STATE OF NEW YORK

DIVISION OF TAX APPEALS

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

Petitioners, Robert and Adelaide Chuckrow, 225 Millwood Road, Chappaqua, New York 10514, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1982 and 1983.

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on October 4, 1991, at 9:15 A.M., with all briefs to be submitted by March 13, 1992. Petitioner filed a brief and reply brief on January 27, 1992 and March 13, 1992, respectively. The Division of Taxation filed a letter brief on February 26, 1992. Petitioner appeared by James J. Tully, Jr. The Division of Taxation appeared by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel).

ISSUES

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

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

III. Whether petitioners are entitled to a charitable deduction in 1982 for a painting donated to the Metropolitan Opera Association.

FINDINGS OF FACT

Petitioners, Robert and Adelaide Chuckrow, timely filed 1982 and 1983 New York State

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

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

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

The Minimum Annual Royalty Deduction

Petitioner is a private investor and businessman. In 1982 he was involved in the exploration, drilling and production of oil and natural gas, doing business as Glade Oil Company. During the course of these activities he entered into a sublease agreement with Sherwood Guernsey, III, doing business as Sherwood Enterprises ("Sherwood"). Under the agreement, petitioner was entitled to drill for and produce oil and natural gas on 22 properties located in western Pennsylvania in return for a minimum annual royalty. The amount of the

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

minimum annual royalty was $16,667.00 per site in the first year ($366,674.00 in total) and $14,245.00 per site in ensuing years (plus a cost of living adjustment after 1984). Under the terms of the sublease, petitioner was required to pay the first year minimum annual royalty on the effective date of the sublease, December 9, 1982, and to pay the second and subsequent years' minimum annual royalty one year from the effective date of the sublease (the anniversary date), and on each subsequent anniversary date.

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

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

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

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

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

> "In lieu of the cash payment on the Anniversary Date, the Sublessee, in its sole discretion, may elect to defer all or any part of the Minimum Annual Royalty due. As a condition of such deferral, the Sublessee shall pay to the Sublessor fifty percent (50%) of all Production Revenues. The term "Production Revenues" shall mean the gross revenues of the Sublessee from the sale of oil and gas produced from any of the properties.... Any amount so paid shall reduce the deferred amount of the Minimum Annual Royalty.
>
> "All deferred amounts remaining unpaid as of the 1993 Anniversary Date of

> the Sublease shall be due and payable without interest at such time. The election to defer granted in this Article shall be deemed to have been made in the event that the Sublessee shall fail to pay a Minimum Annual Royalty when due."

In a sworn and notarized affidavit, petitioner states:

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

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

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

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

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

Attached to petitioner's 1982 New York return was a Federal schedule C for Glade Oil Company on which petitioner reported a net loss of $561,074.00 comprised of intangible

drilling costs of $194,400.00 and a minimum royalty payment of $366,674.00. Petitioner reported no gross receipts or sales from this business. Petitioner is an accrual method taxpayer. The Internal Revenue Service commenced an audit of petitioner's 1982 Federal return which resulted in that return being accepted as filed.

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

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

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

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

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

Mr. Tully: "Why?"

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

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

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

Miscellaneous Expense Deductions

Petitioner's accountant during the audit years was Gerald Reich. Mr. Reich was critically ill during the audit period and unable to provide documents necessary to substantiate petitioner's claimed business deductions. In 1989, petitioner turned to an accountant named Earl Kriger for help in responding to the Division's audit. At Mr. Kriger's urging, petitioner went to the home of Mr. Reich and retrieved whatever personal and business records he could locate. Among the items recovered were expense memorandums prepared by Mr. Russell, showing expenses incurred by petitioner or Glade Oil with respect to investments in the oil and gas business. These included payments to Mr. Russell and a second individual for

reimbursement of expenses. Mr. Chuckrow also recovered cancelled checks, bank statements, and statements of accounts. These documents established payments to various persons for legal fees; payments to Mr. Reich for accounting fees; management fees to different individuals overseeing properties for petitioner; and charitable contributions. From these documents and conversations with petitioner, Mr. Kriger prepared a summary of 1982 business expenses totalling $107,826.00 and a summary of charitable contributions in the amount of $10,020.00. Explanations of the expenses were included on the summary schedule and were prepared from information provided by petitioner.[2]

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

(a) "Richard Goldwater, Attorney. August 10, 1982 business leases were sought but not culminated"	$ 2,000.00
(b) "Sherwood Guernsey - business legal fees"	1,200.00

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

(c) "James E. Conway - legal fee re: Apple Hill - to look after partnership interest which was not acquired"[3] 1,000.00

(d) "Lawrence Williams - legal fees re: Apex - 3 units that became worthless" 1,800.00

(e) "Christian Clode - for supervision of oil interests, fee - $1,000; expenses - $349" 1,349.00

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

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

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

The remainder of the expenses delineated by petitioner were explained through the

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

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

testimony of Michael Neustadt and the affidavit of Mr. Russell. Mr. Neustadt met petitioner in 1979. In 1981, petitioner hired Mr. Neustadt to investigate a hotel business in which petitioner had an investment. Mr. Neustadt performed a management audit of that business and made recommendations to petitioner for operating the business. Mr. Neustadt later became involved in petitioner's oil and gas businesses. Petitioner had an interest in a number of mineral leases in Louisiana in association with an individual named Austin Speed. Petitioner suspected Mr. Speed of dishonesty with respect to his oversight of the oil and gas operations. Mr. Neustadt was engaged to investigate. He traveled to the site of the operations to determine whether wells were in fact being drilled and to study the operations of the drilling and production business. In carrying out these activities, Mr. Neustadt reported to Richard Goldwater, an attorney representing petitioner in a lawsuit which was brought against Mr. Speed. Among the deductions claimed by petitioner were payments totalling $18,760.00 to Mr. Goldwater "for legal action against Austin Speed, who sold an interest in an oil partnership which he did not own." Copies of cancelled checks substantiate the payments to Mr. Goldwater, but there is no further information in the record describing the legal action brought against Mr. Speed or the nature of petitioner's business dealings with Mr. Speed.

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

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

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

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

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

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

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

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

Charitable Contributions

Petitioner claimed a deduction for charitable contributions in the amount of $11,001.00. The Division disallowed $3,500.00 of the total contribution claimed. On audit, petitioner

claimed that a portion of this amount represented a donation made to the Metropolitan Opera Association (the "MET") in the form of a contribution of artwork to a MET raffle. With regard to the disallowance of charitable contributions, the audit report states:

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

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

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

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

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

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

CONCLUSIONS OF LAW

A. The New York adjusted gross income of a resident individual means his Federal

adjusted gross income, modified by the New York additions and subtractions provided for in Tax Law § 612 (Tax Law § 612[a]). Similarly, a New York resident's itemized deductions are his Federal itemized deductions, with certain New York modifications (Tax Law § 615). The adjustments to petitioner's income made by the Division are not based on any of the required New York modifications. Accordingly, petitioner's entitlement to the deductions disallowed by the Division rests upon Federal statute and case law.

B. Petitioner, doing business as Glade Oil, deducted from the gross receipts of Glade Oil a minimum royalty payment in the amount of $366,674.00, as a business expense. Petitioner paid tax based on the accrual method of accounting. For the accrual method taxpayer, expenses are deductible in the taxable year in which (1) all events have occurred which determine the liability and (2) the amount of the expense can be determined with reasonable accuracy (Treas Reg § 1.461-1[a][2]). Section 1.612-3(b)(3) of the Treasury Regulations generally provides that advanced royalties may be deducted only in the year in which mineral product for which the royalties were paid or accrued is sold. That is obviously not the case here inasmuch as Glade Oil neither produced nor sold any product in 1982. There is an exception, however, for the deduction of "advanced minimum royalties" paid or accrued as a result of a minimum royalty provision. Under this exception, "advanced minimum royalties" may, at the option of the payor, be deducted in the year they are paid or accrued. In order to fall within this exception, the minimum royalty provision must:

> "require...that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least twenty years, in the absence of mineral production requiring payments of aggregate royalties in greater amounts." (Id.)

At hearing, the Division's reason for disallowing petitioner's deduction for the minimum royalty payment was articulated by the auditor who conducted this audit. He indicated that the full amount was disallowed because there was no evidence that any payments were actually made. He also stated that the promissory note executed by petitioner was, in his view, a nonrecourse note. Apparently, the auditor believed that petitioner was not obligated to pay on the note, and therefore, no liability accrued in the tax year in which the deduction was taken.

The Division offered no other reason for disallowing the deduction. As was suggested by the auditor's testimony, the Federal courts have held that an obligation that is contingent in nature does not satisfy the regulatory requirements of a minimum royalty provision. In Maddrix v. Commr. (780 F2d 946, 86-1 US Tax Cas ¶ 9189, affg 83 TC 613), the taxpayer was the sublessee of a West Virginia coal sublease. The taxpayer agreed to pay Olentangy Resources, Inc. a minimum annual royalty of $300,000.00 for the right to mine coal reserves on land leased by Olentangy. The sublease also provided that at the commencement of the sublease the taxpayer would pay Olentangy $2,540,000.00 of the annual minimum royalty, with $590,000.00 to be paid in cash and $1,950,000.00 to be paid in nonrecourse promissory notes. Olentangy's sole recourse for the taxpayer's default of any of its obligations was to terminate the agreement and proceed against the taxpayer under the sublease. Upon execution of the sublease in 1977, the taxpayer paid Olentangy $31,230.00 in cash and executed a $103,239.00 nonrecourse note. No coal was mined in 1977, and the taxpayer, who selected to be taxed on the accrual method of accounting, filed a Federal income tax return claiming a business loss of $142,387.00. The court concluded that nonrecourse notes secured only by the taxpayer's mineral interest did not fulfill the requirement of Treas Reg § 1.612-3(b)(3). It explained the basis for its decision as follows:

> "Since the notes issued by the Taxpayer were nonrecourse and secured only by the mineral interest itself, Olentangy could only look to the Taxpayer's interest in the minerals themselves for payment of Taxpayer's obligation. In Wing v. Commissioner [CCH Dec. 40,262], 81 TC 17, 38-42 (1983), the Tax Court expressly held that such an arrangement did not meet the terms of § 1.612-3(b)(3) because it did not **require** annual and uniform payments. In similar circumstances, courts have consistently rejected tax deductions based on nonrecourse notes contingent upon the production of minerals." (Id.; see also, Green v. Commr., 52 TCM 1392.)

At hearing, petitioner proved that the note he executed was a recourse note and that he is fully obligated to pay the note without regard to any other rights or obligations he might have, or have had, under the sublease. Thus, petitioner overcame the Division's only articulated basis (up to that time) for disallowing the deduction. Petitioner's first brief was confined to a discussion of the nature of the promissory note and the evidence establishing that it was a full

recourse note. In its brief, the Division did not address the nature of the promissory note or whether the note obligated petitioner to pay the sublessor without regard to the terms of the sublease, apparently abandoning its original basis for disallowing the deduction. Rather, the Division notes that the sublease contains a provision which allowed Glade Oil to defer payment of the annual royalties under certain conditions. The Division argued that as a result of the deferral provision the sublease did not require annual and uniform payment of advanced minimum royalties, hence no royalties were paid or accrued by petitioner under a minimum royalty provision within the meaning of Treas Reg § 1.612-3(b)(3).[4]

In response to the argument articulated in the Division's brief, petitioner argues that the Division should be prohibited from raising new grounds for denying the deduction in its brief. In his brief, petitioner states:

> "The Petitioners relied on the initial representations by the Department that the MAR was disallowed because the auditor perceived it to be non-recourse in nature, and indeed, that was the focus of testimony at the hearing. At no time did the testimony focus on whether the lease provision allowed payments to be deferred. The Department's new position has been raised too late in this proceeding, and may not properly be considered by this court."

In this proceeding, petitioner bears the burden of proof to show entitlement to each of the deductions claimed on his New York return, including the burden of establishing that the deductions satisfy all statutory and regulatory requirements (Tax Law § 689[e]). At the same time, petitioner is entitled to a fair hearing in which all of the elements of due process are satisfied (Tax Law § 2000). At a minimum, due process requires reasonable notice of the basis for the Commissioner's determination of a tax deficiency because it is impossible for a taxpayer to respond effectively if he is uninformed or misled (see, Matter of Silverstein v. Minkin, 49 NY2d 260, 425 NYS2d 88; Matter of Diamond Terminal Corporation v. Dept. of Taxation and

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[4]The Division also argued that the deduction was properly disallowed under the regulation because no mineral product was sold in 1982. Inasmuch as petitioner never alleged that the deduction was related to oil or gas produced or sold in 1982 and did not claim entitlement to the deduction on this basis, this argument need not be addressed.

Finance, 158 AD2d 38, 557 NYS2d 962; cf., Matter of Tao v. State Tax Commn., 125 AD2d 879, 510 NYS2d 233).

Based upon statements made in the audit report and the testimony of the auditor, it was reasonable for petitioner to believe that the Division's sole objection to the minimum royalty deduction was its belief that the promissory note given in payment of the royalty was a nonrecourse note and that the liability did not definitely accrue in the year in which the deduction was taken. The Division never cited, in its answer or at hearing, to any statute, regulation or case which supported this position. Nevertheless, petitioner introduced sufficient evidence to establish that it was fully liable for payment of the promissory note, and, while citing to Treas Reg § 1.612-3(b)(2), petitioner's legal brief concentrated primarily on proof establishing that under Treas Reg § 1.461(a)(2) the liability definitely accrued in the tax year in which the deduction was claimed. It is understandable that petitioner would have proceeded as he did and would now protest the Division's assertion in its brief of alternative grounds for denying the deduction. While giving weight to these considerations, I am nevertheless constrained to consider the Division's position.

Petitioner carries the burden of proof to show entitlement to the deduction under the governing Federal law. The basic rules governing the deductibility of minimum annual royalty payments are set forth in Treas Reg § 1.612-3(b)(2), and it is petitioner's burden to show that the deduction in issue satisfies the requirements of the regulation (cf., Matter of Smith v. State Tax Commn., 68 AD2d 993, 414 NYS2d 803). In Matter of Chamberlin (Tax Appeals Tribunal, January 30, 1992), the Tribunal sustained the Division's denial of a bad debt deduction, although the Division failed to formulate any argument that responded to petitioner's claim of entitlement to the deduction. In his determination, the administrative law judge held that the Division's failure to state a rationale for its notice of deficiency provided him with no basis for denying the deduction. The Tribunal rejected this approach and held that application of the controlling law to the facts alleged by the petitioner dictated a result in the Division's favor. (Id.) In contrast to Chamberlin, the Division has articulated a legal position which responds to

the facts adduced at hearing. Moreover, the Division's raising of additional grounds for denial of the deduction in its posthearing brief is not prejudicial to petitioner. Petitioner had the opportunity to and did respond to the Division's arguments by filing a memorandum of law. If petitioner believed it necessary to offer additional evidence in support of its position he might have requested an opportunity to do so. Consequently, I find that the Division's arguments must be considered.

To permit a deduction where no income has been received from the sale of minerals, a minimum royalty payment agreement must require that a substantially uniform amount of royalties be paid annually over the life of the lease or for a period of at least 20 years. In determining whether the minimum annual royalty provisions are satisfied, it is necessary to look to the sublease agreement as a whole, along with any pertinent background information (Green v. Commr., supra). The Federal courts have held that:

> "the lease cannot permit the deferral of payment of the minimum annual royalty or relegate its payment to production. There must be an enforceable obligation to make a substantially uniform payment each year." (Walden v. Commr., 55 TCM 332, 334; see also, Oneal v. Commr., 84 TC 1235; Vastola v. Commr., 84 TC 969.)

The terms of the sublease between petitioner and Sherwood ostensibly require that substantially uniform payments be made over the life of the lease. However, the deferral provision enabled petitioner to defer full payment of the minimum annual royalty, at least until 1993, by assigning 50% of the production royalties to Sherwood. Even at the end of the 10-year deferral period, Sherwood's ability to collect the balance due is uncertain. It would appear that petitioner had complete discretion to avoid the minimum annual royalty by exercising the option to defer payment. From this, it can be concluded that advanced royalty payments were not required to be paid at least annually (see, Walden v. Commr., supra).

Petitioner alleges that neither he nor the attorney who drew up the sublease agreement believed that deferral of payments was allowed. Petitioner's subjective belief is not material in determining whether a valid minimum annual royalty provision exists. The first rule of construction of every contract is that when the terms of a written contract are clear and unambiguous the search for the intent of the parties is confined to the language of the contract

(Matter of Nichols v. Nichols, 306 NY 490). The language of the deferral agreement is not vague or unclear, and it is unnecessary to search for meaning outside of the words of the agreement.

Other arguments made by petitioner are also rejected. In support of his position, petitioner cites to Revenue Ruling 77-489, in which the Internal Revenue Service offered an opinion on a situation similar to the one at hand. There, an accrual basis taxpayer executed a lease requiring a minimum annual royalty payment of $60,000.00 over the term of the 10-year lease. On the date the lease was signed, the taxpayer executed a negotiable promissory note payable on demand to the lessor in the principal amount of $600,000.00. The ruling explains that it would be improper to deduct the cumulative amount of the minimum royalties paid by cash or negotiable note in the initial year of the lease, inasmuch as the royalties were fixed in amount and expired annually over the period of the lease. The ruling states that the taxpayer may deduct $60,000.00 in the initial year of the lease and $60,000.00 in each year of the lease thereafter.

The revenue ruling does not offer a basis for granting petitioner the deduction he seeks. The agreement described in the ruling satisfied all of the requirements of Treas Reg § 1.612-3(b)(3). Most significantly, it required a minimum annual payment in a uniform amount over the term of the lease. Petitioner has not shown that he was similarly required to make such a payment.

Petitioner notes that a termination provision in a sublease agreement will not defeat an otherwise valid minimum annual royalty requirement and reasons that a deferral provision should have the same result. In Cheng v. Commr. (938 F2d 141, 91-2 US Tax Cas ¶ 50,346), the court held that an at-will termination provision "which also provides for minimum annual royalty payments", falls within the exemption of Treas Reg § 1.612-3(b)(3). In explaining its decision, the court also stated:

> "The termination clause allows Cheng to end the sublease. It does not, however, allow him to avoid the annual royalty payments due prior to the exercise of the right to terminate the lease." (Id.)

The deferral provision in the sublease executed by petitioner did allow him to avoid the annual royalty payments due, prior to the exercise of the right to terminate the leases. The fact that petitioner exercised his options to terminate or purchase the leases rather than defer payments is not material to the threshold issue: whether the sublease contained a minimum annual royalty provision within the meaning of section 1.612-3(b)(3).

C. Section 162(a)(2) of the Internal Revenue Code permits a taxpayer to deduct all ordinary and necessary expenses incurred in carrying on a trade or business. Investment activities generally do not constitute a trade or business. However, expenses in connection with investment activities may be deductible under IRC § 212(1) or (2) which permit a deduction for certain nonbusiness or investment expenses (IRC § 212). Treas Reg § 1.212-1 provides as follows:

> "An expense may be deducted under section 212 only if--
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> (1) It has been paid or incurred by the taxpayer during the taxable year for (i) the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation or maintenance of property held for the production of such income, or (iii) in connection with the determination, collection or refund of any tax; and
>
> (2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph."

Expenses incurred in managing, conserving, or maintaining property held for investment may be deductible even though the property produces no current income, and there is no likelihood that it will be sold at a profit or that it will be otherwise productive of income, and even though it is held merely to minimize a loss relating to it (Treas Reg § 1.212-1[b]); however, the taxpayer must have an existing interest in the property to which the expenses relate (Hosbein v. Commr., 50 TCM 530, 532).

D. Through the submission of cancelled checks, bank statements, invoices and other documents, petitioner established that he incurred expenditures in the amount of $107,826.00 in 1982. The following expenditures were incurred in connection with the determination of income tax and are deductible under section 1.212-1(a)(1)(iii): $252.00 to Sherwood Guernsey for preparation of a brief in connection with a proceeding with the Internal Revenue Service;

$20,000.00 to Gerald Reich for accounting fees in connection with preparation of tax returns. Some of the expenditures were incurred in connection with the management of property or investments and are also deductible. These include: payments in the amount of $13,200.00 for management of the Sportsmen's Lodge. Petitioner is also entitled to legal fees paid for collection activities in connection with a bad debt, in the amount of $1,168.00. Thus, petitioner substantiated total itemized deductions of $34,620.00. The Division is directed to recalculate petitioner's taxable income accordingly.

E. Petitioner has not shown that he is entitled to the remainder of the deductions claimed. It would appear that a portion of the payments made to Mr. Russell and Mr. Neustadt were deductible expenses. However, there is no doubt that the majority of these expenses were not deductible because they related to property or investments in which petitioner had no ownership interest in 1982. Mr. Neustadt testified that petitioner chose not to invest in the majority of the property investigated by Mr. Neustadt in 1982. Mr. Russell's affidavit states that his expenses were incurred "with regard to the evaluation and operation of various drilling sites". It cannot be determined from this affidavit whether any of Mr. Russell's activities in 1982 pertained to property in which petitioner then had an ownership interest or whether Mr. Russell, like Mr. Neustadt, was investigating potential investment opportunities for petitioner. The expense memorandums prepared by Mr. Russell are not sufficiently detailed to enable me to determine which of the expenses are deductible and which are not. Other claimed deductions appear to have been incurred in connection with potential investments (e.g., legal fees to Mr. Goldwater in the amount of $2,000.00 for leases sought but not obtained) or were sought for expenses which were never fully explained (e.g., legal fees to Mr. Goldwater in connection with a lawsuit involving Austin Speed). The vague and incomplete information offered by petitioner is not sufficient to carry his burden to show entitlement to the other deductions claimed.

F. Petitioner has not shown that he is entitled to an additional deduction for charitable contributions. Section 170 of the Internal Revenue Code allows an individual a deduction for charitable contributions subject to certain limitations. The amount of a charitable contribution

made in property other than money is the fair market value of the property at the time of the contribution (Treas Reg § 1.170A-1[c][1]). The fair market value is the price at which the property would be exchanged between a willing buyer and a willing seller (Treas Reg § 1.170A-1[c][2]). Petitioner has not established that any artwork was relinquished to the MET or to an auction buyer in 1982. The letter of November 6, 1981 indicates an intention to make a donation, but there is no evidence in the record that the donation was actually made. Furthermore, the art appraiser's letter is not sufficient to establish the fair market value of the painting which purportedly was to be donated, a portrait of James Joyce. The appraiser's credentials as an expert in the field of art appraisal were not established by petitioner, and his valuation was too indefinite to be useful (see, Isbell v. Commr., 44 TCM 1143).

G. Pursuant to the Conciliation Order dated October 20, 1989, the tax deficiency for 1982 is reduced to $51,148.43. This amount will be modified in accordance with Conclusion of Law "D". In addition, petitioner is granted a refund for 1983 of $5,101.17, plus interest, as indicated by the Conciliation Order.

H. The petition of Robert Chuckrow is granted to the extent indicated in Conclusions of Law "D" and "G"; the Notice of Deficiency, dated March 25, 1988, shall be modified accordingly; and in all other respects, the petition is denied.

DATED: Troy, New York
July 9, 1992

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE