STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

MARC S. SZNAJDERMAN AND :
JEANNETTE SZNAJDERMAN DETERMINATION
: 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.
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Petitioners, Marc S. Sznajderman and Jeannette Sznajderman,[1] filed a petition 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.[2]

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, One Centre Street, New York, New York, on November 14, 15, 16, 28 and 29, 2012, with all briefs submitted by June 7, 2013, which date began the six-month period for the issuance of this determination. Upon notice to the parties, this period was extended three months pursuant to 20 NYCRR 3000.15(e)(1). Petitioners appeared by Latham & Watkins LLP (Miriam L. Fisher, Esq., Brian C. McManus, Esq., and Joshua Wu, Esq., of

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[1]Since only petitioner Marc S. Sznajderman took part in the subject transaction, reference to the petitioners herein will be in the singular.

[2]The parties executed a Stipulation (petitioners on October 25, 2010 and the Division of Taxation [Division] on October 27, 2010) which provided that the resolution in this matter would apply to five other matters pending before the Division of Tax Appeals (DTA numbers 823196, 823197, 823198, 823199 and 823200), where resolution was defined to mean the final holding of the Division of Tax Appeals and any subsequent appeals, administrative or judicial, determining the tax liability of Marc S. and Jeanette Sznajderman.

counsel) and Stuart A. Smith, Esq. The Division of Taxation appeared by Amanda Hiller, Esq. (Kathleen D. O'Connell, Esq., of counsel).

ISSUES

I. Whether the issuance of the notice of deficiency was barred pursuant to the three-year statute of limitations set forth in Tax Law § 683(a) or valid pursuant to the exception thereto set out in Tax Law § 683(c)(11)(B), which provides that tax may be assessed at any time within six years after the return was filed if the deficiency was attributable to an abusive tax avoidance transaction, 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); (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

Prior to the hearing, the parties entered into a First Stipulation of Facts on November 14, 2012, which contained 80 separately numbered paragraphs. On November 28, 2012, the parties entered into a Revised First Stipulation of Facts, which contained 79 separately numbered paragraphs. The stipulated facts set forth in the latter document have been incorporated into the facts below to the extent they are relevant and proper findings.

In addition, petitioner submitted 397 proposed findings of fact, which have been incorporated substantially into the facts below, except proposed findings 1, 2, 19, 20, 23, 24, 167, 270 through 275, 301, 302 and 381, which are conclusory in nature; 27, for which no citation is given; 79 through 86, 91, 171, 179, 181, 185, 186, 224, 262, 265, 276 through 279, 327 through 329, 335, 345, 346 and 356 through 358, which are not proper findings of fact because they merely list witnesses, paraphrase or quote testimony; 130, 131 and 266 through 269, which are findings of credibility; 280 through 292, 296, 303, 304, 305 through 317, 318 through 326 and 389 through 397, which constitute argument; and 185, which is irrelevant.

At hearing, petitioner objected to the admission of the Division of Taxation's exhibits SS, Expert Report of Robert Peterson in ***Zeluck v. Commr. of Internal Revenue*** (103 TCM 1537 [2012]), and UU, the transcript of the matter of ***Zeluck***. Petitioner filed a motion to exclude the exhibits, which was opposed by the Division of Taxation. The exhibits are accepted into evidence, noting petitioner's objections and will be accorded the weight they are deemed to deserve given the reason for which exhibit SS was prepared and the relevance of the ***Zeluck*** decision with respect to this matter.

1. Petitioner, Marc S. Sznajderman filed a resident personal income tax return for the year 2001 (year in issue) 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 for the purpose of acquiring, drilling and developing oil and gas wells.

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. Subsequently, Mr. Sznajderman 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 is with this financial and business background that petitioner approached his investment in Belle Isle.

5. In 2000, petitioner was introduced to Richard Siegal,[3] 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.

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 conduct oil and gas drilling ventures. These partnerships were designed to be eligible to deduct intangible drilling costs (IDC) 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

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

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 former document informed 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 income of $29,400.00 per unit (where one unit was valued at $280,000.00). The investment proposal said it aimed to redeploy tax dollars to achieve a deduction equal to 2.5 times out-of-pocket expenses in the first year. 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 execution of a full recourse promissory note by the partner in the sum 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 set up several companies to perform different functions in the investment. 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 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 financial expert, believed that petitioner had a reasonable opportunity to both make and lose money on his investment in Belle Isle.

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.

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 Richard 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,

i.e., 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. 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, believing that the courtesy of extending the credit was Richard Siegal’s way of providing additional incentive for participating in the partnership.

21. In all, the general partners in Belle Isle contributed capital 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 petitioner’s participation in the partnership, he 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 current (2001) year.

23. On December 13, 2001, petitioner executed a full recourse subscription note in the sum of $540,000.00 as described in the above paragraph. The note provided for an interest rate of 8% per annum. Interest 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. All accrued and unpaid interest was due and payable on December 31, 2009 and 50% of petitioner's share of Belle Isle's revenues 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) 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, Belle Isle's partners each made 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, like 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. As an added protection for the creditor, petitioner was required to execute a separate collateral agreement with SS&T that required him to purchase municipal bonds that could 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, petitioner had the option to pay the partnership 15% of the face value of the subscription note, which sum SS&T would 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.

27. Both the 8% interest rate provided for in the note and the 7.88% rate expected for the municipal bonds were reasonable for the relevant periods.

28. The payment and surety provisions of both the subscription note and the collateral agreement were subsequently modified in a letter, dated December 13, 2001, from Richard Siegal to petitioner, which provided that petitioner 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 modification evidenced an intent to further secure petitioner's obligation to SS&T.

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 of 60% of his distribution from Belle Isle to SS&T for purposes of purchasing the municipal bonds to collateralize his subscription note liability 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 consideration of this modification, petitioner agreed to increase the percentage of his distributions assigned to SS&T from 60% to 75%.

Petitioner 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 for the purchase of bonds to collateralize his subscription note and his share of the turnkey note liability. 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.

31. Many parties are assembled to perform all the tasks necessary for drilling a well. The operator was the party that acquired the lease and assumed the working, or cost, interest, and also determined if it would add partners, in which case those partners would receive a proportionate share of the working interest. The operator provided 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 engaged was the drilling contractor, who was responsible for providing the drilling rig and personnel. Drilling contractors were 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, provided 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 would 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, it 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 turnkey contract price, 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. 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.[4]

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%.

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.

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[4]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 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 said he did not know that Richard Siegal set the price, even though he admitted Mr. Siegal controlled SS&T and was behind the decisions made on behalf of Belle Isle. Petitioner conceded that he 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 the 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.

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; the collateralization features exemplified by the collateral agreement; 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, 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 financial expert, 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.

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 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 be able to satisfy that obligation. However, in the event the bonds were insufficient or otherwise unavailable to satisfy the note, 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. 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 he relied on 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. In the period subsequent to the year in issue, Palace continued to fully pay all drilling-related costs for Belle Isle in keeping with the turnkey drilling contract. 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. 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 inputted 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 IDC's 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 IDR's.

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); (p) and the 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.

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 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. The Division allowed the cash portion of petitioner's investment but continued to disallow the note or debt portion of petitioner's investment totaling $540,000.00.

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.

STATEMENT OF THE PARTIES' POSITIONS

92. Petitioner contends the Division of Taxation's proposed adjustments to his 2001 personal income tax may only be made if the statute of limitations is extended pursuant to Tax Law § 683(c)(11)(B). Petitioner believes that the six-year statute of limitations provided for in that section is inapplicable because his investment in the Belle Isle partnership was not an abusive tax avoidance transaction. Petitioner contends that the record supports his position that he did not have avoiding tax as a principal purpose in investing in the partnership; that the Division has allowed his cash investment as deductible IDC; that the debt was genuine under the applicable law; and that the investment and the partnership transactions had and have economic substance and significant nontax purposes.

93. The Division of Taxation argues that petitioner has not met his burden of proving that the Belle Isle partnership transactional structure was not an abusive tax avoidance transaction subject to the six-year statute of limitations applicable to such transactions. The Division believes that the chief purpose of the investment was to avoid or evade tax and that petitioner was unable to prove that the investment had economic substance or a valid nontax purpose. In addition, the Division urges upholding its denial of certain IDC because petitioner did not prove that the transaction, his investment, had a reasonable possibility of profit. The Division contends that even if economic substance was demonstrated, the deductions should be disallowed because the subscription and turnkey notes do not constitute bona fide or genuine debt. Also, the

Division urges the imposition of penalties if it is determined that an abusive tax avoidance transaction occurred.

CONCLUSIONS OF LAW

A. Petitioner contends that the Notice of Deficiency issued to him is barred by the statute of limitations, noting that Tax Law § 683(a) provides for assessment of additional personal income tax within three years from the due date of the return or the date it was filed, whichever is later. Here, petitioner filed his 2001 return on April 15, 2002, meaning the Division could assess a deficiency at any time on or before April 15, 2005. Since there is no dispute that the Notice of Deficiency was issued on March 14, 2008, it was issued beyond the three-year statute of limitations and petitioner contends its issuance was time-barred. Although there are several exceptions to the three-year statute of limitations set forth in Tax Law § 683(c) and (d)(1), only one is applicable herein.

Tax Law § 683(c)(11)(B) provides that tax may be assessed at any time within six years after the return was filed if the deficiency was attributable to an abusive tax avoidance transaction. For purposes of Tax Law § 683(c)(11)(B), an abusive tax avoidance transaction is defined as "a plan or arrangement devised for the principal purpose of avoiding tax. Abusive tax avoidance transactions include, but are not limited to, listed transactions described in paragraph five of subsection (p-1) of section six hundred eighty-five of this article" (Tax Law § 683[c][11][C]).

Tax Law § 685(p-1)(5) provides that the terms "reportable transaction" and "listed transaction" have the meanings given to them in Tax Law § 25 and the term "listed transaction" includes any transaction designated as a tax avoidance transaction pursuant to that section. A New York reportable transaction is a transaction that has the potential to be a tax avoidance transaction as determined by the commissioner (Tax Law § 25[a][2]) and may be prescribed by regulation (Tax Law § 25[a][3]). The commissioner has the authority to designate specific transactions that are the same as, or substantially similar to, transactions the commissioner has determined to be tax avoidance transactions (Tax Law § 25[a][4]).

