STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
JADOW AND UMA RAO	:	DECISION DTA NO. 825327
for Redetermination of Deficiencies or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 2002 and 2004 through 2008.	:	

Petitioners, Jadow and Uma Rao[1], filed an exception to the determination of the Administrative Law Judge issued on May 14, 2015. Petitioner, Jadow Rao appeared pro se and petitioner, Uma Rao appeared by Jadow Rao. The Division of Taxation appeared by Amanda Hiller, Esq., (Kathleen D. O'Connell, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a letter brief in opposition. Petitioners filed a letter brief in reply. Oral argument, at petitioners' request was heard on January 21, 2016 in New York, New York, which date began the six-month period for issuance of this decision.

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 Division of Taxation properly disallowed certain losses claimed on schedule E to petitioner's personal income tax returns for the years 2004 through 2008 upon the premise that the claimed losses arose as the result of improper and abusive tax avoidance

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[1] Since only petitioner Jadow Rao took part in the subject transactions, reference to petitioner herein will be to Jadow Rao only.

transactions involving oil and gas drilling expenses of certain partnerships in which petitioner participated.

II. Whether petitioner has established any basis justifying the reduction or cancellation of penalties imposed.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for the originally numbered findings of fact 8, 15 (a), 47, 49, 57, 64 and 75, which have been modified to more accurately and concisely reflect the record. The Administrative Law Judge's findings of fact 54 and 67 have been omitted to more concisely reflect the record and the findings of fact that follow thereafter have been renumbered accordingly.

1. The Division of Taxation (Division) commenced an audit of petitioner, Jadow Rao, in the spring of 2009, after receiving information from the Internal Revenue Service (IRS) regarding allegedly abusive tax shelter oil and gas exploration partnerships in which petitioner was a partner. The tax returns for these partnerships, and other similar partnerships, had been prepared by one Dara Lis, who also prepared petitioner's tax returns.

2. In the course of the foregoing audit, as well as audits of other participating individuals and related entities, the Division worked closely with the IRS, meeting with IRS representatives and obtaining documents from them. The Division ultimately identified and audited some ten oil and gas exploration partnerships, including those relevant to this matter, all of which were promoted by one Dennis McNerney, and for all of which Dara Lis prepared tax returns. None of the partnerships promoted by Mr. McNerney and audited by the Division made money for their partners, absent tax savings.

3. Mr. McNerney, a former insurance agent and thereafter the owner of an entity known as

World Wide Capital Funding, has been a promoter of various financial ventures from as early as 1996, including those known as North American Venture 1996 (NAV 1996) and North American Venture 1997 (NAV 1997). In or about January 2000, Mr. McNerney was indicted on multiple counts relating to investment fraud, including but not limited to five counts of Grand Larceny in the Second Degree, eight counts of Grand Larceny in the Third Degree, Forgery in the Second Degree, and thirteen counts of Fraud in the Sale of Securities. In or about July 2000, Mr. McNerney pled guilty under the indictment and was sentenced to a term of two to six years in prison.[2]

4. Mr. McNerney was released from prison at some point in or about 2003. Thereafter, he resumed promoting various financial ventures, commencing with an entity known as North American Venture 2003 (NAV 2003).

5. In 2009, Dara Lis was arrested on criminal charges for preparing false New York State and federal income tax returns. She pled guilty to Attempted Offering a False Instrument for Filing in the First Degree, and to violating New York State Tax Law § 1807 (a) for having knowingly prepared false personal income tax returns.

6. Petitioner filed a New York State resident income tax return for the year 2002 on or after October 23, 2003, as extended. Petitioner filed an amended 2002 resident income tax return, reporting additional tax due, on or after April 6, 2004.

7. Petitioner filed an amended resident income tax return for the year 2003, reporting additional tax due, on or after June 27, 2005.

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[2] The record in this matter does not specify whether there was any relationship between World Wide Capital Funding and NAV 1996 or NAV 1997, or the precise nature of the relationship between Mr. McNerney, any or all of these entities, and the indictment. There is evidence in the record indicating that another individual (or individuals) "stepped in" and continued the NAV ventures or promoted other ventures akin thereto during the period of Mr. McNerney's incarceration.

8. On or before April 15, 2005, petitioner filed a New York State resident income tax return for the year 2004. On this return, petitioner claimed an aggregate federal schedule E deduction (partnership nonpassive loss) totaling $184,798.00 associated with North American Venture (NAV) and Shamrock III Offset Drilling Project 2003 (Shamrock), another venture in which Mr. McNerney was involved.

9. On or after March 7, 2005, petitioner filed a claim for credit or refund of personal income tax (form IT-113X) for the tax year ended December 31, 2002, claiming a net operating loss (NOL) carryback from the year 2004. Petitioner reported a $98,781.00 NOL on schedule A of federal form 1045, application for tentative refund, for the year 2004, attached to the claim for refund. After a desk audit review of the refund claim, the Division adjusted the net operating loss carryback to $95,781.00, recomputed the tax due after the carryback, and issued an adjusted tax refund in the amount of $7,412.00 on or after April 6, 2005.

10. Petitioner filed, on or after May 4, 2005, an amended 2004 resident income tax return, on which he reported an additional partnership nonpassive loss of $42,906.00 attributable to NAV issuing a corrected schedule K-1 to him. On this amended return, petitioner reported an aggregate federal schedule E deduction (partnership nonpassive loss) totaling $227,704.00 associated with NAV (partnership nonpassive loss of $108,794.00) and Shamrock (partnership nonpassive loss of $118,910.00).

11. On or before April 15, 2006, petitioner filed a 2005 resident income tax return, on which he claimed an aggregate federal schedule E deduction (partnership nonpassive loss) totaling $24,372.00 associated with NAV 2003 and Shamrock. Petitioner filed an undated amended 2005 resident income tax return.

12. Petitioner filed a 2006 resident income tax return on May 18, 2007, as extended. On

this return, petitioner claimed an aggregate federal schedule E deduction (partnership nonpassive loss) totaling $18,059.00 associated with NAV 2003 and Shamrock. Petitioner filed an amended 2006 resident income tax return, reporting additional tax due, on or after May 16, 2009.

