in this article shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required . . . ."

We reject petitioner's contention. Even assuming, as petitioner asserts, that the term principal purpose as used in Tax Law former § 683 (c) (11) (C) must be read consistently with the definition in Treas Reg [26 CFR] 1.6662-4 (g) (2) (C) (ii), the regulation also provides that, in order to fall within its purview, the tax benefits must be claimed "in a manner consistent with the statute and Congressional purpose." Such language invites inquiry into the validity of the claimed IDC deductions (***see Shapiro v Commr***., TC Memo 1995-224 [government does not provide tax benefits for sham investments that lack economic substance]). Under petitioner's proposed construction of the statute, even the most egregiously abusive oil or gas shelter could avoid the six-year limitations period so long as its objective was to deduct IDCs. Such an interpretation is contrary to the legislative intent underlying Tax Law former § 683 (c) (11) (B), a provision that plainly seeks to curb the use of abusive tax shelters through an expanded period of limitations for assessment.

Petitioner has the burden of proof to show that the notice of deficiency at issue was not subject to the six-year limitations period (Tax Law § 689 [e]; ***Matter of Sholly***, Tax Appeals Tribunal, January 11, 1990 [burden on petitioner to show that the six-year statute of limitations for an omission from New York adjusted gross income of an amount in excess of 25% of the amount reported on the return was not applicable]). In reaching this conclusion, we reject petitioner's contention that fundamental considerations of fairness and due process require that the burden of proof be placed on the Division. Tax Law § 689 (e) expressly places the burden of proof on the petitioner in any case before the Division of Tax Appeals, with certain enumerated exceptions. The proper application of the six-year limitations period under Tax Law former § 683 (c) (11) (B) is not such an exception. While we recognize, as we did in ***Matter of Sholly***, that procedural improprieties in a particular case may implicate fundamental fairness and due process such that a shift in the burden of proof is appropriate, no such circumstances are present here (***cf.***, ***Matter of Ilter Sener***, Tax Appeals Tribunal, May 5, 1988 [burden of proof shifts to the Division where a late-payment penalty is asserted for the first time by the Division in its answer as an alternative to the fraud penalty]).

In order to meet his burden to show that the notice of deficiency was untimely, petitioner must establish that his investment in Belle Isle was not an abusive tax avoidance transaction. Tax Law former § 683 (c) (11) (C) defines such a transaction for purposes of Tax Law former § 683 (c) (11) (B) as "a plan or arrangement devised for the principal purpose of avoiding tax." As used in Tax Law former § 683 (c) (11), "principal" means first in importance (***see*** Random House Webster's College Dictionary 1035 [1997]; see also ***Matter of Automatique, Inc. v Bouchard***, 97 AD2d 183,186 [1983] [where a statute does not define a term it is appropriate to interpret it in its ordinary everyday sense]). This definition is in accord with the definition of principal purpose as used in IRC [26 USCA] § 269, involving corporate acquisitions made to evade or avoid income tax (***see e.g., Love v Commr.***, TC Memo 2012-166 ["'principal purpose' means that the evasion or avoidance purpose must exceed in importance any other purpose"]), as well as in Treasury regulations detailing the proper application of penalties for substantial understatement of income tax under IRC [26 USCA] § 6662 (d) (***see*** Treas Reg [26 CFR] 1.6662-4 [g] [2] [C] [i] ["The principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose."]). Accordingly, in order to prevail in the present matter, petitioner must prove that tax avoidance was not the most important purpose of his Belle Isle investment.

For purposes of Tax Law former § 683 (c) (11) (B) and (C), "the term transaction includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan" (20 NYCRR 2500.3 [a] [definition of transaction for purposes of defining "New York reportable transaction," a tax avoidance transaction substantially similar to an abusive tax avoidance transaction under Tax Law former § 683 [c] [11] [B] and [C]).

Tax Law former § 683 (c) (11) (C) offers further guidance as to the meaning of an abusive tax avoidance transaction by noting that such transactions "include, but are not limited to, listed transactions described in [Tax Law former § 685 (p-1) (5)]." In turn, Tax Law former § 685 (p-1) (5) defines a listed transaction as including "any transaction designated as a tax avoidance transaction pursuant to [Tax Law § 25]." Regulations promulgated under Tax Law § 25 define a New York listed transaction as follows:

> "A New York listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the commissioner has determined to be a tax avoidance transaction and identified by notice or other form of published guidance as a New York listed transaction. For purposes of identifying a New York listed transaction, the determination that a type of transaction is a tax avoidance transaction shall be based upon a finding by the commissioner that:

> (1) the transaction is not done for a valid business purpose, that is, one or more business purposes, other than obtaining tax benefits, that alone or in combination constitute the primary motivation for the transaction;
>
> (2) the transaction does not have economic substance apart from its tax benefits; or
>
> (3) the tax treatment of the transaction is based upon an elevation of form over substance" (20 NYCRR 2500.3 [b]).

Treasury regulations promulgated under IRC [26 USCA] § 6662 (d) define "tax shelter" in a manner similar to the definition of an abusive tax avoidance transaction in Tax Law former § 683 (c) (11) (C); that is, a plan or arrangement with the principal purpose of avoiding or evading tax (***see*** Treas Reg [26 CFR] 1.6662-4 [g] [2] [i]). Such regulations further explain the meaning of "tax shelter" as follows:[10]

> "Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter" (Treas Reg [26 CFR] 1.6662-4 [g] [2] [i]).

Whether a transaction is an abusive tax avoidance transaction, that is, a plan or arrangement devised for the principal purpose of avoiding tax, is a question of fact. While the question of purpose is subjective, we give greater weight to objective facts than to a taxpayer's stated intent (***see Lee v Commr.***, 155 F3d 584, 586 [1998] citing Treasury regulation for determining whether an activity is engaged in for profit [26 CFR 1.183-2 [a]). We also look to the substance, and not the form, of the transaction (***see Gregory v Helvering***, 293 US 465, 469 [1935]).

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[10] Given the similarity between the State law and the federal regulation, it is appropriate to look to the regulation for additional guidance as to the meaning of this term (***see e.g., Matter of Great Neck-Port Washington, New York Lodge No. 1543 BPO Elks***, Tax Appeals Tribunal, September 5, 1991).

Upon review of the record, and pursuant to the following discussion, we find that petitioner's Belle Isle investment was an abusive tax avoidance transaction as defined in Tax Law former § 683 (c) (11) (C) and that, accordingly, the subject notice of deficiency was timely issued to petitioner pursuant to Tax Law former § 683 (c) (11) (B).

The Belle Isle partnership employed a financing structure designed to artificially inflate the actual capital contributions of its partners. This was accomplished by the use of the subscription note with a stated principal amount and the concurrent execution of the additional collateral agreement that effectively reduced the principal debt to 15% of the stated amount. Stated in terms of the well-established standards to determine whether a genuine indebtedness exists, we find that petitioner and Belle Isle did not have an intent to create a debtor-creditor relationship with respect to 85% of the face value of the subscription note on December 13, 2001, the date the parties entered into the transaction (***see Calloway v Commr***., 135 TC 26, 37 [2010]).

Specifically, petitioner's subscription note, executed on December 13, 2001, has a stated principal of $540,000.00. However, the terms of the additional collateral agreement, also executed on December 13, 2001, make clear that petitioner's obligation on the principal would be satisfied upon payment of a sum of money equal to the 15% of face value of the note to be used for the purchase of bonds. Specifically, that document provides that, if the partner chooses to pay such a sum to the partnership (in lieu of purchasing and delivering bonds to the partnership) and agrees to extend the subscription note for a total of 25 years, "SS&T will guarantee to invest this money at 7.88% compounded so that at the end of 25 years the sum will be equal to the principal amount of the Note." Mr. Siegal's December 13, 2001 letter to petitioner reiterates this guarantee and explains that, in the event of a shortfall, the proceeds from the bonds would be reinvested until the bond fund equals the face value of the note and that the due date of the note would be extended concomitantly to be coextensive with the maturity date of the bonds.[11] By this guarantee that the bond fund would satisfy the stated principal of the note, petitioner's bond payments are properly seen as payments in satisfaction of a debt and not as purchases of collateral. In other words, the bond fund was not a sinking fund to secure repayment, but was, in fact, the repayment itself. Consistent with this conclusion, the letter also provides that petitioner's personal guaranty will remain on the note to insure that the bonds are redeemed in full by the issuing authority and that petitioner agrees to make good on any loss due to the failure of the issuing authority. The letter thus makes clear that, once the bonds have been purchased, petitioner's liability on the note is limited to that of a guarantor in the event of a default. Considering that, according to Mr. Siegal, "no one has ever been required to pay any portion of their notes since he began structuring these transactions in 1981" (***see*** footnote 3), the likelihood of such a default is low. Accordingly, the form of the transaction notwithstanding, we find that petitioner's cash payment of 15% of the stated principal for the purchase of bonds pursuant to the additional collateral agreement effectively protected petitioner from any realistic possibility of liability with respect to the remaining 85% of the principal amount of the note.

Petitioner's payment of first-year interest on the stated principal does not persuade us that the subscription note was genuine debt in the stated amount. After the first year, the terms of the note required interest to be paid from petitioner's share of net operating revenues, to the extent that such revenues were available. Interest was paid only sporadically after the first year, however, even though operating revenues were, in fact, available to make significantly larger and more consistent interest payments (***see*** findings of fact 24, 73 and 74). Indeed, it appears that the

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[11] This extension of the note's due date until the value of the bonds equals the stated principal has the practical effect of eliminating any real fixed due date for the note and thereby further supports a finding that, except for the 15% to be paid into the bond fund, the subscription note is not genuine debt (***see Hubert Enters., Inc. and Subsidiaries v Commr.***, 125 TC 72, 92 [2005] [fixed maturity date indicative of genuine debt]).

priority for petitioner's distributions in 2003 and 2004 was to effectively reimburse him for his first-year interest payments (***see*** finding of fact 29). We observe that the subscription note makes no provision for such a reimbursement. Given this casual commitment to interest payments after 2002, we conclude that the first-year interest payment requirement was another device intended to support the appearance of a loan in the stated amount. Additionally, under the circumstances, we think it unlikely that Belle Isle will attempt to collect its partners' very large interest accruals when the subscription notes mature.

To the extent that our conclusion herein differs from that of the Administrative Law Judge on the legitimacy of the debt incurred by petitioner, we find that ***Zeluck v Commr***., upon which the Administrative Law Judge relied, is distinguishable. As noted, ***Zeluck*** involved a Siegal oil and gas partnership similar to Belle Isle. Like the Belle Isle partners, the partner in ***Zeluck*** acquired his partnership interest by a combination of cash and a subscription note. Following a review of various indicia of indebtedness, the ***Zeluck*** court determined that, at the time it was entered into, the debt evidenced by the subscription note was genuine. The Tax Court's decision in ***Zeluck***, however, made no reference to any option for the taxpayer in that case to fulfill his subscription note principal obligation through the purchase of bonds. The terms of the bond purchase option herein did provide such an opportunity and, as discussed, effectively reduced the principal amount of the partner's subscription debt to 15% of the face value of the subscription note.

The subscription note portion of petitioner's capital contribution to Belle Isle was recorded at the stated principal amount and was thus overstated to the extent of 85% of the note. 30 of the 34 Belle Isle partners other than petitioner also satisfied their subscription note obligation by paying 15% of stated principal amount into the guaranteed bond fund (***see*** footnote 4). The subscription notes and capital contributions of these partners were thus similarly overstated.

Having concluded that the actual indebtedness given by petitioner and nearly all of the other partners in exchange for their partnership interests was, in substance, less than its stated value, and therefore lacking in economic reality to that extent, it follows that Belle Isle's turnkey contract with SS&T is lacking in economic reality to a similar extent. This is because each partner's payment on his subscription note also reduced his share of the turnkey note liability by the same amount. Accordingly, since nearly all partners paid their subscription note liability by paying 15% of the principal amount for the purchase of bonds, such bond payments also satisfied each partner's turnkey note liability. Indeed, funds deducted from petitioner's distributions for bond purchases were paid to SS&T, the turnkey note holder. The turnkey note, which equaled the sum of the subscription notes (***see*** findings of fact 21 and 39 [a]), was therefore satisfied when each partner met his 15% bond obligation. Accordingly, Belle Isle's 2001 losses, nearly all of which were claimed as IDCs, were not matched by any real economic loss to petitioner or to nearly all other Belle Isle investors to the extent of 85% of the face value of the subscription and turnkey notes.[12]

We reach the foregoing conclusion notwithstanding that, through its partners, Belle Isle made a real investment in the oil and gas industry and therefore had economic substance. The record shows that Belle Isle acquired fractional working interests in 37 undrilled oil and gas sites from the Palace organization. The 37 sites were drilled by third party drillers at a total cost to Palace of more than $50 million, of which $2,172,622.00 was allocable to Belle Isle's working interest. 22 of the wells produced oil or gas in commercial quantities and from 2002 through July 2012, Belle Isle made quarterly distributions to its partners totaling $2,343,499.00, of which $1,235,384.00 was distributed directly to the partners as cash payments. Petitioner received

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[12] We reject any claim that earnings on the bonds constitute consideration for the turnkey drilling services. Such earnings were paid by the bond issuer and not Belle Isle or its partners.

distributions of $177,058.00 from 2002 through 2011. Of this amount, $78,707.00 was distributed as cash directly to petitioner. Furthermore, given the unpredictable nature of oil and gas exploration, petitioner's return on his investment could have been greater.

As noted previously, however, "[t]he existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter" (Treas Reg [26 CFR] 1.6662-4 [g] [2] [i]). Here, the Belle Isle partners' capital contributions were artificially inflated for the sole purpose of claiming tax deductions. Petitioner's stated capital contribution of $840,000.00 was inflated by $459,000.00 over his real capital contribution of $381,000.00.[13] Given this "elevation of form over substance" to obtain significant tax benefits (***see*** 20 NYCRR 2500.3 [b] [3]), we conclude that petitioner has failed to establish that his primary purpose in entering into the Belle Isle transaction was not tax avoidance.

Our finding that the capital contributions of Belle Isle's partners were artificially inflated also provides a basis to conclude that petitioner has failed to meet his burden of proof to establish entitlement to his claimed schedule E deductions (***see*** Tax Law § 689 [e]). We also note that petitioner offered no line item detail of the specific costs incurred by SS&T under the turnkey contract. Accordingly, we find that the Division properly denied petitioner's refund claim (***see*** finding of fact 90).

We turn now to the issue of penalties. The Division asserts penalties pursuant to Tax Law § 685 (b) (1), (2), and former (p).[14] Tax Law § 685 (b) (1) and (2) provide for the imposition of penalties if any part of a deficiency is due to negligence or intentional disregard of Article 22 of

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[13] $381,000.00 equals petitioner's cash contribution of $300,000.00 plus 15% of the $540,000.00 face value of his subscription note.

[14] Tax Law § 685 former (p) was effective until July 1, 2015 (***see*** L 2005 c 61, pt N, § 12 [iii]).