The regulation at 20 NYCRR 2500.3 further defines the term "New York reportable transaction" as follows:

> (a) General. A New York reportable transaction is a transaction that has the potential to be a tax avoidance transaction under article . . . 22 . . . of the Tax Law. 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. There are three categories of New York reportable transactions: New York listed transactions, New York confidential transactions, and New York transactions with contractual protection.

The term "New York listed transaction" is defined in the regulations 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].)

In fact, the Department did issue Taxpayer Services Bureau memoranda, TSB-M-05(2)C and TSB-M-05(4)I, that further explained the reporting requirements with respect to the disclosure of information relating to transactions that presented the potential for tax avoidance.

B. The burden of proof with regard to the issue of whether the subject transaction was an abusive tax avoidance transaction rests with petitioner. (***Matter of Sholly***, Tax Appeals Tribunal, January 11, 1990 [where a six-year statute of limitations was applicable pursuant to Tax Law §

1083(d) with respect to an omission from gross income of an amount in excess of 25 percent of the amount stated on the franchise tax report].) In ***Matter of Sholly***, the Tribunal relied on Tax Law § 689(e) and § 1084(e), which expressly place the burden of proof on the petitioner, subject to certain exceptions inapplicable here. In view of that express statutory directive, the Tribunal rejected federal case law placing the burden of proof on the Internal Revenue Service, saying it was not controlling for New York tax purposes and that the taxpayer bears the burden of showing that the six-year limitations period does not apply.

C. Without a doubt, petitioner's investment in Belle Isle was painstakingly dissected by the parties at hearing and in their briefs. From the testimony and the documents submitted, it appears that the structure of the transaction crafted by Richard Siegal accomplished the goal of bringing investors together, pooling their funds and using the capital to drill oil and gas wells that had been chosen for production potential.

Although the Division objects to various aspects of Mr. Siegal's scheme to create fractional general partnership interests in oil and gas wells, thus qualifying them for IDC deductions, it has been no more successful herein than the IRS or earlier efforts of its own to demonstrate that the structure of the deal was unsound. (***Zeluck v Commr of Internal Revenue***)

But the creation of a valid partnership, which in turn contracted with drillers pursuant to a turnkey contract and used creative equity and debt financing, is not the full scope of the inquiry made by this determination. Economic substance apart from the tax benefits will not be concluded if the transaction was based on nongenuine debt or if any key part of the transaction was not reasonable, such that the IDC deductions generated were also not reasonable. These are issues for which petitioner bears the burden of proof (***Matter of Sholly***).

D. The Tax Court decision in ***Zeluck*** is dispositive of the issue of whether the structure of this transaction created genuine debt, which would support an argument that the transaction has economic substance, a valid business purpose and not merely elevating form over substance.

The context within which the instant transaction occurred, the oil and gas industry, is an important factor in the determination of whether petitioner's investment is an abusive tax avoidance transaction.

> The IDC [intangible drilling costs] deduction was written into the tax code in 1913 and percentage depletion in 1926. These provisions and the working interest exception have an established history and are there for a reason. They work to encourage individual investment in the oil and gas industry and to influence the competitiveness of small independent producers.
>
> Moreover, these provisions support an oil and gas industry that is a significant piece of our national economy. An American Petroleum Institute study found that the oil and gas industry's total employment impact to the national economy in 2011 accounted for 9.8 million jobs or roughly 5.6% of total US employment. These provisions help to stimulate production for small independent producers which directly contributes to US employment, US energy security, and keeping US dollars at home.

(*Repealing the IDC Deduction Would Cost Thousands of Industry Jobs*, http://energytaxfacts.com/2013/11/oil-and-gas-journal-op-ed-repealing-the-idc-deduction-would-cost-thousands-of-industry-jobs [Independent Petroleum Association of America, Energy Tax Facts,, November 13, 2013].)

Congress established this deduction to encourage and entice investors to invest capital in the very risky business of exploring for and developing gas and oil, without which adequate capital would not be available for doing so. Even Mr. Plastino, petitioner's financial expert witness could only place the reasonable chance of profitability as equal to the reasonable chance of incurring a loss.

Intangible drilling costs are payments for nonsalvageable capital expenditures incurred in connection with oil and gas drilling. Because they have no salvage value, they have been permitted treatment as expenses and deducted in the year incurred, rather than over the life of the project (IRC § 263[c]; Treas Reg § 1.612-4[a]). Petitioner testified that he knew of this advantageous benefit and conceded that he would not have accepted the investment proposal without the tax benefits.

E. The ***Zeluck*** case, which involved a Richard Siegal oil and gas partnership, presented the same investment scheme as the one in Belle Isle. In ***Zeluck***, the plaintiff invested $310,000.00 in an oil and gas partnership in 2001, $110,000.00 in cash and $200,000.00 in a subscription note due in 2009. The partnership then used the subscription notes as security on a turnkey note given to a drilling company. In addition, plaintiff Zeluck signed an assumption agreement that made him liable on the turnkey note up to the amount of his subscription note.

To this point, the ***Zeluck*** matter is indistinguishable from the facts herein, most notably in the Tax Court's acceptance of the transactional structure. However, the facts in ***Zeluck*** diverge thereafter. Plaintiff Zeluck claimed deductions for 2001 and 2002 based on costs incurred by the partnership, reducing his capital account from $310,000.00 to $32,407.00. In 2003, the partnership terminated and distributed the capital account proceeds to plaintiff. Zeluck never made payments on the subscription note and failed to make scheduled interest payments. A notice of deficiency was issued to Zeluck by the IRS based upon the debt arising from the subscription note and assumption agreement becoming nongenuine in 2003. The Tax Court held that Zeluck had to recognize a gain of $200,000.00 for 2003 pursuant to IRC § 465(e), which provides for a recapture of losses where risk no longer exists.

Significantly, the Tax Court did not question the investment's financial structure prior to the year 2003, when the partnership abruptly terminated and the debt became nongenuine, thus accepting such debt in prior years as genuine. The terms of the subscription note in ***Zeluck*** were almost identical (with no material differences) to that in this matter, down to the security interest he gave to the partnership to collateralize his payment on the subscription note.

The court appeared to go out of its way to confirm the propriety of the transaction. It noted that Richard Siegal had decades of experience in the oil and gas industry, participating in the drilling of approximately 3,000 wells. It made a point of noting that Siegal's tax returns and the returns of various entities he owned and operated had been audited by taxing authorities (including the New York State Department of Taxation and Finance) "many times over his career with no material changes made to the returns." In fact, the partnership in ***Zeluck*** had been audited by New York State for the year 2001, presumably with no material change.

In ***Zeluck***, just as in the instant matter, Richard Siegal owned or organized all of the entities with which the investment partnership did business. Those included many of the same companies that did business with Belle Isle: Palace, Vail Drilling Co., BOM and BiState. So closely aligned are the facts in the two matters, it is worthwhile to note the Tax Court's description of the ***Zeluck*** transaction.

> PW Partnership and Palace Exploration entered into an agreement [prospect agreement] whereby PW Partnership would pay $370,000 to receive an interest in certain well prospects Palace Exploration owned. PW Partnership also entered into a turnkey drilling contract with Vail Drilling. According to the turnkey drilling contract, Vail Drilling agreed to begin drilling on well prospects in which PW Partnership owned an interest by the end of 2001.
>
> In exchange for providing drilling services, Vail Drilling received $22,440,000 from PW Partnership, $7,720,000 in cash and $14,720,000 in the form of a promissory note written by PW Partnership in favor of Vail Drilling [turnkey note]. The turnkey note carried the same payment terms and December 31, 2009, maturity date as the subscription notes except no interest was required to be paid on the turnkey note during 2002. The turnkey note was secured by the subscription notes payable to PW Partnership, all collateral securing the subscription notes, and the contract between Vail Drilling and PW Partnership.
>
> Pursuant to the turnkey drilling contract and the turnkey note, PW Partnership provided the subscription notes from each partner as collateral for the turnkey note, as well as any interests PW Partnership held in the well prospects or well

> production. In addition, petitioner, Kevin Zeluck, Mr. Weitz, Mr. Luxenberg, and Mr. Schoenhaut each entered into a separate assumption agreement with Vail Drilling by which they assumed their pro rata shares of the turnkey note according to the percentage interests they held in the PW Partnership. The amounts of the individual liabilities could not exceed the amounts due under each partner's individual subscription note [including accrued interest]. The subscription notes and assumed liabilities on the turnkey note were coterminous liabilities; when a partner made a payment on the subscription note liability, both liabilities were reduced by the amount of the payment. The same security interests granted to PW Partnership in the subscription notes were granted to Vail Drilling as collateral for the assumption agreements. (***Zeluck***.)

F. The Tax Court held that for the year 2002, Mr. Zeluck's liability under the subscription note and related assumption agreement was genuine, not becoming nongenuine until 2003 when the partnership abruptly terminated. However, since the instant matter is analogous to the circumstances presented in ***Zeluck*** for 2002, it remains important guidance herein, because if petitioner's debt is found to be genuine, it supports the notion that the investment had economic substance and was not merely elevating form over substance.

The Tax Court's test for genuine indebtedness was garnered from ***Welch v. Commissioner*** (204 F3d 1228, 1230 [9th Cir 2000]) where the court enumerated seven factors in determining whether a genuine indebtedness existed, which were listed with the proviso that no one factor may be determinative or that the list is exhaustive: (a) whether the promise to repay is evidenced by a note or other instrument; (b) whether interest was charged; (c) whether a fixed schedule for repayments was established; (d) whether collateral was given to secure payment; (e) whether repayments were made; (f) whether the borrower had a reasonable prospect of repaying the debt; and (g) whether the parties conducted themselves as if the debt was genuine.

Just as the Tax Court held that the subscription note and assumption agreement constituted a genuine debt for 2002 based on the above-referenced factors, the year analogous to the circumstances herein, the facts in this matter support a conclusion that a genuine indebtedness was created consistent with the factors enumerated above.

Pursuant to the subscription agreement, petitioner paid to the partnership $300,000.00 in cash and tendered a full recourse promissory note in the sum of $540,000.00 due December 31, 2009 with interest of 8% after an initial grace period at a lower rate. Belle Isle then pledged the subscription notes as collateral for the turnkey note given to SS&T. Petitioner also assumed a pro rata share of the liability under the turnkey note through the assumption agreement he executed with SS&T and Belle Isle, thus creating a parallel and coextensive liability between the subscription and turnkey notes. The turnkey note contained similar terms as the subscription note, calling for Belle Isle to repay by December 31, 2009 at 8% with a lower initial rate. The ***Zeluck*** Court found these notes to be genuine indebtedness of the partner and the Division has not convincingly countered with any evidence or arguments to find otherwise. Further, the facts confirm that these transactions were treated consistently in the financial books and records and tax returns of Belle Isle.