13. Petitioner filed a resident income tax return for the year 2007 on April 15, 2008.

14. Petitioner filed a resident income tax return for the year 2008 on April 15, 2009.

15. As a result of its audit, on February 28, 2011, the Division issued to petitioner six notices of deficiency pertaining to the years 2002, and 2004 through 2008, asserting additional tax due in the aggregate amount of $20,161.16, plus interest and penalties, as follows:

a) 2002: notice number L-035461731 was premised upon the disallowance of the NOL carryback in the amount of $95,781.00 from the year 2004. Because petitioner's 2004 adjusted gross income was adjusted to disallow federal schedule E losses associated with NAV 2003 and Shamrock, he no longer had a NOL to carryback to the 2002 tax year. Adding back the disallowed NOL carryback resulted in an increase of $95,781.00 to petitioner's federal adjusted gross income, resulting in turn in additional tax due of $7,412.32, plus interest and penalties (including a 5% negligence penalty per Tax Law § 685 [b] [1], a penalty equal to 50% of any interest due per Tax Law § 685 [b] [2], a substantial understatement of tax liability penalty per Tax Law § 685 [p], and a penalty equal to 100% of any interest due (L 2005, ch 61, part N § 11 (L) [Voluntary Compliance Initiative]).

b) 2004: notice number L-035461774 was premised upon the disallowance of $227,704.00 in deductions taken on schedule E for NAV 2003 and Shamrock because petitioner failed to provide all requested documentation substantiating the deductions. As a result of the disallowance of $227,704.00 in deductions, petitioner no longer had a net operating loss for the year 2004. Adding back these disallowed deductions, increased petitioner's federal adjusted gross income to $89,915.00, resulting in turn in additional tax due of $3,976.34, plus interest and penalties (including a 5% negligence penalty per Tax Law § 685 [b] [1], a penalty equal to 50% of any interest due per Tax Law § 685 [b] [2], a substantial understatement of tax liability penalty per Tax Law § 685 [p], and a penalty equal to 100% of any interest due per the Voluntary Compliance Initiative).

c) 2005: notice number L-035461874 was premised upon the disallowance of $24,372.00 in deductions taken on schedule E for NAV 2003 and Shamrock because petitioner failed to provide all requested documentation substantiating the deductions. Adding back these disallowances resulted in an increase of $24,372.00 to petitioner's federal adjusted gross income resulting in turn in additional tax due of $713.00, plus interest and penalties (including a 5% negligence penalty per Tax Law § 685 [b] [1], and a penalty equal to 50% of any interest due per Tax Law § 685 [b] [2]).

d) 2006: notice number L-035461857 was premised upon the disallowance of $18,059.00 in deductions taken on schedule E for NAV 2003 and Shamrock because petitioner failed to provide all requested documentation substantiating the deductions. Adding back this disallowance resulted in an increase of $18,059.00 to petitioner's federal adjusted gross income, resulting in turn in additional tax due of $1,238.00, plus interest and penalties (including a 5% negligence penalty per Tax Law § 685 [b] [1], and a penalty equal to 50% of any interest due per Tax Law § 685 [b] [2]).

e) 2007: notice number L-035461885 was premised upon the disallowance of a deduction of $220.00 taken on schedule E for Shamrock because petitioner failed to provide all requested documentation substantiating the deductions. Adding back this disallowance resulted in an increase of $220.00 to petitioner's federal adjusted gross income resulting in turn in additional tax due of $15.07, plus interest and penalties (including a 5% negligence penalty per Tax Law § 685 [b] [1], and a penalty equal to 50% of any interest due per Tax Law § 685 [b] [2]).

f) 2008: notice number L-035461860 was premised upon the disallowance of $87,786.00 in deductions taken on schedule E because petitioner failed to provide all requested documentation substantiating the deductions taken. Adding back these disallowances resulted in an increase of $87,786.00 to petitioner's federal adjusted gross income, resulting in turn in additional tax due of $6,806.15, plus interest and penalties (including a 5% negligence penalty per Tax Law § 685 [b] [1], a penalty equal to 50% of any interest due per Tax Law § 685 [b] [2], and a substantial understatement of tax liability penalty per Tax Law § 685 [p]).

16. The notices of deficiency for the years 2004 and 2005 were issued pursuant to Tax Law § 683 (c) (11) (B), under its six-year statute of limitations on assessments pertaining to deficiencies attributable to abusive tax avoidance. The notice pertaining to the year 2002 was based upon the disallowance of the NOL carryback from 2004, and was issued within the same six-year statute of limitations as the notice pertaining to the year 2004 pursuant to Tax Law § 683 (b) (4). The notices of deficiency for the years 2006, 2007 and 2008 were issued within the general three-year statute of limitations on assessments set forth in Tax Law § 683 (a)[3].

17. Petitioner filed a petition with the Division of Tax Appeals contesting the total amount due asserted in all six notices of deficiency, i.e., $45,733.08, for the years 2002, and 2004 through 2008. Petitioner does not dispute the computation of the Division's adjustments; rather, he asserts that the deductions disallowed by the Division constituted permissible deductions for intangible drilling costs. He also asserts that the notices of deficiency issued to him for the years

[3] Each of the notices of deficiency issued for the years 2006 through 2008 stated that pursuant to Tax Law § 683 (c) (11), tax may be assessed any time within six years after the return has been filed if the deficiency is attributable to an abusive tax avoidance transaction.

2002, 2004 and 2005 are barred by the statute of limitations.

18. As part of its audit activities, the Division obtained the Confidential Placement Memoranda for Shamrock (Shamrock Placement Memo), NAV 2003 (NAV 2003 Placement Memo), and North American Venture 2004 (NAV 2004) (NAV 2004 Placement Memo), as well as excerpts from the offering materials for North American Ventures 2005 and 2006 (NAV 2005 and NAV 2006, respectively).

19. The Shamrock Placement Memo terminates by its terms on March 2, 2004, unless extended for an additional 30 days. It offers a cash-only investment in a total of 17 units at $6,500.00 per unit. An additional assessment of up to $1,050.00 per unit could be requested by the managing partner, Majestic Management Corporation.[4]

20. The "investment" in NAV 2003, per the NAV 2003 Placement Memo, is structured such that for each unit purchased, the participant pays $5,400.00 in cash and executes promissory notes in the aggregate amount of $17,500.00. The participant, as a result, becomes a "working interest owner" (WIO) in oil and gas wells. The NAV 2003 Placement Memo indicates that the notes will be paid back from production revenues, if any, but offers no forecast of production revenues. The NAV 2004 Placement Memo sets forth essentially the same structure, with the same one-to-four (1:4) cash ($5,400.00) to total investment ($22,900.00) ratio per unit subscribed. This same ratio is present in NAV 2005 and NAV 2006 ventures, as well.[5]

21. The first page of the NAV 2004 Placement Memo calculates the estimated tax benefits per unit purchased. Specifically, the purchase of one unit for $5,400.00 in cash, plus a $1,500.00

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[4] It appears that Energy Resource Management LLC, a company in which Mr. McNerney is a principal, was a subscriber in the Shamrock venture, the offering memorandum for which includes geology reports, a radiometric evaluation, and a turnkey drilling contract that specify the wells and well locations to be drilled.

[5] The Division presents the ratio as a four-to-one (4:1) note to cash ratio. In fact, the note ($17,500.00) to cash ($5,400.00) ratio is approximately three-to-one (3:1).

Lease Acquisition Promissory Note, and a $16,000.00 Turnkey Drilling Contract Promissory Note, would generate a first year total tax loss of $21,460.00 and yield estimated tax benefits in the amount of $4,000.00. The NAV 2004 Placement Memo states that "[b]ecause of the leveraged aspects of the investment, the operations of the Program should allow Participants to realize a 2004 tax write-off of 400% on cash contributed." The NAV 2003 Placement Memo states that WIOs "should be entitled to deduct all intangible drilling and development costs for which liability for payment is incurred in '01-'02 provided economic performance, as described above, has occurred in 2003 or by March 31, 2004."

22. Tangible drilling costs (TDC) include (generally) physical items such as the well head, tubulars and casing materials, as well as costs associated with well prospects that are required to be capitalized for federal income tax purposes. Intangible drilling costs (IDC) are the oil and gas well service expenses and equipment expenses having no salvage value that are incurred as incident to and necessary for drilling and completing oil and gas wells. IDCs are deductible (by election) as a dollar-for-dollar write down in the year in which a well is "spudded,"[6] as opposed to being treated as capital costs that are amortized over a ten-year period. This preferential tax treatment, allowing oil and gas operators the opportunity for substantial tax savings for participating in drilling and completion operations, was provided by Congress as an exception to the general deductibility rules, and was aimed at encouraging exploration for and production of oil and gas resources (Internal Revenue Code [IRC] [26 USCA] § 263 [c]; Treas Reg [26 CFR] 1.612-4 [a]; ***Exxon Corp. v United States***, 547 F2d 548, 554 [1976]).

23. The parties to the Lease Acquisition Promissory Note (***see*** finding of fact 21) were Energy Resource Management, LLC (ERM) and the individual program subscribers. The parties

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[6] "Spudded" was defined as the point at which initial drilling of a well is commenced.

to the Turnkey Drilling Promissory Note (***see*** finding of fact 21) were the Striker Group, Ltd/US Oil & Gas Corp. (Striker) and the individual program subscribers. The lenders on the Lease Acquisition Promissory Note and the Turnkey Drilling Contract Promissory Note were ERM and Striker. The NAV 2003 and NAV 2004 Placement Memos describe ERM as "a recently formed Nevada Corporation," and describe Striker as an entity with "no prior management history," whose "affiliates have participated as WIOs, General Partners or Managers in drilling, and re-completion [sic] gas and oil ventures over the last 20 years for their own account's [sic]." In ERM's Executive Summary, its strategic goal is described as follows:

> "[u]tilize Intangible Drilling Cost Tax Benefits to lower *each taxpayer* down in the 15% Federal tax bracket. Finance the purchase of a Working Interest (Economic Interest) in a developmental oil & gas project from pure tax savings. For qualified individuals, oil and gas can be a wise and potentially profitable investment."

24. The program manager for NAV 2003, NAV 2004, NAV 2005 and NAV 2006 was ERM, a company in which Mr. McNerney is a principal. With respect to NAV 2003, the program manager was to receive a fee equaling $95,000.00, plus 40% of program revenues at payout, plus a share of program revenues equal to its proportionate share of units purchased prior to payout. The program manager was to purchase at least 1% of available units. For NAV 2004, the program manager was to receive a management fee equaling $95,000.00, plus 10% of the net revenues attributable to the program.

25. The Turnkey Drilling Contract Promissory Note bears nonrecourse simple interest at the rate of 6%, matures after 15 years, and carries options to extend the term of the note for a total of another 15 years. The Lease Acquisition Promissory Note likewise matures after 15 years, and carries options to extend the term of the note for a total of another 15 years.

26. As noted, participants in the foregoing ventures were denominated WIOs and not

general partners. As such, "[e]ach WIO will be acquiring a working interest in the Well(s) and not a partnership interest in a General Partnership," such that "the concept of joint and several liability as found in a General Partnership should not exist." At the same time the Placement Memos state that "an investment in the program is not an investment in a limited partnership."

27. As relevant to this matter, petitioner's tax returns reflect claimed deductions based upon investments in McNerney-promoted partnerships from 2004 through 2008. Although petitioner's first year of investment was 2004, he was identified as a partner in Shamrock and NAV 2003.

28. In the course of its audit, the Division sent an Information Document Request (IDR), dated August 21, 2009, to Shamrock. There was no response to this IDR.

The Division also sent an IDR, dated August 24, 2009, to North American Venture. There was no response to this IDR.

29. As part of its audit, on January 27, 2010, the Division interviewed petitioner under oath regarding his investments in McNerney-promoted oil and gas partnerships. At the time of the interview, petitioner had known Mr. McNerney for about 25 years. According to petitioner, Mr. McNerney first mentioned an investment in an oil and gas partnership to him approximately two years before he actually invested. Prior to his investment, as time allowed, petitioner, a physician, conducted research on the Internet, and also read books and magazines regarding the oil crisis. Over time, whenever he saw petitioner, Mr. McNerney continued to mention oil and gas partnership investments to him.

30. Shortly before his first investment in a McNerney-promoted venture, petitioner went to Mr. McNerney's office where he was shown "a CD which showed oil being explored" and produced. Around the same time, Mr. McNerney referred petitioner to Dara Lis. Petitioner sent

his tax information for prior years to Ms. Lis, who reviewed the same and gave him a written analysis of his tax savings from investment in the McNerney partnerships. Mr. McNerney suggested to petitioner that he could carryback losses from an investment in 2004 to the 2002 tax year. Immediately thereafter, petitioner decided to invest in a McNerney oil and gas partnership. During the interview, petitioner stated that his first year of participation was 2004. Petitioner also stated that the amount he invested, i.e., the number of units he purchased, was determined by his tax position. In addition, petitioner stated that Mr. McNerney allowed him to make partial payments towards his investment.

31. Petitioner's check, dated December 28, 2003, payable to "North American Venture 2003 / FBO Rakestraw Project," in the amount of $5,400.00, bearing the memo notation "Purchase W/I 2003 (Partial)," was cashed on or about March 30, 2004.

Petitioner's check, dated March 24, 2004, payable to "North American Venture FBO Rekestraw [sic] drilling Project," in the amount of $18,400.00, bearing the memo notation "Purchase: W.I. NAV (Bal due)," was cashed on or about March 30, 2004.

32. During the year 2004, a number of checks were written on and cashed against petitioner's checking account, as follows:

a) a check, dated July 30, 2004, payable to "US Oil & Gas," in the amount of $8,600.00, bearing the memo notation "Purchase Working Int. IDDC's, Il;"

b) a check, dated September 11, 2004, payable to "PRL Oil Co Inc - FBO NAV 2004," in the amount of $3,200.00, bearing the memo notation "Purchase Working Interest OIL/ 2004 NAV, TX;"

c) a check, dated October 8, 2004, payable to "PRL Oil Co. Inc / fbo NAV 2004," in the amount of $2,500.00, bearing the memo notation "PRL TX Project purchase Working Interest;"

d) a check, dated November 9, 2004, payable to "TRL Oil C/o - NAV 2004," in the amount of $2,900.00, bearing the memo notation "Purchase Int. Towards TX Project;"

e) a check, dated December 4, 2004, payable to "Majestic Mgt / FBO NAV - '04," in the amount of $2,220.00, bearing the memo notation "(Purchase Working INT Partial);"

f) a check, dated December 7, 2004, payable to "Majestic Mgt / FBO NAV - '04," in the amount of $2,220.00, bearing the memo notation "(Purchase Working INT Partial);" and

g) a check, dated December 21, 2004, payable to "US Oil & Gas / FBO NAV 2004," in the amount of $5,400.00, bearing the memo notation "Purchase Working Interest Illinois Project."

33. In conjunction with his interview, petitioner provided closing documents related to his purchase of 5.5 units in NAV 2004. Among those closing documents was a receipt for placement memorandum and representations that petitioner signed on December 26, 2004. During his interview, petitioner acknowledged receiving the NAV 2004 Placement Memo. However, petitioner stated he had not reviewed it. Petitioner also stated that he had not reviewed the closing documents for NAV 2004 "in great depth." Petitioner signed a turnkey drilling agreement promissory note, dated December 26, 2004, in the amount of $88,000.00 ($16,000.00 per unit), payable to "The Striker Group, Ltd/US Oil & Gas Corp." He also signed a lease acquisition promissory note, dated December 26, 2004, in the amount of $8,250.00 ($1,500.00 per unit), payable to ERM on December 31, 2019.

34. During the year 2005, a number of checks were written on and cashed against petitioner's checking account, as follows:

a) a check, dated March 11, 2005, payable to "US Oil & Gas / FBO NAV 2004," in the amount of $10,000.00, bearing the memo notation "purchase Working Interest Indian PT;'

b) a check, dated March 16, 2005, payable to “US Oil & Gas / FBO NAV 2004,” in the amount of $8,000.00, bearing the memo notation “Purchase Working Int IL Proj;”

c) a check, dated April 29, 2005, payable to “US Oil & Gas Corp / FBO NAV 2004,” in the amount of $20,000.00, bearing the memo notation “Purchase Wkg Int. ILL Project;” and

d) a check, dated June 1, 2005, payable to “US Oil & Gas / FBO NAV 2004,” in the amount of $12,000.00, bearing the memo notation “Purchase Wkg Int Indian pt. Project.”

35. Petitioner did not carefully look into why he filed an amended return for the year 2004. Rather, he relied on Ms. Lis and Mr. McNerney.

36. In conjunction with his purchase of one unit in NAV 2005, petitioner signed, among other documents, a lease acquisition promissory note, dated December 28, 2005, in the amount of $1,500.00 ($1,500.00 per unit), payable to ERM on December 31, 2020; and a turnkey drilling agreement promissory note, dated December 28, 2005, in the amount of $16,000.00 ($16,000.00 per unit), payable to “The Striker Group, Ltd,” on December 31, 2020.

37. Petitioner wrote a check, dated April 8, 2006, payable to “US Oil & Gas Ventures / FBO NAV 2005,” in the amount of $5,400.00, bearing the memo notation “Purchase WIP Various Projects.”

38. During the interview, petitioner stated that he signed notes for every McNerney-promoted investment in which he participated.

39. Following the January 27, 2010 interview, the Division sent petitioner an IDR, dated March 29, 2010, requesting specified information and documents following up on the interview.

40. Sometime before the January 27, 2010 interview, petitioner provided a total of 14 checks relating to his investment in McNerney-promoted oil and gas partnerships and bearing various dates between December 28, 2003 and April 8, 2006. By letter dated May 4, 2010, in

response to the Division's March 29, 2010 IDR, petitioner's former representative indicated that petitioner had already provided copies of all checks he was able to obtain.

41. The Division sent an IDR, dated October 20, 2010, to petitioner. The IDR advised that the Division was auditing participants in abusive tax avoidance schemes and transactions. It also advised that under Tax Law § 683 (c) (11) (B), tax may be assessed within six years after the filing of a return if a deficiency is attributable to an abusive tax avoidance transaction. The IDR requested specified documents relating to petitioner's claimed loss from NAV 2003, Shamrock and the US Oil & Gas Ventures JV 2007 partnerships. The IDR provided that "[i]f the documentation is not submitted or is not submitted timely, the reported loss deduction will be disallowed and you will receive a bill for the additional tax, interest and applicable penalties due."

42. Petitioner did not provide to the Division any further documentation regarding his oil and gas investments for the years 2004 through 2008. He also never provided any evidence that any oil and gas wells were actually drilled. In fact, as audited at the federal level for the year 2006, the NAV 2003 partnership produced no evidence that any drilling activity was undertaken on its behalf, or that it had a working interest in any oil or gas lease.

43. When interviewed, petitioner stated that he received some "semi-regular checks" with respect to his participation in the McNerney ventures, but produced no evidence as to the amounts of any such checks. The only information that petitioner received regarding his investments in McNerney-promoted oil and gas ventures were e-mails from Mr. McNerney and year-end schedules K-1. Although he asked Mr. McNerney, on a number of occasions, about the amount of oil produced, petitioner never received any information regarding the amount of oil produced by the wells in which he invested. Mr. McNerney advised petitioner that his

obligations under the promissory notes would be paid for over the course of the length of the notes by the revenues resulting from the production and sale of oil and gas. Although petitioner acknowledged that he would personally have to repay the notes if all the wells were dry, he was confident that most of the wells would produce oil based upon the CD he had seen. Petitioner did not know how much, if any, revenue from oil production had been applied to his promissory notes, or the amount of the balance owed on such notes.

44. One of petitioner's partners in NAV 2003 did not recall signing any notes, and denied seeing any venture documents. Other investors in the McNerney partnerships, interviewed by the Division, indicated that they were advised directly by the promoter (Mr. McNerney) that their obligations under any promissory notes connected with the partnerships would be funded (paid for) over the course of the length of the notes by the revenues resulting from the production and sale of oil and gas, and from the tax deductions (and consequent refunds), attributable to the investments. They also stated they did not know how much remained due and owing on any notes, as well as their belief and expectation of never having to repay any of the notes other than via the results of the operations of the wells and the refunds as described.[7]

45. The amount of a given participant's investment was determined by Dara Lis, based upon that investor's income and allowable deductions, and was calculated to generate a specific tax deduction. In some instances, the tax refund resulting from the immediate deductibility of IDCs was calculated for a given investor and tax year, in view of that taxpayer's other income and deductions, for the purpose and as a means of funding the cash portion of a subsequent year's investment in the McNerney promoted ventures. In short, the amount of the investment was

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[7] Transcripts of interviews of the other investors, of a deposition of Dara Lis, and of the proceeding in the ***Matter of Francoforte***, (Division of Tax Appeals, February 19, 2015), are included in the record as Exhibits AA, BB, MM, and SS.

"backed into" based upon the other information on a given investor's tax return.[8]

46. After its audit of petitioner's returns, and in view of the information gleaned from its audits of the McNerney partnerships, the Division concluded that the McNerney-promoted oil and gas partnerships in which petitioner invested were abusive tax avoidance transactions within the meaning of Tax Law § 683 (c) (11) (C). The Division also concluded that NAV 2003 and Shamrock were partnerships for tax purposes, and that petitioner was a partner in both NAV 2003 and Shamrock (***see*** finding of fact 61).

47. In general, oil and gas exploration activities hinge in large part upon the resources available for investment in oil and gas drilling. The largest segment of oil and gas drilling is done by the larger national oil and gas corporate entities (e.g., Exxon-Mobil, Shell, British Petroleum, Chevron-Texaco) and by the larger national independent drillers and producers. In addition, there are relatively smaller independent or local oil and gas firms that lack the large amount of liquidity required to drill large numbers of wells on their own. These entities put together drilling ventures to obtain capital for drilling particular well prospects, and to share the costs and risks as well as the potential rewards among the many investors in such ventures. A third category of oil and gas ventures, prevalent since the early 1980s, involve ventures engaged in abusive tax avoidance or evasion schemes, typically centered on creating IDCs to be available for immediate deductibility. These schemes often involve illegitimate ("bogus") promissory notes coupled with prospectuses carrying highly inflated and nonspecific IDCs. These ventures typically employ high note-to-cash ratios aimed mainly at gaining large tax deductions for

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[8] In some years, it appears amended returns were filed claiming participation in a given venture, and hence deductibility of IDCs for that year, such that a refund was generated, paid and "invested" into a McNerney venture for the ensuing year. In other instances, it appears a participant's "overinvestment" (i.e., unusable or excess loss versus available income to offset) for a given year was, by the expedient (or artifice) of backdated short-term notes, assigned to a different venture participant.

investors based on such up-front deductibility of (inflated) IDCs, while simultaneously raising a large amount of up-front cash for the promoter ostensibly to be used for drilling purposes, but often simply siphoned off by the unscrupulous promoter. In many instances, no wells are ever sited or actually drilled by these types of ventures.

48. With respect to oil and gas exploration partnership ventures, many parties are assembled to perform all the tasks necessary for drilling an oil or gas well. The "Operator" is the party that acquires the well site lease and assumes the working, or cost, interest therein. The Operator determines if it will add partners, in which case those added partners will 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 an "authority for expenditure" (AFE). This estimate is based upon a number of factors, including price quotations from providers of specific drilling activities. The AFE should include line item detail of all the projected IDC and TDC expenses (***see*** finding of fact 22), based upon the Operator's best estimate of such costs, any of which could be adversely affected by unexpected complexities and other drilling risks. When the Operator determines the costs of drilling, and lists the same via an AFE, he will provide the list as part of a "cash call" to the WIOs for the up-front cash to pay for drilling. The Operator will, if authorized by the WIOs, enter into a drilling contract and proceed with drilling. In turn, if commercially viable production is achieved from the drilled well, the Operator will do a second cash call to complete the well by installing necessary tanks, lines, surface equipment and the like.

49. An Operator would never contract a driller to drill multiple wells in different states, as the drilling contracts in the North American and Shamrock venture materials purport to do; operators hire drillers with experience and familiarity with a given location.

50. 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 hired to drill on a “day rate” basis, a “footage” basis or a “turnkey” basis. A day rate contract for drilling services is based upon the driller’s daily billing rate for the drilling rig and crew. A footage contract for drilling, as the name implies, is based upon the driller’s price per foot of well depth drilled. In day rate and footage contracts, the Operator bears all the cost and time risks of the drilling operation, including cost increases or overruns should trouble in drilling be encountered. That said, the day rate and footage contract methods are the least expensive if the drilling operation is managed effectively by an experienced and capable Operator.

51. Turnkey drilling contracts, by contrast, provide that the driller accepts a fixed fee for drilling and 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 the commencement of production. The turnkey arrangement thus passes risks and uncertainties to the drilling contractor, while protecting the working interest participants. This is why turnkey drilling contracts may be well suited for certain drilling partnerships, where partners would prefer to pay their fixed costs at one time prior to commencement of a project.

52. As described, a key benefit for turnkey drilled venture participants is the protection it gives against cost inflation due to unforseen (or unforeseeable) difficulties that may be encountered or associated with any drilling venture, such as failure to achieve commercial quantities of oil and gas (hydrocarbons), known as dry holes, or low post-completion production rates. By entering into a turnkey drilling contract, participants may avoid costs of environmental damage and accidents, and limit their exposure to the wide variation in drilling completion costs. At the same time, and for assuming these risks, turnkey drillers are able to command a higher rate than day rate or footage rate drillers.

53. Factors considered by turnkey drilling contractors when pricing a turnkey contract might include the estimated cost of 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. Legitimate turnkey drillers are often enticed by added price incentives such as an added markup for achieving fast well completion. At the same time, abusive tax shelter ventures use turnkey drilling contracts to lump large (overstated) IDCs in the venture solely for the benefit of their immediate deductibility. Mr. McNerney alone appears to have determined the turnkey drilling contract price for the ventures audited by the Division, and there is no evidence in the record concerning how he established his pricing.

54. An oil and gas drilling prospectus, as would be provided to potential investors, generally contains a geological and geophysical description of the prospect well or wells, a title search, a listing of potential working interest owners or participants in the drilling venture, and any state regulatory filings. A prospectus also typically includes the specific well site location, offset production and subsurface structure information, and estimates as to potential oil and gas production. The NAV 2003 and NAV 2004 Placement Memos contain none of this information.

55. An oil and gas drilling prospectus would also include an AFE, prepared by the well Operator to reflect proposed well costs (***see*** finding of fact 48). The AFE would be reviewed and approved by the WIOs prior to drilling. The Placement Memos for both NAV 2003 and NAV 2004 recite the cost for turnkey drilling to be $5,110,000.00 in each instance, but do not contain an AFE from the Operator for either partnership breaking down the estimated costs to be incurred by each partnership. Without an AFE, or the names and locations of the proposed wells, or other information typically included in an AFE and a prospectus, it is impossible to estimate the costs

of drilling a well, or to assess the reasonableness of the turnkey drilling price, or to make an intelligent or informed decision about investing.

56. As noted earlier, the Operator of an oil and gas well contracts a driller to drill the wells. The driller does not contract with non-operator WIOs, and such a fractional interest owner or owners (WIOs) would not have the individual authority to hire a driller.

57. The facts set forth in findings of fact 47 through 56 were established through the affidavit of Mikel Morris and the transcript of the proceeding in ***Matter of Francoforte***. Mr. Morris, a petroleum engineer, has a BS degree in Petroleum Engineering from the University of Oklahoma, an MSBA in Corporate Finance from the University of Southern California, an MBA in Business Administration from the University of Southern California, and an MS in Petroleum Engineering from the University of Houston. His employment experience includes work as a production engineer for Amoco Production Corporation, Crown Central Petroleum, Minerals Management Service, and Jicarilla Apache Oil and Gas Administration; as interim manager and petroleum engineer for the IRS; as Energy Consultant to the U.S. State Department, U.S. Army, and Iraqi Minister of Oil; and as petroleum engineer for Petroleum Comptroller Services. Mr. Morris was deployed to Djibouti as a deputy section leader for the U.S. Africa Command. He has extensive experience in federal and state regulation of the petroleum industry, as well as considerable operational experience in the field. Mr. Morris also has experience as an agent for the Internal Revenue Service, working specifically on audits of intangible drilling cost deductions claimed in relation to oil and gas drilling ventures. The Division retained Mr. Morris to review and render an opinion on the NAV 2003 and Shamrock ventures.[9]

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[9] Mr. Morris's full curriculum vitae is included in the record as Exhibit OO. In ***Matter of Francoforte***, Mr. Morris was qualified without objection as an expert witness with regard to the oil and gas industry in general, and with regard to IDC issues in particular.

58. Mr. Morris opined that:

> "the North American and Shamrock venture materials purport to utilize long term debt to finance drilling in order to exaggerate the available intangible drilling cost for immediate deduction through the use of a turnkey drilling contract which has no legal significance because drilling could not and would not be done under such a contract. Moreover, because the materials do not provide the purported working interest owner 'investor' the estimated cost of drilling contained in the AFEs for the wells to be drilled, the 'investor' has no way of determining whether the cost of the turnkey drilling contract is reasonable."

59. Mr. Morris further opined that high note-to-cash ratios, based upon highly marked-up drilling cost rates, are not unusual in abusive tax shelter cases. He stated, in sum, that because of the inflated markups and resulting inflated long-term note-to-cash ratios found in abusive tax avoidance ventures such as those present here, an investor would never receive payout on his total investment (including the notes) but instead would simply receive huge current tax write-offs.

60. While the NAV 2003 and NAV 2004 Placement Memos lack the foregoing information about specific well prospects and estimated costs, they do discuss in detail the tax implications of the ventures. Mr. McNerney described his oil and gas drilling programs as funded "with pure tax dollars following favorable 'Congressional Tax Incentives.'" He closed his e-mails to participants with the salutation, "Best regards, and Happy Tax Profits!" Promotional materials for NAV 2005 describe an investor's "Economic Tax Gain of $7,130.00" as "a 30.3% pure profit on Tax Savings re-directed to purchase your Working Interest in NAV 2005." It states, further, that:

> "[y]our Economic Tax Gain of $7,132.00 invested each year for 10 years at 15% annual yield will accumulate to $163,700.00 of personal wealth, all from Pure Tax Savings. Further, your particiaption [sic] in our Drilling Projects will be more likely than not to produce future Tax Advantaged Cash Flow to you through 'Depletion Allowance'. By participating in NAV 2005 your AGI will be reduced below $100,000.00, thus you qualify for both the 'Roth IRA, and Roth IRA

> Conversion', with 'Everest Sized Tax Benefits'. Additionally, you can avail yourself of 'Excess IDC Deductions in 2005 sufficient to create *an NOL Carryback into 2003, then receive a Federal and State Refund of $16,500.00 for 'Additional Asset Accumulation' purposes, and future 'Family Wealth Creation.*'"

61. Mr. McNerney recapitalized and added new investors in subsequent years after the partnerships were 100% subscribed, using the same Employer Identification Number (EIN) and the same partnership name. He also permitted investors to subscribe to partnerships more than 90 days after the close of the taxable year, leading to the filing of amended returns so as to claim IDC deductions and resulting tax refunds for the prior year, based on the amount allegedly paid to enter the partnership (***see*** finding of fact 45). Under these circumstances, it is very difficult to ascertain in what year and in which venture an investment may have been actually made.

62. The Receipt for Placement Memorandum and Representations contained in the Placement Memos for NAV 2003 and NAV 2004, to be signed by the program subscribers, asserts that the undersigned subscriber is sufficiently experienced in oil and gas investments and business matters to analyze and evaluate the information contained in the Memorandum and other offering materials. Mr. Morris noted, in this context, that the identity, reputation and industry history of an oil and gas promoter would be important considerations for a potential investor, as would seeking out an industry expert to review the investment package and its materials.

63. The IRS audited NAV 2003 and issued a form 886-A explanation of items (also known as a Revenue Agent Report or "RAR"). Among other items, the RAR concludes that the partners purportedly signed notes payable to ERM or entities related to Dennis McNerney, but there is no evidence that any partner in the partnership is personally liable on any promissory notes entered into either by such partner or by the partnership; that there is no evidence that any

partner has pledged as security any property, including any property that is not used in the activity at issue; that interviews with partners indicate that there is no realistic possibility of economic loss with respect to any promissory notes; that the amounts purportedly borrowed for use in the partnership will not increase the partner's amount at risk since the lender (ERM and Dennis McNerney entities) has an interest other than that of a creditor in the activity and is related to a person (other than the partner) who has an interest other than as a creditor in the activity; and that, accordingly, partners may deduct otherwise allowable partnership losses for 2006 only to the extent of their cash investment in the partnership. The RAR further notes that the partners could not include the amount of any promissory notes in basis because there is no evidence that these purported notes represent bona fide debt. The RAR concludes that there is no evidence "the Partnership NAV 2003 had any notes pertaining to any oil or gas leases or any turnkey drilling contract on which it made any payments." Further, there were no records presented to substantiate that any drilling activity was undertaken on the partnership's behalf, or that the partnership held any working or operating interest in any oil or gas leases.

64. The parties agreed to proceed in this matter by written submission. Petitioner submitted the following documents on July 11, 2014:

a) Exhibit 1 - A document entitled "The Tax Advantages of Oil and Gas Drilling, ©2003 Energy Resource Management Corporation;"

b) Exhibit 2 - An excerpt from IRS publication 535, business expenses, for use in preparing 2002 returns, pertaining to intangible drilling cost (page 29) and the depletion deduction on oil and gas properties (page 43);

c) Exhibit 3 - A two-page printout entitled "Tax Matters FAQ" regarding tax benefits for Veteran Oil Partners LLC Oil & Gas drilling programs from the Veteran Oil Partners website;

d) Exhibit 4 - A copy of an unsigned letter, dated July 28, 2004, from Anithalee Alex, Jr., President, US Oil & Gas, Teutopolis, Illinois, to Energy Resource Management, LLC, "the Working Interest Participant;"

e) Exhibit 5 - A three-page document entitled "Summary North American Venture 2004" that stated it was "presented for analysis purposes *only*, and an offering can be made only by presentation of a Confidential Private Placement Memorandum relating hereto and pursuant to strict procedures;"

f) Exhibit 6 - A one-page interoffice memorandum, dated July 29, 2004, from U.S. Oil and Gas, Teutopolis, Illinois, to ERM, LLC, the subject of which was an "Oil Lease Program;"

g) Exhibit 7- copies of 12 canceled checks drawn on petitioner's checking account, bearing various dates from December 23, 2003 through April 8, 2006, related to petitioner's investments;

h) Exhibit 8 - A copy of a canceled check, dated March 9, 2007, drawn on petitioner's checking account, payable to "The Striker Group LTD," in the amount of $18,000.00, bearing the memo notation "Purchase, WIP 2007;"

i) Exhibit 9 - A copy of a canceled check, dated July 10, 2008, drawn on petitioner's checking account, payable to "The Striker Group, LTD," in the amount of $25,000.00, bearing the memo notation "For Capital Illinois WIP / 2008."

65. In the July 11, 2014 letter that accompanied petitioner's submission, he asserted, in pertinent part, the following:

> "[h]erein please find my documents which I formed the basis [sic] for my Understanding and investing in oil and gas wells. I was not swayed or influenced by Any body's [sic] claim. The documents include IRS publication about intangible drilling Costs, oil and gas wells, how to make choice, energy credits for costs of geothermal wells, exploration costs etc. After reading and assimilating

> the information from these Documents, I was convinced that oil and gas exploration in USA is indeed a genuine idea to make this country strong and self sufficient in oil production rather than relying on middle eastern countries which not only sells [sic] oil at exorbitant costs but also divert our hard earned money for political activities. Therefore it was my decision to put money in our own backyard rather than sending it to other countries."

66. Petitioner did not submit any supporting documentation pertaining to his partnership interest in Shamrock.

67. The record does not include any evidence that petitioner signed any promissory notes for the years 2006 through 2008.

68. Petitioner did not submit any evidence that any payments were made on notes associated with his investments in McNerney-promoted partnerships, or that he received payments from oil production related to the same.

69. Petitioner submitted no evidence that any oil and gas wells were actually drilled.

70. Petitioner did not submit any documentation pertaining to matters being litigated at the United States Tax Court (US Tax Court) under docket numbers 260-12; 6587-12 and 6588-12.

71. The record does not include any correspondence either to or from the Division pertaining to petitioner's 2003 income tax return.

72. In accordance with the revised submission and briefing schedule established by letter dated May 23, 2014, petitioner's rebuttal documents and initial brief were due on September 4, 2014, at which time the record in this matter closed. Petitioner did not submit any rebuttal documents or brief by September 4, 2014.

73. Included with petitioner's letter/reply brief, were two documents. The record in this matter closed on September 4, 2014, the revised deadline set for the submission of petitioner's rebuttal documents and initial brief. These documents were returned to petitioner with an

explanation that no evidence could be submitted after the record closed.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge concluded that the record clearly established that the McNerney-promoted ventures in which the petitioner chose to participate in 2004 and 2005 were abusive tax avoidance transactions. The Administrative Law Judge explained that there was nothing in the record that would credibly support a conclusion that petitioner entered into the transactions at issue for any purpose other than the generation of a tax benefit. This determination was based upon the Administrative Law Judge's conclusions that: (1) with regard to Shamrock, petitioner introduced no supporting documentation regarding his investment; (2) with regard to NAV 2003, the record supports a finding that the principal purpose of the venture was tax avoidance in that the documents and transcripts of interviews submitted into evidence support this conclusion, there is no objective evidence establishing that any well sites were leased, any wells were ever drilled, or any evidence that there were ever any revenues generated from oil production. Furthermore, there was no evidence as to how the lease acquisition or turnkey drilling contract prices were calculated. Finally, there was no proof that the promissory notes involved in the transactions constituted bona fide debt.

Based on the above conclusions, and in accordance with Tax Law § 683 (C) (11) (B), the Administrative Law Judge found that the tax in this matter could be assessed at any time within six years after the latter of either the due date of the return at issue, or the date on which it was filed. Furthermore, as the notice of deficiency for 2002 was based upon a NOL carryback from 2004, the tax for 2002 could be assessed within the same time frame allowed for the assessment of the tax for 2004.

Accordingly, the Administrative Law Judge determined that the Division properly disallowed petitioner's claimed Schedule E deductions for 2002, 2004 and 2005, and that the additional tax was properly assessed.

The Administrative Law Judge separately addressed the notices of deficiency for 2006 through 2008 as they were issued within the normal three-year statute of limitations provided for in Tax Law § 683 (a). The Administrative Law Judge noted that petitioner, in order to substantiate his Schedule E deductions for 2006 through 2008, submitted only copies of three checks drawn on his checking account that purportedly represented the cash portion of his investments in the McNerney-promoted ventures for those years. The Administrative Law Judge specifically pointed out that petitioner did not submit any evidence that he even signed any promissory notes, any evidence that any well sites were leased or drilled, or, if they were, any evidence that such well sites produced any oil or gas revenues. Therefore, the Administrative Law Judge concluded that petitioner failed to prove, as he was required to do by Tax Law § 689 (e), that he was entitled to any Schedule E deductions for the years 2006 through 2008.

Additionally, the Administrative Law Judge found that petitioner did not prove that he was entitled to any relief based upon: (1) an estoppel argument regarding the Division's supposed acceptance of his 2003 tax return; or (2) the alleged existence of related matters currently before the United States Tax Court.

Finally, the Administrative Law Judge found that petitioner had been negligent in that he had not adequately investigated the McNerney-promoted ventures prior to investing in them and did not have substantial authority for the positions taken on his returns as filed. The Administrative Law Judge upheld all of the penalties assessed by the Division.

SUMMARY OF ARGUMENTS ON EXCEPTION

Petitioner's argument on exception centers on the fact that IDCs are valid expenses of oil and gas ventures and are not required to be capitalized. Petitioner asserts that this preferential tax treatment was expressly authorized by Congress to encourage exploration for, and production of, oil and gas resources. Petitioner asserts that he invested in the McNerney-promoted ventures because he was personally aware of oil and gas shortages, having had to wait in line for gas, and that he believed it was preferable to invest in such resources in the United States.

Petitioner also argues that there was a law change regarding NOLs in that NOLs incurred in 2003 were carried back two, or if eligible, three years.

Petitioner asserts that although he had known Mr. McNerney for a number of years, he was not aware of any of Mr. McNerney's previous fraudulent activities. Petitioner also asserts that Ms. Lis merely prepared his tax returns and that her fraudulent behavior only came to his attention in 2009 and that she did commit fraud with regard to his tax returns. Furthermore, petitioner asserts that he did not spend the necessary time to investigate Mr. McNerney, or the ventures, due to constraints on his time imposed by his family and profession. In short, petitioner argues that he should not be held responsible for the fraudulent practices of Mr. McNerney or Ms. Lis.

The Division does not disagree with petitioner's assertions that IDCs may be deducted as current business expenses. Rather, the Division asserts that the IDCs stemming from petitioner's investments in the McNerney-promoted ventures were not valid business expenses.

The Division asserts that the Administrative Law Judge properly found that petitioner's investments in the McNerney-promoted ventures consisted of abusive tax avoidance transactions lacking in economic substance in that such transactions did not have "purpose, substance or utility apart from anticipated tax consequences" (citing ***Matter of Kellwood***, Tax Appeals Tribunal, September 22, 2011).

In response to petitioner's argument that he should not be held responsible for the fraudulent practices of others, the Division points out that one of the factors to be examined when conducting an analysis under the economic substance doctrine is whether the investor conducted due diligence prior to investing. The Division argues that petitioner admitted that he did not conduct the necessary investigation of the McNerney-promoted ventures. Furthermore, the Division points to the evidence in the record that petitioner did nothing more than view a CD about oil exploration and production in the promoter's office. The Division notes that, although acknowledging receipt of the NAV 2004 Placement Memo, petitioner admits that he did not read it and did not read the NAV 2004 closing documents in great depth. The Division argues that even if petitioner had read the materials concerning NAV 2003 and NAV 2004, those materials indicate that the sole purpose of the ventures was to provide its investors with tax benefits.

Additionally, the Division asserts that even if petitioner proved he had a legitimate business motive in investing, he must also prove that, objectively, the McNerney-promoted ventures had some reasonable expectation of profit. The Division asserts that as petitioner did not prove that any oil or gas wells were even drilled, there could be no reasonable expectation of profit.

Furthermore, the Division contends that the lease acquisition and turnkey drilling notes do not constitute bona fide or genuine debt for which petitioner is in any realistic manner obligated to pay, or at risk of being required to pay.

In response to petitioner's argument that there was a law change regarding NOL carrybacks for the year 2003, the Division asserts that as the year 2003 is not at issue, the argument is irrelevant.

OPINION

We affirm the determination of the Administrative Law Judge.

We first review the fundamentals underlying this matter. The lack of evidence in the record prohibits us from being able to ascertain with any certainty what year, and in which venture, petitioner's investments were actually made (***see*** findings of fact 45 and 61). However, it is clear that the income tax deficiencies at issue result from the Division's denial of petitioner's distributive share of the McNerney-promoted ventures' losses for 2004 through 2008, consisting apparently of claimed IDC expense deductions. 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). As noted by petitioner, 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]).

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 § 683 [c] [11] [B]). As noted, the Division contends that petitioner's investments in the McNerney-promoted ventures were such abusive tax avoidance transactions, and accordingly, asserts that the six-year period under Tax Law § 683 (c) (11) (B) is applicable herein. As the notices of deficiency for 2004 and 2005 were issued within six years after the relevant returns were filed, but later than three years after such returns were filed (***see*** findings of fact 6, 8, 9, 10, 11 and 15), the notices would be time-barred unless the exception applies. The notice of deficiency for the year 2002 would also be time-barred unless the exception applies. This is because such notice was based upon a NOL carryback from the year 2004, and thus is governed by the statute of limitations applicable to that year (Tax Law § 683 [b] [4]).

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]). 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 investments in the McNerney-promoted ventures were not abusive tax avoidance transactions. Tax Law § 683 (c) (11) (C) defines such a transaction for purposes of Tax Law § 683 (c) (11) (B) as "a plan or arrangement devised for the principal purpose of avoiding tax." As used in Tax Law § 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 investments.

For purposes of Tax Law § 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 § 683 [c] [11] [B] and [C]).

Tax Law § 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 § 685 (p-1) (5)]." In turn, Tax Law § 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 § 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

[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).

> 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]).

From the very beginning, the investments were promoted to petitioner not as a venture that would make money based upon the discovery of oil or gas, but rather as a means of avoiding tax, which would provide petitioner with additional funds, lower his income to allow him to take advantage of other tax benefits and obtain refunds that could add to his family's wealth (***see*** finding of fact 60). The very first page of the NAV 2004 Placement Memorandum shows the calculation of the estimated tax benefits per unit purchased, i.e., the purchase of one unit for $5,400 cash plus a $1,500 lease acquisition promissory note and a $16,000 turnkey drilling contract non-recourse promissory note would generate a first year total loss of $21,460 and yield estimated tax benefits in the amount of $4,000 (***see*** finding of fact 21). The NAV 2004 Placement Memorandum also states that "[b]ecause of the leveraged aspects of the investment, the operations of the program would allow participants to realize a tax write-off of 400% on cash contributed." Petitioner was referred by Mr. McNerney to Dara Lis, an accountant who calculated the amount of a given participant's investment by determining the amount that would be required for that participant to generate a tax deduction in a particular amount (***see*** findings of facts 30 and 45).

Further, petitioner submitted no evidence to substantiate that any drilling activity was ever undertaken on behalf of any of the McNerney-promoted ventures. Indeed, as audited at the federal level for 2006, NAV 2003 not only failed to produce any evidence that any drilling activity was ever undertaken on its behalf, but also produced no evidence that it even had a working interest in any oil or gas lease (***see*** finding of fact 42).

Petitioner also provided no evidence tending to prove that the promissory notes involved in the transactions constituted genuine debt. Petitioner was unable to produce any evidence that any payments were made on the notes, and did not know how much, if any, revenue from oil or gas production had been applied to his notes, or even the balance of such notes. Additionally, the audit at the federal level of NAV 2003 found that even though participants purportedly signed notes, there was no evidence that any participant was personally liable, had pledged as security any property, or, based upon interviews with the participants themselves, that there was any realistic possibility of economic loss to any of the participants with respect to any of the promissory notes (***see*** finding of fact 63). Accordingly, it is found that petitioner did not have an intent to create a debtor-creditor relationship based upon any of the promissory notes involved in the McNerney-promoted ventures (***see Calloway v Commr.***, 135 TC 26, 37 [2010]).

Transactions cease to merit tax respect when they have no economic effects other than the creation of tax benefits (***United Parcel Service v Commissioner***, 254 F3d 1014, 1018 [2001]). An examination of the record in the present matter shows that the principal purpose of investing in the McNerney-promoted ventures was the generation of tax benefits for participants.

Petitioner obviously has not met his burden to prove that he entered into these transactions for a valid nontax business purpose and that the transactions had "purpose, substance, or utility apart from (their) anticipated tax consequences" ***(Matter of Kellwood*)**. Accordingly, we agree with the Administrative Law Judge's conclusion that the Division properly disallowed petitioner's claimed Schedule E deductions for 2002, 2004 and 2005, and that the tax was assessed within the time allowed by the applicable statute of limitations.

The notices of deficiency issued by the Division for the years 2006 through 2008 present a different issue, as these notices were issued within the three-year statute of limitations set forth in Tax Law § 683 (a). We find that the Administrative Law Judge fully and correctly addressed this issue in the determination and we affirm for the reasons stated therein.

With regard to petitioner's argument that NOLs incurred in 2003 are carried back two, or if eligible, three years, we find that the argument is not relevant to the present matter as the year 2003 is not at issue herein.

Petitioner did not raise any arguments on exception regarding the Administrative Law Judge's conclusion that petitioner did not prove that he was entitled to estoppel based upon the Division's acceptance of his 2003 tax return. Nor did petitioner raise any arguments on exception regarding the determination of the Administrative Law Judge that he not was entitled to any relief based upon the alleged existence of related matters currently before the United States Tax Court. Accordingly, such issues are not addressed in this decision.

Finally, the Administrative Law Judge upheld the following penalties imposed by the Division: negligence penalties pursuant to Tax Law § 685 (b) (1) and (2) for each year at issue; a penalty for substantial understatement of income pursuant to Tax Law § 685 (p) for the years 2002, 2004 and 2008; and, a penalty for the years 2002 and 2004 under the Voluntary

Compliance Initiative. As neither party specifically addressed the issue of penalties on exception, we will only note that we agree with the analysis of the Administrative Law Judge regarding the negligence penalties, find no basis in the record that would support a finding of reasonable cause for the waiver of the substantial understatement of income penalties, and, having found that the transactions at issue for the relevant years were abusive tax avoidance transactions, find no basis for any relief for petitioner from the Voluntary Compliance Initiative penalties.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Jadow and Uma Rao is denied;

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

3. The petition of Jadow and Uma Rao is denied; and

4. The notices of deficiency, dated February 28, 2011, for the years 2002 and 2004 through 2008, are sustained.

DATED: Albany, New York
July 21, 2016

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

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