the Tax Law or the regulations thereunder. Tax Law § 685 former (p) provides for the imposition of penalty where there is a substantial understatement of the amount of income tax required to be shown on the return. Under this provision, a substantial understatement means that the understatement of tax, that is, the difference between the tax required to be reported and the tax actually reported, is greater than 10% of the tax required to be reported. Substantial understatement excludes any portion of the understatement attributable to the tax treatment of an item for which there is substantial authority for such treatment. Tax Law § 685 former (p) allows abatement of penalty under that section upon a showing of reasonable cause and good faith. Regulations applicable to Tax Law § 685 former (p) provide that, in determining whether reasonable cause and good faith exist, "the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability" (20 NYCRR 2392.1 [g] [2]). The reasonableness of any misunderstanding of fact or law must be considered "in light of the experience, knowledge and education of the taxpayer" (20 NYCRR 2392.1 [g] [2] [i]). The regulations also indicate that reliance on professional advice may constitute reasonable cause under certain circumstances (***see*** 20 NYCRR 2392.1 [g] [2] [iv] [a]).

We find that the deficiency herein results from petitioner's intentional disregard of Article 22 of the Tax Law and that, accordingly, penalties pursuant to Tax Law § 685 (b) (1), (2), and former (p) are properly imposed. As discussed, this decision finds that the capital contributions of petitioner and other Belle Isle partners were artificially inflated by the use of the subscription note with a stated principal amount and the concurrent execution of the additional collateral agreement that effectively reduced the principal debt to 15% of the stated amount. Given his education and experience (***see*** findings of fact 3, 4, and 6), petitioner knew or should have known that his first-year deduction from his Belle Isle investment was premised on the stated amount of the subscription note and not on the reality of the additional collateral agreement. Petitioner also knew or should have known that his partnership deductions are necessarily limited to the economic reality of his capital contribution (***see*** IRC [26 USC] §§ 705, 722). While the record amply demonstrates that oil and gas ventures and the proper tax treatment thereof can be factually and legally complex, the notion that a partner's first-year partnership deductions may not exceed his or her capital contribution is a simple and basic principle.

In support of his claim for penalty abatement, petitioner asserts that he had substantial authority for his tax return position. Petitioner cites the Administrative Law Judge's conclusion that he incurred genuine debt in the face amount of the subscription notes as such authority. We disagree. As discussed, our decision differs with the Administrative Law Judge's conclusion on the indebtedness issue and we find no other authority supportive of petitioner's position that his indebtedness for the face amount of the note is genuine when, in economic reality, his liability was limited to 15% of the face value of the note. In any event, petitioner obviously did not rely on the Administrative Law Judge's determination when he filed his tax return. We also note that the opinion of Stuart Becker and Company with respect to another Richard Siegal oil venture that petitioner reviewed prior to making his investment in Belle Isle makes no reference to a bond purchase option similar to that chosen by petitioner and the other Belle Isle investors (***see*** finding of fact 10). There is no substantial authority or reasonable reliance on a professional's advice if the professional does not have all of the facts of the transaction (***see*** 20 NYCRR 2392.1 [g] [2] [iv] [a] [1] [i]). The Stuart Becker and Company opinion may not, therefore, serve as substantial authority or constitute reasonable reliance on professional advice to support abatement of penalties herein. Furthermore, the record does not establish that the advice given by petitioner's own accounting firm addressed the specifics of petitioner's tax reporting position (***see*** finding of fact 11). Petitioner thus has not shown that any reliance on such advice was reasonable.

The Division also asserted penalty for failure to participate in the voluntary compliance initiative pursuant to L 2005, c 61, Part N, § 11 (l). As petitioner offered no specific argument against the imposition of this penalty, it is sustained.

Accordingly, it is ORDERED, ADJUDGED, and DECREED that:

1. The exception of Marc S. Sznajderman and Jeannette Sznajderman is denied;

2. The exception of the Division of Taxation is granted to the extent that this decision finds that 85% of the principal amount of petitioner Marc S. Sznajderman's indebtedness to Belle Isle Drilling Company was not genuine;

3. The determination of the Administrative Law Judge is affirmed;

4. The petition of Marc S. Sznajderman and Jeannette Sznajderman is denied; and

5. The Division of Taxation's denial of refund, dated January 18, 2011, is sustained.

DATED: Albany, New York
July 11, 2016

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

/s/ James H. Tully, Jr.
James H. Tully, Jr.
Commissioner