With respect to the second requirement for finding a genuine indebtedness, it is clear that the terms of the notes called for payment of interest at a fixed rate of 8%, which was payable quarterly until 2003, when payments were to be taken from net operating revenues. Again, the Court in ***Zeluck*** found the same notes to constitute genuine indebtedness.

The subscription and turnkey notes both provided repayment schedules for the principal amounts due thereunder by a specified maturity date. The terms of both notes call for payment of principal, after payment of interest, out of 50% of the remaining net operating revenues. By memorandum dated July 29, 2004, this percentage was raised to 75% to accelerate payments to facilitate the purchase of bonds that would pay off the remaining principal due by the maturity date. A key factor considered by the courts in finding a valid indebtedness is the fixed maturity date, which indicates a fixed obligation to pay. (***Hardman v. U.S.***, 827 F2d 1409, 1412 [9th Cir

1987].) The fact that both the subscription note and turnkey notes had such stated maturity dates enhances the repayment schedules set forth.

The fourth factor used by the Court in ***Zeluck*** to determine whether the debt was genuine was whether collateral was pledged to secure payment. Both the subscription and turnkey notes were secured. The former were secured by a security interest in his partnership interest and rights to the production and proceeds from Belle Isle's oil and gas wells and the latter by the partners' subscription notes, any collateral securing the subscription notes and the partnership's interests in the wells and production therefrom.

The requirement that repayments be made has been fulfilled by petitioner's full compliance with his scheduled payment obligations set forth in the subscription and assumption agreements.

As of July 2012, Belle Isle's partners had paid $885,387.00 in interest on their subscription notes. During 2002 and 2003, Belle Isle's partners each made 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. Apart from his four payments in the amount of $10,800.00 in 2002, petitioner made payments of interest from partnership distributions from 2003 through 2010 totaling $12,952.00; and 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. Since all accrued and unpaid interest is due and payable on maturity, any arrears do not constitute a breach of the terms of the notes by the terms of the agreements.

From the credible testimony of Mr. Sznajderman and the agreements and notes he signed, it is concluded that he had a reasonable expectation of repaying the debt pursuant to the terms of the notes he executed. His experience and resources, along with the collateral agreements and the temporary assignment of net proceeds to purchase municipal bonds that at maturity, would cover the face value of the notes confirm this. Petitioner testified that he was well aware of the fact that he was responsible for any interest remaining due at maturity and was ready to meet that obligation if that contingency arose, cognizant of the real possibility that the ultimate amount due might be very sizeable.

Finally, the Court in ***Zeluck*** looked to see if the parties conducted themselves as if the debt was genuine. This holistic part of the test looked at the entire transaction. In the instant matter, the record confirms that the parties intended to create a debtor-creditor relationship with the execution of the subscription and turnkey notes, that they conducted themselves in a manner consistent with the creation of a genuine debt and took measures to insure that the debt would be repaid.

The parties followed the terms of the notes and agreements they executed, which included modifications to the maturity dates and terms of the purchase of municipal bonds to pay for petitioner's principal amount due, neither of which compromised the original intent to create a debtor-creditor relationship (***see generally, NA General Partnership v. Commr.***, TC Memo 2012-172 [2012]), but did further support the fact that the parties followed provisions in the assumption agreement in furtherance of the terms of the subscription notes.

G. There is no evidence to show that the Belle Isle partnership was not properly formed or operated as a valid New York partnership that invested in the acquisition and development of oil and gas leases, acquired oil and gas leases developed and operated by other oil and gas companies, and produced and sold hydrocarbons.

The facts and analysis above demonstrate that petitioner and his partners in Belle Isle purchased their interests with a combination of cash and debt and shared proportionately in the revenues and liabilities of the partnership as intended. (Partnership Law § 10; ***Boyarsky v. Froccaro***, 125 Misc2d 352 [1984].)

Although the Division raised concerns about the legitimacy of Belle Isles's acquisition of working interests in the wells in which it bought interests and petitioner's status as a general partner that also acquired a general interest, thus allowing him to share in the tax benefits (IDC's), it has not pointed to any credible flaw in the agreements or notes that support such concerns. It was established that petitioner's working interest was burdened with the costs of development and operation of the property, and was entitled to a percentage of the proceeds of those activities. (***Marathon Oil Co. v. Commr.***, 838 F2d 1114 [10th Cir 1987].)

Belle Isle's operations were carefully monitored and recorded by BOM, which maintained the record-keeping system that tracked well production, capital, revenues, losses, and other financial and statistical information. In turn, this information was provided to Belle Isle's accountants who entered the information on Belle Isle's financial books and records and tax returns.

From this, it is concluded that petitioner's investment transaction with Belle Isle created genuine debt, recognized by the United States Tax Court and supportive of petitioner's claim that his investment in Belle Isle was not an abusive tax avoidance transaction.

H. Petitioner was a savvy and intelligent businessman with an expertise in finance. His credible testimony indicated that he investigated the Belle Isle partnership before investing and trusted Richard Siegal, the father of a business associate (Bippy Siegal) with considerable experience and a good reputation in the oil and gas industry. He was not intimidated by the risks involved in the venture and candidly spoke of how he valued the tax incentives outlined in the investment proposal, which he understood had the potential to deliver a deduction estimated to be 2.5 times an investor's cash investment the first year. In fact, he freely admitted that the investment was untenable without the tax benefits.

