NEW YORK STATE

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	DETERMINATION DTA NO. 825455
BENTLEY BLUM	:	
for Redetermination of a Deficiency or for Refund of New York State and New York City Personal Income Taxes under Article 22 of the Tax Law and the Administrative Code of the City of New York for the Year 1996.	:	

Petitioner, Bentley Blum, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income taxes under Article 22 of the Tax Law and the Administrative Code of the City of New York for the year 1996.

Petitioner, by its representative, Kestenbaum & Mark (Bernard S. Mark, Esq., of counsel), and the Division of Taxation, by Amanda Hiller, Esq. (Christopher O'Brien, Esq., of counsel), waived a hearing and agreed to submit the matter for a determination based on documents and briefs to be submitted by November 10, 2014, which date commenced the six-month period for the issuance of this determination. After review of the evidence and arguments presented, Arthur S. Bray, Administrative Law Judge, renders the following determination.

ISSUE

Whether petitioner has established that the notice of deficiency based upon an unreported Federal audit change for the year 1996 was improper.

FINDINGS OF FACT

1. The Brooklyn District Office of the Internal Revenue Service (IRS) engaged in a program known as the Oil and Gas project examination wherein it examined various individual investors, TEFRA partnerships[1] and corporations concerning the tax years 1994 through 1997. All of the corporations under review by the IRS were controlled, directly or indirectly, by petitioner, Bentley Blum, and were engaged in the promotion, sale or operation of drilling interests in various oil and gas leased properties during the tax years 1994 through 1996.

2. The partnerships were created in order to enter into turnkey contracts with one of the corporations for the exploration, drilling and completion of oil and gas wells. Interests in the partnerships were sold to numerous investors in the United States. The partnerships claimed substantial losses for intangible drilling and other operating costs during the years in issue. Typically, investors would submit a cash payment of 15 percent of the amount of the investment and sign a long-term promissory note for the balance. Funds received by the partnerships were transferred to the various corporations and promoters and charged to various accounts concerning operations, consulting, management and income.

3. The IRS conducted its examination and concluded that the various partnership interests were not engaged in for profit and were organized as a tax shelter. It also concluded that the investments of the individual investors were not "at risk" and that the partnership activities were subject to the passive activities rules. Moreover, the IRS Engineering Division concluded that the intangible drilling and development costs that had been claimed were significantly greater

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[1]In general, a TEFRA partnership is a partnership with 11 or more partners during the partnership's tax year (Treas Reg § 301.6231[a][1]-[1][a][1]).

than the industry norms. On the basis of these findings, the IRS determined that the losses claimed by all of the investors should be disallowed and negligence penalties should be imposed.

4. With respect to the corporations and the tax returns of the individual promoters, including petitioner, the IRS examination resulted in its tracing a number of transfers of funds between the entities. The IRS proposed that the transferred amounts be treated as taxable income of the promoters, including petitioner, as either gross receipts or constructive dividends because of the lack of evidence of the transferred amounts' nontaxable status.

5. Based on the forgoing, the IRS issued to petitioner an Examination Report for the years 1994 through 1997, dated February 24, 2000, by which it made adjustments to income on the basis of finding constructive dividends, a flow through of funds and a reduction of a net operating loss carryover for the years 1994 through 1997.

6. Petitioner's representative disagreed with the proposed adjustments and argued that since 1980 one group of companies had specialized in domestic and international oil drilling and, over that period of time, had provided turnkey drilling services in nearly 300 wells. Petitioner's representative also argued that the drilling and related corporations had operated in a business-like manner and that the partners in the different drilling programs were unrelated and operated at arm's length. He also contended that the investors' initial cash investments and the amounts of their promissory notes were at risk. The legitimacy of the liabilities was supported by documentation showing cash payments on promissory notes from previous programs and litigation undertaken by the taxpayer companies to collect on prior promissory notes.

7. Petitioner's representative also argued that the taxpayer companies assumed a number of risks and were entitled to a substantial profit. He noted that the costs charged to the individual investors were arm's length and in line with the amounts charged in prior programs. With regard

to the turnkey price, petitioner's representative maintained that the taxpayer companies were obligated to cover the costs of surveying, testing, drilling and completion of the wells without additional funds from the investors.

8. With respect to the income realized by the individual companies, petitioner's representative took the position that the funds were originally deposited with marketing companies and then transferred to a cental management company that paid monies back to the individual companies to meet expenses such as payroll, operating expenses, management fees and syndication costs.[2] Petitioner's representative contended that this system created an efficient centralized accounting and record-keeping system and was regularly used by the corporate group prior to the examination. He maintained that the examination adjustments led to income each time funds were transferred between the companies with no adjustment for deductions to the transferring company. As a result, there was duplication of the income attributed to the companies.

9. On the basis of the facts and arguments presented, the IRS Appeals Office and IRS Area Counsel settled the partnership cases permitting the investors' claimed losses in an amount equal to each investor's cash investment plus 50 percent of the face amount of the promissory note.

10. After months of continued negotiations, a global approach was utilized in order to settle all of the cases. For settlement purposes, the TEFRA partnership losses would be allowed to the extent of out-of-pocket cash expenditures and 50 percent of the promissory note amounts. The partner-promoter losses that exceeded out-of-pocket cash expenditures were disallowed. As

[2]Petitioner's representative argued that the initial payment was made to the marketing companies to control liability.

to three of the partnerships that were made up of partners who were relatives, business associates or employees of petitioner in related entities, the losses were disallowed in full. For the remaining investors, the losses were allowed to the extent of one-quarter of their promissory note amounts, and the total amount of the losses was added to petitioner's 1997 taxable income.

11. The adjustments at the corporate and promoter levels consisted of a flat sum settlement of $2,200,000.00 for the 1997 tax year of Kraft Capital Corporation, an entity that was related to petitioner. In addition, a flat sum settlement of $510,000.00 in a tax deficiency for petitioner for the 1996 tax year was proposed in settlement of the 1994 through 1996 tax years. In addition, a net operating loss carry forward amount that petitioner reported for the 1997 tax year was reduced by 50 percent to make provision for the dividend and flow-through adjustments. The IRS also eliminated all of the penalties.

12. Petitioner timely filed a New York State personal income tax return for 1996.

13. The Division issued a Notice of Deficiency, dated May 22, 2012, which explained that petitioner had a deficiency of New York State and New York City personal income tax in the amount of $159,561.00 plus interest for a balance due of $473,208.56. The notice explained that it was based on the unreported federal change for 1996. Further, it calculated the New York State and New York City tax on the income base that resulted in the $510,000.00 federal tax amount. The calculation resulted in an income base of $1,378,343.00. This amount was used as the federal adjusted gross income in the Division's calculation.

SUMMARY OF THE PARTIES' POSITIONS

14. According to petitioner, Tax Law § 683(a) bars an assessment of tax for the year 1996. Petitioner submits that Tax Law § 659 does not require a taxpayer to report a flat sum settlement and that there was no change to his adjusted gross income or taxable income for 1996. Petitioner

also maintains that the global settlement was between him and the IRS was not relevant to his New York taxable income in 1996.

15. The Division maintains that it relied upon the Revenue Agent's Report created by the IRS and the adjustments reflected therein. According to the Division, the determination that the global settlement resulted in additional income is simply an extrapolation of the changes made by the IRS. It is submitted, that it is implausible to think that the taxpayer would owe additional federal taxes without an adjustment to income. The Division contends that the $510,000.00 was tax that petitioner paid on behalf of his investors that would have otherwise been assessed but was deemed petitioner's tax. The Division posits that once petitioner agreed to the terms of the settlement, he had an obligation to report the federal change under Tax Law § 659. Lastly, the Division argues that the statute of limitations has not passed because petitioner was not in compliance with Tax Law § 659.

CONCLUSIONS OF LAW

A. In this matter, petitioner's representative submitted an affidavit stating that a timely return was filed for 1996. The Division has not challenged this assertion and therefore this determination will proceed on this premise. In general, personal income tax must be assessed within three years after the return was filed (Tax Law § 683[a]). Since the last day for filing a timely personal income tax return was April 15 of the succeeding year (Tax Law § 651), it follows that the Division had until on or before April 15, 2000 to assert a deficiency of personal income tax for 1996. However, there is an exception to the forgoing rule which provides that an assessment may be made at any time if a taxpayer fails to report a federal audit change (Tax Law §§ 659, 683[c][1][C]; ***see Matter of Mulderig v. New York State Dept of Taxation and Fin.***, 55 AD3d 1159 [3d Dept 2008]).

B. In 2003, the date of the federal adjustment, Tax Law § 659 provided:

> "If the amount of a taxpayer's federal taxable income, federal items of tax preference, total taxable amount or ordinary income portion of a lump sum distribution or includible gain of a trust reported on his federal income tax return for any taxable year, or the amount of a taxpayer's earned income credit or credit for employment-related expenses set forth on such return, or the amount of any federal foreign tax credit affecting the calculation of the credit for Canadian provincial taxes under section six hundred twenty or six hundred twenty-A of this article, or the amount of any claim of right adjustment, is changed or corrected by the United States internal revenue service or other competent authority or as the result of a renegotiation of a contract or subcontract with the United States, or the amount an employer is required to deduct and withhold from wages for federal income tax withholding purposes is changed or corrected by such service or authority or if a taxpayer's claim for credit or refund of federal income tax is disallowed in whole or in part, the taxpayer or employer shall report such change or correction or disallowance within ninety days after the final determination of such change, correction, renegotiation or disallowance, or as otherwise required by the commissioner, and shall concede the accuracy of such determination or state wherein it is erroneous."

C. Here, petitioner's representative has shown through the documentation from the Internal Revenue Service that the $510,000.00 was a "Flat Sum Settlement" that constituted an agreed upon sum in satisfaction of the liability of petitioner and other parties. It was not a change in petitioner's taxable income.[3]

D. A careful reading of Tax Law § 659 shows that a taxpayer is directed to report certain specific changes to New York. However, a flat sum settlement is not one of the changes listed. It follows that there was no federal change mentioned by Tax Law § 659 that petitioner was required to report and that the Notice of Deficiency was barred by the statute of limitations.

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[3] It is noted that the federal resolution of the tax issue presented here is not unique (***see e.g. United States ex rel New River Company v. Morgenthau***, 105 F2d 50, ***cert denied*** 308 US 577).

E. The petition of Bentley Blum is granted and the Notice of Deficiency, dated May 22, 2012, is cancelled.

DATED: Albany, New York
April 16, 2015

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE