STATE OF NEW YORK

DIVISION OF TAX APPEALS

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

Petitioners, Jadow and Uma Rao,[1] filed a petition for redetermination of deficiencies or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 2002 and 2004 through 2008.

On April 1, 2014 and April 21, 2014, respectively, petitioners, appearing by petitioner Jadow Rao, and the Division of Taxation, appearing by Amanda Hiller, Esq. (Kathleen D. O'Connell, Esq., of counsel), waived a hearing and submitted the matter for determination based upon documents and briefs to be submitted by November 21, 2014, which date commenced the six-month period for issuance of this determination. After due consideration of the evidence and arguments presented, Winifred M. Maloney, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether the Division of Taxation properly disallowed certain losses claimed on Schedule E to petitioner's personal income tax returns for the years 2004 through 2008 upon the

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

premise that the claimed losses arose as the result of improper and abusive tax avoidance transactions involving oil and gas drilling expenses of certain partnerships in which petitioner participated.

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

FINDINGS OF FACT

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

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

3. Mr. McNerney, a former insurance agent and thereafter the owner of an entity known as World Wide Capital Funding, has been a promoter of various financial ventures from as early as 1996, including those known as North American Venture 1996 (NAV 1996) and North American Venture 1997 (NAV 1997). In or about January 2000, Mr. McNerney was indicted on multiple counts relating to investment fraud, including but not limited to five counts of Grand Larceny in

the Second Degree, eight counts of Grand Larceny in the Third Degree, Forgery in the Second Degree, and thirteen counts of Fraud in the Sale of Securities. In or about July 2000, Mr. McNerney pled guilty under the indictment and was sentenced to a term of two to six years in prison.[2]

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

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

6. Petitioner filed a New York State Resident Income Tax Return for the year 2002 on or after October 23, 2003, as extended. Petitioner filed an Amended 2002 Resident Income Tax Return, reporting additional tax due, on or after April 6, 2004.

7. Petitioner filed an Amended Resident Income Tax Return for the year 2003, reporting additional tax due, on or after June 27, 2005.

8. On or before April 15, 2005, petitioner filed a New York State Resident Income Tax Return for the year 2004. On this return, petitioner claimed an aggregate federal schedule E deduction (partnership nonpassive loss) totaling $184,798.00 associated with North American Venture (NAV) and Shamrock Offset Drilling Project (Shamrock).

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

9. On or after March 7, 2005, petitioner filed a Claim for Credit or Refund of Personal Income Tax (Form IT-113X) for the tax year ended December 31, 2002, claiming a net operating loss (NOL) carryback from the year 2004. Petitioner reported a $98,781.00 NOL on Schedule A of federal Form 1045, Application for Tentative Refund, for the year 2004, attached to the Claim for Refund. After a desk audit review of the refund claim, the Division adjusted the net operating loss carryback to $95,781.00, recomputed the tax due after the carry back, and issued an adjusted tax refund in the amount of $7,412.00 on or after April 6, 2005.

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

11. On or before April 15, 2006, petitioner filed a 2005 Resident Income Tax Return, on which he claimed an aggregate federal schedule E deduction (partnership nonpassive loss) totaling $24,372.00 associated with North American Venture 2003 (NAV 2003) and Shamrock. Petitioner filed an undated amended 2005 Resident Income Tax Return.

12. Petitioner filed a 2006 Resident Income Tax Return on May 18, 2007, as extended. On this return, petitioner claimed an aggregate federal schedule E deduction (partnership nonpassive loss) totaling $18,059.00 associated with NAV 2003 and Shamrock. Petitioner filed an amended 2006 Resident Income Tax Return, reporting additional tax due, on or after May 16, 2009.

13. Petitioner filed a Resident Income Tax Return for the year 2007 on April 15, 2008.

14. Petitioner filed a Resident Income Tax Return for the year 2008 on April 15, 2009.

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

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

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

Compliance Initiative.

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

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

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

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

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

17. Petitioner filed a petition with the Division of Tax Appeals contesting the total amount due asserted in all six notices of deficiency, i.e., $45,733.08, for the years 2002, and 2004 through 2008. Petitioner does not dispute the computation of the Division's adjustments; rather, he asserts that the deductions disallowed by the Division constituted permissible deductions for intangible drilling costs. He also asserts that the notices of deficiency issued to him for the years 2002, 2004 and 2005 are barred by the statute of limitations.

18. As part of its audit activities, the Division obtained the Confidential Placement Memorandum (Placement Memo) for Shamrock III Offset Drilling Project 2003 (Shamrock III), NAV 2003, and NAV 2004, as well as excerpts from the offering materials for North American

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

Ventures 2005 and 2006 (NAV 2005 and NAV 2006, respectively).

19. The Shamrock III Offset Drilling Project 2003 Confidential Private Placement Memorandum terminates by its terms on March 2, 2004, unless extended for an additional 30 days. It offers a cash-only investment in a total of 17 units at $6,500.00 per unit. An additional assessment of up to $1,050.00 per unit could be requested by the managing partner, Majestic Management Corporation.[4]

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

21. The first page of the NAV 2004 Placement Memo calculates the estimated tax benefits per unit purchased. Specifically, the purchase of one unit for $5,400.00 in cash, plus a $1,500.00 Lease Acquisition Promissory Note, and a $16,000.00 Turnkey Drilling Contract Promissory Note, would generate a first year total tax loss of $21,460.00 and yield estimated tax benefits in the amount of $4,000.00. The Placement Memo states that "[b]ecause of the leveraged aspects of

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

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

the investment, the operations of the Program should allow participants to realize a 2004 tax write-off of 400% on cash contributed." The NAV 2003 Placement Memo states that WIOs "should be entitled to deduct all intangible drilling and development costs for which liability for payment is incurred in '01-'02 provided economic performance, as described above, has occurred in 2003 or by March 31, 2004."

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

23. The parties to the Lease Acquisition Promissory Note (***see*** Finding of Fact 21) were Energy Resource Management, LLC (ERM) and the individual program subscribers. The parties to the Turnkey Drilling Promissory Note (***see*** Finding of Fact 21) were the Striker Group, Ltd/US Oil & Gas Corp. (Striker) and the individual program subscribers. The lenders on the Lease

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

Acquisition Promissory Note and the Turnkey Drilling Contract Promissory Note were ERM and Striker. The NAV 2003 and NAV 2004 Placement Memos describe ERM as "a recently formed Nevada Corporation," and describe Striker as an entity with "no prior management history," whose "affiliates have participated as WIOs, General Partners or Managers in drilling, and re-completion [sic] gas and oil ventures over the last 20 years for their own account's [sic]." In ERM's Executive Summary, its strategic goal is described as follows:

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

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

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

26. As noted, participants in the foregoing ventures were denominated WIOs and not general partners. As such, "[e]ach WIO will be acquiring a working interest in the Well(s) and not a partnership interest in a General Partnership," such that "the concept of joint and several

liability as found in a General Partnership should not exist." At the same time the Placement Memos state that "an investment in the program is not an investment in a limited partnership."

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

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

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

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

30. Shortly before his first investment in a McNerney-promoted venture, petitioner went to Mr. McNerney's office where he was shown "a CD which showed oil being explored" and produced. Around the same time, Mr. McNerney referred petitioner to Dara Lis. Petitioner sent his tax information for prior years to Ms. Lis, who reviewed the same and gave him a written analysis of his tax savings from investment in the McNerney partnerships. Mr. McNerney

suggested to petitioner that he could carry back losses from an investment in 2004 to the 2002 tax year. Immediately thereafter, petitioner decided to invest in a McNerney oil and gas partnership. During the interview, petitioner stated that his first year of participation was 2004. Petitioner also stated that the amount he invested, i.e., the number of units he purchased, was determined by his tax position. In addition, petitioner stated that Mr. McNerney allowed him to make partial payments towards his investment.

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

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

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

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

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

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

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

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

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

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

33. In conjunction with his interview, petitioner provided closing documents related to his purchase of 5.5 units in NAV 2004. Among those closing documents was a Receipt For Placement Memorandum and Representations that petitioner signed on December 26, 2004. During his interview, petitioner acknowledged receiving the Placement Memo for NAV 2004. However, petitioner stated he had not reviewed it. Petitioner also stated that he had not reviewed the closing documents for NAV 2004 "in great depth." Petitioner signed a Turnkey Drilling Agreement Promissory Note, dated December 26, 2004, in the amount of $88,000.00 ($16,000.00 per unit), payable to "The Striker Group, Ltd/US Oil & Gas Corp." He also signed a Lease Acquisition Promissory Note, dated December 26, 2004, in the amount of $8,250.00 ($1,500.00 per unit), payable to ERM on December 31, 2019.

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

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

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

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

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

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

36. In conjunction with his purchase of one unit in NAV 2005, petitioner signed, among other documents, a Lease Acquisition Promissory Note, dated December 28, 2005, in the amount of $1,500.00 ($1,500.00 per unit), payable to ERM on December 31, 2020; and a Turnkey Drilling Agreement Promissory Note, dated December 28, 2005, in the amount of $16,000.00 ($16,000.00 per unit), payable to “The Striker Group, Ltd,” on December 31, 2020.

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

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

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

40. Sometime before the January 27, 2010 interview, petitioner provided a total of 14 checks relating to his investment in McNerney-promoted oil and gas partnerships and bearing various dates between December 28, 2003 and April 8, 2006. By letter dated May 4, 2010, in response to the Division’s March 29, 2010 IDR, petitioner’s former representative indicated that petitioner had already provided copies of all checks he was able to obtain.

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

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

43. When interviewed, petitioner stated that he received some "semi-regular checks" with respect to his participation in the McNerney ventures, but produced no evidence as to the amounts of any such checks. The only information that petitioner received regarding his investments in McNerney-promoted oil and gas ventures were e-mails from Mr. McNerney and year-end Schedules K-1. Although he asked Mr. McNerney, on a number of occasions, about the amount of oil produced, petitioner never received any information regarding the amount of oil produced by the wells in which he invested. Mr. McNerney advised petitioner that his obligations under the promissory notes would be paid for over the course of the length of the notes by the revenues resulting from the production and sale of oil and gas. Although petitioner

acknowledged that he would personally have to repay the notes if all the wells were dry, he was confident that most of the wells would produce oil based upon the CD he had seen. Petitioner did not know how much, if any, revenue from oil production had been applied to his promissory notes, or the amount of the balance owed on such notes.

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

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

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

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

46. After its audit of petitioner's returns, and in view of the information gleaned from its audits of the McNerney partnerships, the Division concluded that the McNerney-promoted oil and gas partnerships in which petitioner invested were abusive tax avoidance transactions within the meaning of Tax Law § 683(c)(11)(C). The Division also concluded that NAV 2003 and Shamrock were partnerships for tax purposes, and that petitioner was a partner in both NAV 2003 and Shamrock (***see*** Finding of Fact 62).

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

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

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

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

49. Drilling contracts are for one well only. Operators do not contract with drillers to drill multiple wells for one price. Occasionally, a contract to drill one well will include an option to contract to drill future wells, but operators simply do not contract drillers to drill multiple

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

50. The primary service provider that the Operator engages is the drilling contractor, who is responsible for providing the drilling rig and personnel. Drilling contractors are hired to drill on a "day rate" basis, a "footage" basis or a "turnkey" basis. A day rate contract for drilling services is based upon the driller's daily billing rate for the drilling rig and crew. A footage contract for drilling as the name implies, is based upon the driller's price per foot of well depth drilled. In day rate and footage contracts, the Operator bears all the cost and time risks of the drilling operation, including cost increases or overruns should trouble in drilling be encountered. That said, the day rate and footage contract methods are the least expensive if the drilling operation is managed effectively by an experienced and capable Operator.

51. Turnkey drilling contracts, by contrast, provide that the driller accepts a fixed fee for drilling and developing wells up to the point at which they enter production. The turnkey driller is obligated to cover all costs, including cost overruns and delays, incurred prior to the commencement of production. The turnkey arrangement thus passes risks and uncertainties to the drilling contractor, while protecting the working interest participants. This is why turnkey drilling contracts may be well suited for certain drilling partnerships, where partners would prefer to pay their fixed costs at one time prior to commencement of a project.

52. As described, a key benefit for turnkey drilled venture participants is the protection it gives against cost inflation due to unforseen (or unforeseeable) difficulties that may be encountered or associated with any drilling venture, such as failure to achieve commercial quantities of oil and gas (hydrocarbons), know as dry holes, or low post-completion production

rates. By entering into a turnkey drilling contract, participants may avoid costs of environmental damage and accidents, and limit their exposure to the wide variation in drilling completion costs. At the same time, and for assuming these risks, turnkey drillers are able to command a higher rate than day rate or footage rate drillers.

53. Factors considered by turnkey drilling contractors when pricing a turnkey contract might include the estimated cost of drilling rig and crew; project management and supervision; required drilling and support services; the depth of the well; anticipated bottom pressures; potential technical risks; opportunities for unexpected cost overruns; overhead; insurance; and target profit margins. Legitimate turnkey drillers are often enticed by added price incentives such as an added markup for achieving fast well completion. At the same time, abusive tax shelter ventures use turnkey drilling contracts to lump large (overstated) IDCs in the venture solely for the benefit of their immediate deductibility. Mr. McNerney alone appears to have determined the turnkey drilling contract price for the ventures audited by the Division, and there is no evidence in the record concerning how he established his pricing.

54. Unlike the McNerney ventures here at issue, legitimate oil and gas drilling ventures do not employ long-term notes to finance their operations. Rather, entities involved in such ventures typically operate on a cash basis due to the need to pay for drilling crews, equipment maintenance costs, liability costs, and daily operating expenses for their drilling equipment and activities. A driller could not remain viable and liquid by waiting, as would be the case here, for 15 to 30 years for payment under long-term promissory notes. Likewise, Operators do not wait 15 years for WIOs to pay lease acquisition costs associated with an oil and gas well, as would be the case with the McNerney ventures' lease acquisition promissory notes. Lease acquisition costs must be paid before the Operator may enter the property to begin development. It is not

industry practice to use a long term lease acquisition promissory note because WIOs are required to pay up front their share of the costs associated with developing and drilling a well in order to share in the associated revenue if the well is successful.

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

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

57. As noted earlier, the Operator of an oil and gas well contracts a driller to drill the wells. The driller does not contract with non-operator WIOs, and such a fractional interest owner or owners (WIOs) would not have the individual authority to hire a driller. A typical legitimate turnkey drilling contract involves a markup on costs ranging from 3% to 10% over a day rate or footage rate contract rate. With added incentives, such markup on costs may rise to as high as

25% over a day rate or footage contract rate. In some oil and gas ventures, the turnkey drilling price has been inflated to as much as 500% over the estimated cost of drilling set forth in the AFE. However, a legitimate Operator would never hire a turnkey driller at such a markup because the Operator could hire a turnkey driller for the above-noted basic markup rates (3% to 10%) or incentive-added rates (up to 25%).

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

ventures.[9]

59. Mr. Morris opined that:

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

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

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

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

> "[y]our Economic Tax Gain of $7,132.00 invested each year for 10 years at 15% annual yield will accumulate to $163,700.00 of personal wealth, all from Pure Tax Savings. Further, your particiaption [sic] in our Drilling Projects will be more likely than not to produce future Tax Advantaged Cash Flow to you through 'Depletion Allowance'. By participating in NAV 2005 your AGI will be reduced below $100,000.00, thus you qualify for both the 'Roth IRA, and Roth IRA Conversion', with 'Everest Sized Tax Benefits'. Additionally, you can avail yourself of 'Excess IDC Deductions in 2005 sufficient to create *an NOL Carryback into 2003, then receive a Federal and State Refund of $16,500.00 for 'Additional Asset Accumulation' purposes, and future 'Family Wealth Creation.*'"

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

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

64. The IRS audited NAV 2003 and issued a Form 886-A Explanation of Items (also known as a Revenue Agent Report or "RAR"). Among other items, the RAR concludes that the

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

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

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

Energy Resource Management Corporation";

b) Exhibit 2 - An excerpt from Internal Revenue Service Publication 535, Business Expenses, For use in preparing 2002 Returns, pertaining to intangible drilling cost (page 29) and the depletion deduction on oil and gas properties (page 43);

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

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

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

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

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

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

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

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

> “[h]erein please find my documents which I formed the basis [sic] for my Understanding and investing in oil and gas wells. I was not swayed or influenced by Any body’s [sic] claim. The documents include IRS publication about intangible drilling Costs, oil and gas wells, how to make choice, energy credits for costs of geothermal wells, exploration costs etc. After reading and assimilating the information from these Documents, I was convinced that oil and gas exploration in USA is indeed a genuine idea to make this country strong and self sufficient in oil production rather than relying on middle eastern countries which not only sells [sic] oil at exorbitant costs but also divert our hard earned money for political activities. Therefore it was my decision to put money in our own backyard rather than sending it to other countries.”

67. As a rebuttal document, the Division submitted a printout from the Veteran Oil Partners website (Exhibit UU) that indicated “The Veteran Companies” were founded in 2010 by two former United States Marines.

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

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

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

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

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

73. The record does not include any correspondence either to or from the Division

pertaining to petitioner's 2003 income tax return.

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

75. Included with petitioner's letter/reply brief, were two documents. The record in this matter closed on September 4, 2014, the revised deadline set for the submission of petitioner's rebuttal documents and initial brief. The following documents were returned to petitioner with an explanation that no evidence could be submitted after the record closed:

a) A copy of a check drawn on Petro Operating Group, LLC's Wells Fargo checking account, dated June 18, 2013, payable to Uma R. Rao, in the amount of $723.64;

b) A copy of a check drawn on Petro Operating Group, LLC's Wells Fargo checking account, dated March 25, 2014, payable to Uma R. Rao, in the amount of $754.21.

SUMMARY OF THE PARTIES' POSITIONS

76. Petitioner correctly points out that the Division's proposed adjustment to his 2004 and 2005 personal income tax (and the related proposed carry back adjustment to the year 2002), may only be made if the statute of limitations is extended pursuant to Tax Law § 683(c)(11)(B), i.e., the six-year statute of limitations applicable to abusive tax avoidance transactions. Petitioner claims that his investments in the McNerney partnerships were not abusive tax avoidance transactions. Petitioner contends that he received "profits" from oil production, all of which were accounted for in subsequent years, that prove the oil and gas ventures, in which he participated, had valid economic purposes and were not tax avoiding schemes. He further contends that in late 2010, the Division notified him that there was a discrepancy on his 2003 tax

return. Petitioner asserts his letter of response, dated January 3, 2011, explained that the deduction taken was based upon his oil and gas venture participation. He further asserts that the Division accepted his explanation and did not issue an assessment for the year 2003. Petitioner maintains that the same conclusion should be reached for the years 2004 and 2005.

77. Petitioner claims the assessments at issue should be cancelled because matters related to his oil and gas venture participation for the years at issue are pending before the US Tax Court under docket numbers 260-12, 6587-12 and 6588-12.

78. Petitioner also contests the imposition of interest and penalties. He claims that he chose to invest in oil and gas development in the United States through the McNerney-promoted ventures for patriotic reasons, as well as the tax benefits available for such investments. Petitioner contends that Mr. McNerney acted as a front man to bring in participants for oil and gas ventures because oil drilling entails millions of dollars of investment. Petitioner further contends that Mr. McNerney never disclosed his past legal problems to him. Instead, petitioner maintains that Mr. McNerney only advised him about various oil and gas wells that were being drilled and his "percentage participation." Petitioner asserts that Mr. McNerney emailed him "hundreds of papers" to prove that these ventures had economic substance and were not tax avoidance schemes.

79. The Division asserts, in contrast, that petitioner has not met his burden of proving that the partnerships in which he was involved were not abusive tax avoidance transactions subject to the six-year statute of limitations applicable to such transactions under Tax Law § 683(c)(11)(B). The Division believes that the principal purpose of the drilling ventures in which petitioner participated was to avoid or evade tax, rather than to profit from mineral production. The Division claims that the documents submitted consist almost exclusively of discussions of the tax

treatment of oil and gas drilling ventures and copies of cancelled checks. The Division points out that petitioner did not submit any supporting documentation related to his investment in the Shamrock venture. It argues that while petitioner produced copies of checks purportedly written in connection with his investment in NAV 2003, NAV 2004 and NAV 2005, the checks written in 2007 and 2008 to the Striker Group do not specify a partnership venture. The Division also argues that petitioner did not produce any evidence that he signed any lease acquisition or turnkey drilling promissory notes for the years 2006 through 2008. The Division urges that its denial of the schedule E deductions taken by petitioner was proper because petitioner did not, and can not prove that there was any reasonable objective or subjective possibility of profit resulting from the ventures and transactions giving rise to such deductions. The Division contends that even if economic substance could be demonstrated, the deductions claimed by petitioner should nonetheless be disallowed because the lease acquisitions and turnkey drilling notes do not constitute bona fide or genuine debt for which petitioner is in any realistic manner obligated or at risk of being required to pay.

80. The Division asserts that the penalties imposed, based upon petitioner's participation in abusive tax avoidance transactions, are proper and should be sustained.

CONCLUSIONS OF LAW

A. As noted in Finding of Fact 75, petitioner attempted to submit additional documents after the record was closed. These documents were rejected.

The Tax Appeals Tribunal has established a firm policy of not allowing the submission of evidence after the record was closed. In ***Matter of Saddlemire*** (Tax Appeals Tribunal, June 14, 2001), the Tribunal succinctly stated:

"[w]e have held that in order to maintain a fair and efficient hearing system, it is

> essential that the hearing process be both defined and final. If the parties are able to submit additional evidence after the record is closed, there is neither definition nor finality to the hearing. Further, the submission of evidence after the closing of the record denies the adversary the right to question the evidence on the record (***Matter of Emerson***, Tax Appeals Tribunal, May 10, 2001; ***Matter of Schoonover***, Tax Appeals Tribunal, August 15, 1991)."

Therefore, the additional documents submitted after the close of the record could not be considered in making this determination.

B. Petitioner contends that the notices of deficiency issued to him for the years 2002, 2004 and 2005 are barred by the statute of limitations. Tax Law § 683(a) provides, generally, that the Division may assess additional personal income tax within three years from the due date of a return, or within three years from the date on which the return was filed, whichever is later. Petitioner's return for the year 2002 was filed on or after October 23, 2003, as extended. Petitioner filed an amended return for the year 2004 on or after May 4, 2005 and he filed his return for the year 2005 on or before April 15, 2006. In turn, then, the Division could assess a deficiency for such years at any time within the following three years in each instance (i.e., on or before October 23, 2003, May 4, 2008 and April 15, 2009, respectively). There is no dispute that the notices of deficiency were all issued on February 28, 2011, and thus the notices for the years 2002, 2004 and 2005 were in fact issued beyond the three-year statute of limitations under Tax Law § 683(a).[10]

C. There are several exceptions to the general three-year statute of limitations, as set forth in Tax Law § 683(c) and (d)(1). Relevant to this matter is the exception set forth at Tax Law § 683(c)(11)(B), providing that tax may be assessed at any time within six years after the later of

[10] The notices of deficiency for the years 2006, 2007 and 2008 were also issued on February 28, 2011, a date falling within three years after the May 16, 2009 filing of petitioner's amended return for 2006, the April 15, 2008 filing due date for petitioner's 2007 return and the April 15, 2009 filing due date for petitioner's 2008 return. Such notices are thus clearly not barred by the statute of limitations on assessment in any event.

the due date for the return or the date on which it was filed, if the deficiency is attributable to an abusive tax avoidance transaction. The February 28, 2011 issuance date for the notices of deficiency for the years 2004 and 2005 fall well within this six-year statute of limitations. Since the notice pertaining to the year 2002 was based upon the disallowance of the NOL carryback from the year 2004, it was issued within the same six-year statute of limitations as the notice pertaining to the year 2004 pursuant to Tax Law § 683(b)(4). Thus the notices would be timely issued if such six-year statute properly applies, i.e, that the transactions in question were abusive tax avoidance transactions.

D. In view of the foregoing, both the correctness of the Division's disallowance of petitioner's claimed schedule E deductions (giving rise to the additional tax asserted as due in this case), and of the application of the six-year statute of limitations, turn on whether the claimed but disallowed deductions resulted from abusive tax avoidance transactions. 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]; emphasis added).

E. In general and unless otherwise specified, the burden of proof rests on the petitioner (Tax Law § 689[e]; 20 NYCRR 3000.15[d][5]). The burden of proof with regard to the issue of whether a given transaction was an abusive tax avoidance transaction, and was thus subject to the six-year statute of limitations, likewise 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.

F. As noted above, the Division denied the schedule E deductions related to petitioner's investments in Shamrock and NAV 2003 for the years 2004 and 2005, (and disallowed the NOL carryback from 2004 to the year 2002). Review of the record in this matter clearly establishes that the McNerney promoted ventures in which petitioner chose to participate were abusive tax avoidance transactions. First, there is nothing in the record that would credibly support a conclusion that there was any economic substance to the ventures, aside from the generation of tax benefits for participants. Economic substance is determined from an examination of the purpose of a transaction, and a taxpayer is not entitled to the tax benefits of a transaction unless he can prove that he entered into it for a valid nontax business purpose and that the transaction has "purpose, substance, or utility apart from [its] anticipated tax consequences" (***Matter of Kellwood***, Tax Appeals Tribunal, September 22, 2011).

With respect to the Shamrock venture, petitioner did not submit any supporting documentation related to his investment in the same. The absence of any supporting documentation makes it impossible to determine whether the Shamrock venture had any economic purpose or substance other than to create tax losses, and whether petitioner entered, if at all, into the venture for a valid nontax business purpose. As such, petitioner has failed to prove that his investment in the Shamrock venture had any economic purpose or substance, aside from the tax benefits it generated for him (Tax Law § 689[e]). With respect to petitioner's investment in NAV 2003, the terms of the offering materials for the partnerships, the letters from the promoter, and the information provided upon petitioner's interview by the Division, along with the interviews and testimony of other participants in the ventures, clearly show that the principal purpose of the McNerney ventures was tax avoidance. This evidence reflects an exhaustive discussion of and focus on the tax benefits accruing from participation, but provides little or no information concerning such matters as the locations or names of the wells to be drilled, or the anticipated oil or gas production and revenues to be derived therefrom. The descriptions of the principals managing the investment and the drilling operations are at best vague. There is no objective evidence establishing that any well sites were in fact leased or that any wells were ever drilled for the partnerships involved, or that any such wells (if drilled) produced any oil or gas revenues (***see*** Findings of Fact 42). In this regard, the record contains no evidence of any fixed payment schedules for any well-derived revenues, nor any schedule for the repayment of amounts owed under the lease acquisition or turnkey drilling contract promissory notes, nor any evidence that payments have been made on any of these notes.

G. In addition, the record includes no evidence concerning how the lease acquisition or turnkey drilling contract prices were calculated. The record includes no AFE or other cost estimation information, and the turnkey drilling contract price would appear to bear no relationship to the actual estimated cost of drilling any particular wells. It is particularly telling that the identical turnkey drilling contract price ($5,110,000.00) is charged for both NAV 2003 and NAV 2004 (***see*** Finding of Fact 56). The record includes no information concerning well locations, target depths, likely oil or gas production, title information, state regulatory filings, or geological or geophysical information, and little real information about the parties managing the investment or its drilling operations. All this information would be vital to an investor (or advisor) in analyzing whether the investment had economic substance or any objectively reasonable possibility of generating any profit (apart from tax savings).

H. There is also no proof that the promissory notes in this case constituted genuine or bona fide debt. The genuine test for determining whether a genuine indebtedness exists examines a number of factors. No one factor is considered to be determinative, and the list of factors is not exhaustive (***see Welch v. Commissioner***, 204 F3d 1228 [9th Cir 2000]). Factors to be considered include: (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 (***id.*** at 1230) Petitioner signed notes related to his investments for the years 2004 and 2005. Review of these notes indicates that interest was charged at the rate of six percent (albeit simple, *nonrecourse* interest). Although Mr. McNerney advised petitioner that his obligations under the promissory notes would be paid for over the course of the length of the notes from revenues resulting from the production and sale of oil and gas, petitioner acknowledged that he would personally have to repay the notes if all the wells were dry. However, he was confident that most of the wells would produce oil based upon the CD he had seen. There is no evidence that fixed schedules of repayments were established or that petitioner made any payments on the notes. Indeed, petitioner did not know how much, if any, revenue from oil production had been applied to his promissory notes, or the amount of the balance owed on such notes. Moreover, the notes are long-term (15 to 30 year) notes not typically used in turnkey drilling operations. Given their duration to maturity these notes would not provide sufficient liquidity (cash) to sustain the costs of drilling and production. Finally, without any listing of the expense items included in and underlying the turnkey drilling contract prices, it cannot be said such prices were reasonable by industry standards or otherwise. In this regard, petitioner needed to provide some evidence to support the validity of the cost of the turnkey drilling contracts, a logical source for possible padding of IDCs, and he has not done so. This failure to justify the reasonableness of the turnkey drilling contract prices is convincing evidence that the McNerney promoted transactions in which petitioner was involved had tax avoidance as their primary motive, and that such transactions had no economic substance apart from the tax benefits conferred thereunder.[11]

I. The record clearly shows that petitioner, a physician, performed very little investigation into the McNerney ventures before investing. Petitioner's document submission in this matter included five documents that he claimed formed the basis for his understanding of and investment in oil and gas wells. Review of those documents indicates that they primarily discuss the tax treatment of oil and gas ventures. When interviewed, petitioner stated that prior to investing, the only research he did on the McNerney ventures was to watch a CD about oil exploration and production at Mr. McNerney's office. Although he acknowledged receiving the Placement Memo for NAV 2004, petitioner stated that he never read it. He also stated that he had not read the "closing documents" for NAV 2004 "in great depth." Petitioner did not retain an independent expert in oil and gas ventures to review any materials concerning the McNerney

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[11] With no evidence that any leases were acquired or any drilling was undertaken (***see*** Finding of Fact 64), it cannot be concluded that any claimed IDC deductions (whether padded or not) would be allowable in any event, or that any of the subject ventures advanced the oil and gas exploration goals intended by Congress in allowing favorable treatment for IDC's (***see*** Finding of Fact 22). Instead, it appears these ventures merely utilized the availability of such favorable treatment as a means of obtaining unsubstantiated and unsupportable deductions in contravention of Congress's intent.

ventures prior to his investment. Rather, he relied upon Mr. McNerney, the promoter of the ventures, and Ms. Lis, to whom Mr. McNerney referred him. Even a cursory reading of the materials concerning NAV 2003 and NAV 2004 reveals their purpose and result to be solely premised upon garnering tax based benefits. The evidence as a whole leads to the inescapable conclusion that the ventures at issue were abusive tax avoidance transactions with respect to which the six year statute of limitations under Tax Law § 683(c)(11)(B) was properly invoked (specifically as applicable for the years 2004 and 2005). Further, the same evidence overwhelmingly establishes that the transactions had tax avoidance as their primary motive, that the amounts "invested" as set forth on the promissory notes accompanying the ventures did not represent amounts of genuine debt that were at risk as to the investors, that the ventures had no objective or subjective possibility of generating any profit for investors (beyond tax savings), and that the ventures had no economic substance apart from the tax benefits they conferred. Accordingly, the Division properly disallowed the Schedule E deductions claimed by petitioner upon the basis of his investments in such ventures for the years 2004 and 2005. The Division also properly disallowed the 2004 NOL carryback to the year 2002.

J. Petitioner claims that in late 2010, the Division notified him of a discrepancy on his 2003 tax return. He further claims that he sent a response letter dated January 3, 2011 that explained that his schedule E deduction was based on his oil and gas venture participation. Petitioner maintains that the Division accepted his response, and did not disallow the claimed Schedule E deduction for the year 2003. He argues that this is proof that his oil and gas partnership investments were not abusive tax avoidance transactions to which the six-year statute of limitations applies. Petitioner's argument is without merit. Petitioner submitted no evidence regarding the Division's alleged review of his 2003 tax return or his alleged response to the same. As such, it is impossible to determine what review, if any, was conducted by the Division concerning petitioner's 2003 tax return. Furthermore, during his January 27, 2010 interview by the Division, petitioner stated that his first year of participation in a McNerney venture was the year 2004, not 2003. Petitioner claimed a NOL carryback from the year 2004 to the year 2002. For the reasons set forth in the above conclusions of law, the McNerney promoted ventures in which petitioner invested for the years 2004 and 2005 were determined to be abusive tax avoidance transactions with respect to which the six year statute of limitations under Tax Law § 683(c)(11)(B) was properly invoked.

K. The Division disallowed petitioner's schedule E deductions related to his participation in McNerney promoted ventures for the years 2006 through 2008, and issued notices of deficiency on February 28, 2011, a date falling within three years after the May 16, 2009 filing of petitioner's amended return for 2006, the April 15, 2008 filing date for petitioner's 2007 return and the April 15, 2009 filing due date for petitioner's 2008 return. To substantiate the schedule E deductions claimed on his returns for the year 2006 through 2008, petitioner submitted copies of three checks drawn on his checking account that purportedly represented the cash portion of his investments in McNerney promoted ventures for such years. Other than the vague memo notations that appear on all three checks, petitioner did not submit any detailed information regarding his purported investments in McNerney promoted ventures for the years 2006 through 2008. Petitioner did not submit any evidence that he signed any promissory notes related to his purported investment in any McNerney ventures for the years 2006 through 2008. He also failed to submit any evidence that any well sites were in fact leased or that any wells were ever drilled for the partnerships involved, or that any such wells (if drilled) produced any oil and gas revenues. The paucity of evidence makes it impossible to determine what amount, if any, of the intangible drilling cost deductions claimed were actually related to oil and gas wells. As such, petitioner has failed to prove that he is entitled to any schedule E deductions for the years 2006 through 2008 (Tax Law § 689[e]).

L. Although Petitioner argues that the assessments should be cancelled because matters related to his oil and gas venture participation for the years at issue are pending before the US Tax Court under docket numbers 260-12, 6587-12 and 6588-12, he failed to submit any documentation pertaining to those matters being litigated under such docket numbers. Moreover, Tax Law § 697(b)(1) provides that the Division:

> "for the purpose of ascertaining the correctness of any return, or for the purpose of making an estimate of taxable income of any person, shall have power to examine or cause to have examined, by any agent or representative designated by it for that purpose, any books, papers, records or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take testimony and require proof material for its information, with power to administer oaths to such person or persons."

This statutory provision clearly enables the Division to conduct independent audits of any return or person in order to ascertain whether respective filed returns are correct.

M. Lastly, the Division has imposed penalties pursuant to Tax Law § 685(b)(1) and (2) for each year at issue, a penalty pursuant to Tax Law § 685(p) for the years 2002, 2004 and 2008, and also a penalty for the years 2002 and 2004 under the Voluntary Compliance Initiative (***see*** Finding of Fact 15). 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 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. Petitioner, a

physician, never bothered to read the investment materials, or to read in any depth the closing documents before signing them. He did not retain an expert in oil and gas ventures to review the subject transactions. Nor did he seek the advice of a tax professional with experience and expertise in the oil and gas industry. Rather, he relied on Mr. McNerney, the promoter himself, and Ms. Lis, the accountant to whom petitioner was referred by the promoter. Further, the record reflects nothing that would support a conclusion that petitioner had substantial authority to support the reporting position concerning the claimed schedule E deductions set forth on his tax returns as filed. Therefore, petitioner is determined to have been negligent, such that penalties were properly imposed pursuant to Tax Law § 685(b)(1), (2) and (p) (***Matter of Murray***, Tax Appeals Tribunal, December 14, 1995). Such penalties, as well as that asserted for the years 2002 and 2004 pursuant to the provision of the Voluntary Compliance Initiative
are sustained.

N. The petition of Jadow and Uma Rao is denied and the notices of deficiency dated February 28, 2011, together with interest and penalties, are sustained.

DATED: Albany, New York
May 14, 2015

/s/ Winifred M. Maloney
ADMINISTRATIVE LAW JUDGE