Petitioner testified that in all his business ventures his principal goal was to make a profit, and the Belle Isle investment was no exception, albeit with significant risks. Petitioner thought that an investment in Belle Isle would diversify his portfolio of investments with a counter-cyclical (to the stock market's) position that would generate cash flow through petroleum and gas production. However, he conceded that the tax benefits were critical to his ability to realize a net gain on his investment. This resonated with the language of the investment proposal which identified its aim as a "redeployment of tax dollars to achieve a deduction equal to 2.5 times the amount of out-of-pocket cash actually expended in the first year." And, in fact, the goal was achieved.

Given petitioner's desire to achieve a profit in all his ventures and his financial background, it is baffling why he chose not to consult with any oil and gas industry experts or tax advisers with oil and gas experience before investing in Belle Isle and placing himself in a position where he could easily lose a significant sum of money. It is doubtful that he was convinced of the profitability of the investment by speaking with the promoter, Richard Siegal, whose interests he knew, or should have suspected, conflicted with his own, to the extent that Mr. Siegal would profit considerably even if Belle Isle's wells never produced commercial quantities of hydrocarbons. Likewise, it is equally as doubtful that petitioner was persuaded by the less than ringing endorsement of his own accountants, not experienced in oil and gas, who could only muster the opinion that the "[partnership] documents did not appear to them to be out of the ordinary or cause any undue concern." Rounding out what he termed "due diligence," he mentioned looking at an opinion prepared for another Siegal partnership, scanning a list of other investors (identifying some he knew) and seeking unspecified information on the oil and gas industry on the internet. Together, these efforts do not rise to a level of due diligence of an experienced and prudent investor.

It is true that petitioner's belief that he could make money on his investment was supported by the testimony of his financial expert, Mr. Plastino, who asserted that based upon his analysis of the partnership, performed 11 years after the fact, the structure of the investment, including the notes signed by petitioner that provided for significant interest rates, his chances of making a profit were equal to incurring a loss. But Mr. Plastino's analysis only established that there was a potential for profit that was no greater than the potential for loss. Mr. Plastino's conclusions stressed the volatility of the industry, just as the testimony of Mr. Hudgens illustrated how the analysis and selection of the Chapman 34-2 well, foreseen as a well that would produce a substantial return on investment, ultimately developed problems and became a "dud."

Petitioner did not have any knowledge of how the turnkey contract price was reached other than he knew Richard Siegal set the price. He read the turnkey agreement with care prior to his investment because he believed it was an important document that defined his participation as a general partner with a working interest in the wells (through Belle Isle). He knew that his IDC deductions were derived from Belle Isle's IDC deductions that sprung from the turnkey contract price and that those deductions were precisely as promised in the Investment Proposal based upon the price set by Mr. Siegal.

I. Although the structure of the investment has been found to create genuine debt, it remains to be determined if the terms of the turnkey contract were reasonable, such that the intangible drilling costs generated therefrom were reasonable also and not abusive. The determination of whether this transaction constitutes an abusive tax avoidance transaction now turns on whether the price and other key terms are based on contractual elements to which value can be ascribed

Initially, it should be noted that the copies of the turnkey agreement and many of the other contracts and notes in evidence were not fully executed or even executed at all, e.g., the agreement of partnership, additional collateral for subscription note and prospect agreement. The documents were accepted into evidence as material and relevant to the issues herein and they are deemed true copies of the documents that credible testimony identified as having been executed. This is so, even though originals were not located after a conscientious search almost 11 years after the documents were created. (***See*** State Administrative Procedure Act § 306[1]; Prince, Richardson on Evidence § 568 [10th ed 1973] [whenever a party seeks to prove the contents of a writing, he must produce the original writing or satisfactorily account for its absence (the best evidence rule)].)

With respect to the turnkey agreement specifically, petitioner did review it before he invested in the partnership in 2001, and the managing partner, Mr. Coleman, confirmed that he routinely signed the turnkey agreements on behalf of each partnership in his capacity as managing partner. Further, a memorandum from Mr. Siegal to petitioner, dated January 17, 2002, noted that the memorandum was accompanied by the Belle Isle prospectus and the countersigned closing documents. The fact that the parties subsequently conducted themselves consistent with the terms of the turnkey agreement supports a finding that the parties executed and performed on the agreement. Thus, it is determined that the contract was executed.

J. In ***Bernuth v. Commr.*** (470 F2d 710 [2d Cir 1972]) ***affg*** 57 TC 225), the question presented was whether the Bernuths were entitled to claimed deductions for IDC for several oil and gas wells in which they had fractional interests. In ***Bernuth***, the IRS utilized engineering and evaluation reports to establish average costs of drilling wells under straight footage contracts and adding a 30% increment to all for the generally high price of turnkey contracts. The result was then compared to the turnkey contract price agreed to by the Bernuths, and the difference became the basis for the deficiency issued. In finding for the IRS, the Court noted the IDC deduction provided a strong incentive to overstate the drilling costs and that investors in "package deals" do not have the same incentive to minimize costs as an independent investor who must negotiate the drilling price himself. The Court held that it was the burden of the taxpayers to come forward with proof about the reasonableness of the drilling deductions, stating,

> Consequently, we agree with the Tax Court that the mere entry into evidence of the terms of the contract here did not operate to overcome the presumption of correctness given to the Commissioner's deficiency determination. In view of the obvious incentive for padding the drilling costs here, . . . the Tax Court was not at all remiss in expecting the taxpayers to come forward with proof [of] . . . the drilling deductions.

(***Bernuth*** at 716.)

The turnkey contract executed by Belle Isle was at the heart of the IDC deduction and a crucial element in determining if the transaction as a whole is an abusive tax avoidance transaction. Petitioner knew before investing that the turnkey contract drove the IDC deduction, which would be passed to him and his partners from Belle Isle. He candidly stated that he carefully examined the turnkey agreement because he recognized its importance to him as a general partner and working interest owner. Therefore, it is imperative that petitioner establish that the contract price was reasonable and grounded in tangible values, as required by the Court in ***Bernuth***.

In this matter, the turnkey drilling contract price was $10,836,000.00. The Division's investigation into the well files and estimates for some of the wells yielded an approximated drilling cost (based on AFE's) for the wells of $2.1 million using a depth estimation method performed by Mr. Morris, and a cost of $1.77 million using a methodology created by the auditor, James Fahrenkopf. According to Mr. Fahrenkopf, of the 37 wells in the Belle Isle portfolio, he had the AFE's for 75% and used the average of known AFE's for the remaining 25%, for which he did not have AFE's. The IDC claimed by Belle Isle for these wells was $9.9 million. Even allowing for the value of overhead costs, profit margin and insulation from risk, the turnkey price appears to be exorbitant in the context of the evidence adduced and the allowance by the IRS in ***Bernuth***. Petitioner's failure to ascribe values to the items he claimed added substantial value to the contract did nothing to prove the validity of the IDC deductions ultimately claimed. The fact that Belle Isle owns fractional shares in many wells, thereby making it more difficult to discern actual costs for each well, is not a compelling reason for finding that the price set by Mr. Siegal was reasonable.

Petitioner argues that even if the markup was 500%, as the Division contends, one major catastrophic event could exceed the price charged in the contract, just as one very successful well could exceed the costs of drilling all the wells combined. Therefore, petitioner reasoned, the contract must be commercially sound and reasonable. However, by that logic, *any* price would have to be considered reasonable. Further, petitioner did not address the fact that the turnkey contract required the driller to provide customary liability and property insurance, which would presumably have had an impact on any losses incurred.

Based on his experience in the field, Mr. Morris, the Division's petroleum engineering expert witness, credibly testified that 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; and target profit margins. However, even with these obligations, Mr. Morris believed from his industry experience that the standard markup on a turnkey contract was 10 to 25% over the cost of a day rate contract. The Court in ***Bernuth*** indicated the IRS had allowed a 30% premium for the added benefits of a turnkey contract. As recited in the facts, the day rate contracts typically provided that drillers would provide services based on the drillers' billing rate for rig and crew, while the operator bore all the costs and time risks of the drilling operation if trouble was encountered.

While this analysis and the resulting estimate was rudimentary, it was instructive with respect to what factors played a role in the pricing of such contracts and was based on the best information available to Mr. Morris, who had considerable experience in the industry.

On the other hand, Mr. Krehel, equally experienced and learned in the field, would only aver that he would not speculate on the pricing of the turnkey contract in issue because he believed the wells had to be analyzed individually due to their varied type and location for purposes of drilling, completion and hookup to the tank as well as the risks associated with each project. Unfortunately, Mr. Krehel did not perform such an analysis of the available well files.

Mr. Krehel stated that the turnkey contract in issue "appears reasonable relative to standard industry practice" and that it insured against unforeseen cost overruns and well problems, but given the lack of specific cost detail for each well he did not think it 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, 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. And 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.

It is noteworthy that neither Mr. Krehel's testimony nor his expert report specifically support the turnkey price paid by Belle Isle. In fact, his report states most ambiguously, "[b]y reading the terms of the turnkey agreement which specified that all well costs were included, one would assume that all costs were reasonably covered."

Although Mr. Coleman and Mr. Howard knew that Richard Siegal determined the turnkey contract price, neither gentleman knew how the price was calculated. Mr. Coleman, managing partner for Belle Isle, who also ran his own oil and gas company for 12 years, admittedly did not negotiate the turnkey agreement, did not establish the price or know how it was derived and never questioned Richard Siegal's calculation of same.[5]

After Mr. Siegal unilaterally determined the turnkey contract price, he had Belle Isle, through Mr. Coleman, and SS&T, whose sole shareholders of were Richard Siegal's three sons and his wife, agree to its terms and execute same. The absence of arms-length negotiations coupled with a complete lack of transparency fueled the strong incentive to overstate the drilling costs to maximize the IDC and made it impossible to find the turnkey price "reasonable." In fact, as the Division contends, it provided a convenient mechanism for Mr. Siegal to deliver on the promise made in the Investment Proposal to "deliver a deduction of 2.5 times the cash investment."

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[5]It is curious that petitioner was so cavalier in his acceptance of Mr. Coleman as the managing partner of Belle Isle, since he had prior experience with partnerships and was aware of the power usually wielded by such managers. Although Mr. Coleman chose to delegate all his responsibilities to others he regarded as experts, he was no less accountable for the actions of his chosen delegates, and he should have had some inkling of how the turnkey price was calculated as Belle Isle's managing partner.

Petitioner has not met his burden of proof on the reasonableness of the turnkey contract and therefore has failed to demonstrate that his investment in Belle Isle was not an abusive tax avoidance transaction. Without any proof of the value of other items in the turnkey contract, it cannot be said the price was reasonable by industry standards in light of the apparent 500% markup. Mr. Morris's opinion was not countered with any credible evidence to establish what a reasonable percentage add-on would be over the day rate. Since the significant difference between the AFE's for the wells and the contract price was not accounted for, the conclusion of an abusive tax avoidance transaction is inescapable.[6]

K. The Division's allowance of a portion of the IDC deductions to the extent of petitioner's cash contribution, due to equitable considerations or under a mistake of fact, is an issue not before this forum. The Division's allowance of part of the deductions claimed and adjustment of the amount of tax due herein, will not be disturbed. From the evidence adduced, the Division's position with respect to whether the investment was an abusive tax avoidance transaction appears unchanged. For purposes of this determination it is of no moment that the Division limited its argument to the debt portion of the consideration given. Since it was petitioner's failure to substantiate the price of the turnkey contract that is considered the decisive factor herein, both the debt and equity portion of the investment are treated equally. As in ***Bernuth***, the portion in issue was the amount over and above the drilling costs and the premium for the added benefits of a turnkey contract. Therefore, the Division's allowance has no effect on the conclusion reached herein.

The failure to justify the reasonableness of the turnkey contract price is convincing evidence that the transaction had tax avoidance as its primary motive. It may well be that

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[6]Regardless of whether you use the day rate, AFE's, the estimate used by Mr. Fahrenkopf or other estimate, it remains that petitioner needed to account for the significant cost of the turnkey contract, a logical source for possible padding of IDC's.

petitioner enters business investments to make money, but here the certainty rested with the IDC, while the prospect for making money was expertly defined as only a “reasonable chance of making money and a reasonable chance of losing money.” Thus, it is determined that the transaction had no economic substance apart from the tax benefits conferred.

L. In the instant matter, the Division has imposed penalties pursuant to Tax Law § 685(b)(1), (2), and (p). 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 the Tax Law or the regulations thereunder. Tax Law § 685(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.

It cannot be said that petitioner acted without negligence in this matter. He was well aware of the partnership documents he would be asked to sign and was provided copies of same prior to his investment. He was aware of what generated the IDC’s that created the attractive deductions promised in the investment proposal, and he was aware of the principals and decision makers of both Belle Isle and SS&T. These were red flags that went unheeded. Self-dealing between the parties to the turnkey contract coupled with extraordinary and immediate tax benefits that were directly related to the turnkey contract price and also accurately predicted by the investment proposal, at the very least, posed questions that should have signaled to petitioner that further scrutiny was necessary.

Yet, petitioner never questioned the price of the turnkey contract or sought independent professional advice with respect to this critical element underlying the generation of his very large IDC deductions. He spoke with Richard Siegal, other investors and informally asked his accountants what they thought of the investment. This did not rise to the level of bona fide independent inquiry for an investment of this magnitude and there certainly was no reliance on the advice of a tax professional with experience and expertise in the oil and gas industry.

The Tax Court in ***Bernuth*** opined that the extent to which the cost of drilling is deductible is dependent on the manner in which the price was fixed by the parties to the agreement. Just as in ***Bernuth***, the price specified in the contract between Belle Isle and SS&T appeared excessive. Since the Bernuths submitted no evidence to account for the excess, the court was constrained to agree that the price was excessive given the valuations submitted by the IRS. Here, the circumstances were less favorable to petitioner because he did not negotiate the turnkey contract and he knew that Richard Siegal was the person relied upon by Belle Isle and SS&T for setting the contract price -- a dollar amount that would fix both the IDC deduction for petitioner and his Belle Isle partners and the profit flowing back to Richard Siegal. In fact, George Coleman and Paul Howard confirmed that Richard Siegal alone supplied the turnkey agreement price, which yielded precisely the IDC's promised in the investment proposal, yet neither of them, who had worked closely with Mr. Siegal for decades, had any idea how he arrived at that figure.

Given his background and business acumen, petitioner knew, or should have known, that this arrangement lacked the protections of an arm’s-length negotiated agreement and that he should have investigated further or sought the advice of an independent expert. Having failed to do either, he did not act with ordinary care and prudence, is determined to have been negligent and is liable for the penalties imposed pursuant to Tax Law §§ 685(b)(1), (2) and (p). (***Matter of Murray***, Tax Appeals Tribunal, December 14, 1995.)

With regard to the penalty asserted (and paid by petitioner) pursuant to the Voluntary Compliance Initiative (L 2005, ch 61, Part N, § 11), petitioner chose not to waive his right to appeal and thus the penalty asserted under the notice remains in issue. Therefore, the conclusion reached with regard to the penalties addressed above is applicable to the penalty paid as part of petitioner's participation in the voluntary compliance initiative, and the request for a refund thereof is denied.

M. The petition of Marc S. Sznajderman and Jeannette Sznajderman is denied and the Division's denial of refund, dated January 18, 2011, is sustained.

DATED: Albany, New York
March 6, 2014

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE