STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
JOSEPH AND NANCY FRANCOFORTE	:	DETERMINATION DTA NO. 825390
for Redetermination of Deficiencies or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 2004 through 2007.	:	

Petitioners, Joseph and Nancy Francoforte, 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 2004 through 2007.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, in Rochester, New York, on May 8, 2014, at 10:30 A.M., with all briefs to be submitted by August 29, 2014, which date commenced the six-month period for the issuance of this determination. Petitioners appeared by petitioner Joseph Francoforte. The Division of Taxation appeared by Amanda Hiller, Esq. (Kathleen D. O'Connell, Esq, of counsel).[1]

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 2007 upon the premise that the claimed losses arose as the result of improper and abusive tax avoidance

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[1] Petitioner Nancy Francoforte received innocent spouse treatment in this matter. Consequently, all references to petitioner herein shall mean only petitioner Joseph Francoforte, unless otherwise specified or made necessary by context.

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

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

FINDINGS OF FACT

1. The Division of Taxation (Division) commenced an audit of petitioner, Joseph Francoforte, in the spring of 2009, after receiving information from the Internal Revenue Service (IRS) regarding an allegedly abusive tax shelter oil and gas exploration partnership in which petitioner was a partner. The tax returns for this partnership, 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 and conversing 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. Dennis 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. NcNerney 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 Ventures 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 each of the years 2003 through 2007. Each such return was filed on or before its due date of April 15 of the following year, with the exception that the 2007 return was filed after its due date of April 15, 2008. Petitioner also filed, on or before October 23, 2004, an amended return for the year 2003.

7. On his amended 2003 return, petitioner reported a loss, based on a federal schedule E deduction in the amount of $4,420.00 associated with NAV 2003, and claimed a resulting refund in the amount of $301.00. On his 2004 return, petitioner claimed an aggregate federal schedule E deduction (partnership loss) totaling $19,993.00 associated with NAV 2003 and with the entity known as Reid Hocking 2003. On his 2005 return, petitioner claimed an aggregate federal schedule E deduction (partnership loss) totaling $17,315.00 associated with NAV 2003 and Reid

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

Hocking 2003. On his 2006 return, petitioner claimed a federal schedule E deduction (partnership loss) in the aggregate amount of $26,981.00 associated with NAV 2003 and Reid Hocking 2003. On his 2007 return, petitioner claimed a federal schedule E deduction (partnership loss) in the aggregate amount of $992.00 associated with NAV 2003, Reid Hocking 2003, and the entity known as US Oil and Gas Ventures (US O & G).

8. As the result of its audit, on February 28, 2011, the Division issued to petitioner four notices of deficiency, pertaining to the years 2004 through 2007, asserting additional tax due in the aggregate amount of $4,228.90, plus interest and penalties, as follows:

> 2004: Notice Number L-035461876 was premised upon the disallowance of $19,993.00 in deductions taken on Schedule E for NAV 2003 and Reid Hocking 2003. Adding back these disallowances increased petitioner's federal adjusted gross income to an amount in excess of $28,000.00, consequently caused the disallowance of his claimed household credit, and resulted in additional tax due of $1,299.00, plus interest and penalties (including a 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 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]).

> 2005: Notice Number L-035461729 was premised upon the disallowance of $17,315.00 in deductions taken on Schedule E for NAV 2003 and Reid Hocking 2003. Adding back these disallowances increased petitioner's federal adjusted gross income to an amount in excess of $28,000.00, consequently caused the disallowance of his claimed household credit and resulted in additional tax due of $1,040.00, 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]).

> 2006: Notice Number L-035461894 was premised upon the disallowance of $26,981.00 in deductions taken on Schedule E for NAV 2003 and Reid Hocking 2003. Adding back these disallowances resulted in an increase of $26,981.00 to petitioner's federal adjusted gross income, resulting in turn in additional tax due of $1,846.90, 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]).

2007: Notice Number L-035461732 was premised upon the disallowance of $992.00 in deductions taken on Schedule E for NAV 2003, Reid Hocking 2003 and US O & G. Adding back these disallowances resulted in an increase to petitioner's federal adjusted gross income, resulting in turn in additional tax due of $43.00, 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]).

9. The notices for the years 2004, 2005 and 2006 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 transactions. The notice pertaining to the year 2007 was issued within the general three-year statute of limitations on assessment set forth at Tax Law § 683(a). Petitioner challenged all of the notices by filing a petition with the Division of Tax Appeals.

10. As part of its audit activities, the Division obtained the Confidential Placement Memorandum (Placement Memo) for NAV 2003 and NAV 2004, as well as excerpts from the offering materials for North American Ventures 2004, 2005 and 2006 (NAV 2004, NAV 2005 and NAV 2006, respectively). 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 the NAV 2005 and NAV 2006 ventures as well.[3]

[3] 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).

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

12. Tangible Drilling Costs (TDC) include (generally) physical items such 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," as opposed to being treated as capital costs that are amortizable over a ten-year period.[4] 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

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

oil and gas resources (IRC § 263[c]; 26 CFR 1.612-4[a]; ***Exxon Corp. v. US***, 547 F2d 548, 554 [Ct Cl 1976]).

13. The parties to the Lease Acquisition Promissory Note (***see*** Finding of Fact 11) were Energy Resource Management, LLC (ERM) and the individual program subscribers. The parties to the Turnkey Drilling Contract Promissory Note (***see*** Finding of Fact 11) were the Striker Group, Ltd/US Oil & Gas Corp. (Striker) and the individual program subscribers. The lenders on the Lease Acquisition Promissory Note and the Turnkey Drilling Contract Promissory Note were ERM and Striker. The NAV 2003 and NAV 2004 Placement Memos describe ERM as "a recently formed Nevada Corporation," and describe Striker as an entity with "no prior management history," whose "affiliates have participated as WIOs, General Partners or Managers in drilling, and re-completion [sic] gas and or 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 IDC Tax Benefits to lower <u>*each taxpayer*</u> 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."

14. The Program Manager for NAV 2003, 2004, 2005 and 2006 was ERM, a company in which Dennis 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.

15. 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.

16. 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."

17. As relevant to this matter, petitioner's tax returns reflect claimed deductions based upon investments in McNerney-promoted partnerships from 2003 through 2007. As part of its audit, the Division sent an Information Document Request (IDR), dated August 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. 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."

18. Petitioner responded to the foregoing IDR by a letter dated September 3, 2010, in which he stated that he "cannot procure documents, which determine my extent of participation," and expressed a desire to "settle any disputes" with the Division. Petitioner testified, at hearing,

that he would have provided the requested documents, had he not deemed his letter dated September 3, 2010 to be a "sufficient response" to the IDR.

19. The Division sent petitioner a second IDR, dated December 8, 2010, again advising petitioner that it was auditing participants in abusive tax avoidance schemes and transactions and again noting the six-year statute of limitations. This IDR requested specific documents relating to NAV 2003, Indian Point Project 2003, and Reid Hocking 2003.

20. Petitioner produced a letter, dated January 3, 2010 purportedly responding to the December 8, 2010 IDR.[5] This letter asserts that petitioner was not a participant in Reid Hocking 2003 for any tax year. However, and in contrast, audits of petitioner's tax returns for the years at issue indicate claimed losses connected in part with Reid Hocking 2003. The letter also states that petitioner has a Schedule K-1 for participation in NAV 2003. However, petitioner did not enclose or include this document with his letter. Petitioner further states that the Division "must have overlooked the fact that Dara Lis/DL Tax Accounting negligently included my tax-exempt military pension as an income item!" Petitioner's letter notes that the IRS had opened audits of the 2006 and 2007 ventures, and had made no legal finding that they fell afoul of the tax law. Finally, the letter asserts that the principal purpose of the ventures was oil and gas exploration and development, and states that the extended statute of limitations does not apply.

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

22. Petitioner was not an experienced investor. At hearing, petitioner explained that he overheard Dennis McNerney talking to another investor in a bar/restaurant in the Buffalo, New

[5] Since petitioner's letter was in response to the Division's December 8, 20<u>10</u> IDR, it would appear that petitioner simply and erroneously misdated his letter January 3, 20<u>10</u> rather than January 3, 20<u>11</u>.

York, area and that he began to ask Mr. McNerny about his oil and gas ventures. In turn, petitioner was referred to Dara Lis by Dennis McNerney. Petitioner never researched the promoter, Dennis McNerney, but noted that a bartender at the same bar/restaurant told him, after his tax issues arose, about "something going on [regarding Mr. McNerney] that was in the past."

23. Petitioner stated that he "received a few checks early on" with respect to his participation in the McNerney ventures, but produced no evidence as to the amounts of any such checks. Further, he produced no documentary evidence that he made payments for (i.e., invested any cash in) or received any additional payments from his investments in any McNerney promoted oil and gas partnerships. In addition, petitioner produced no evidence that any oil or 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 or operating interest in any oil or gas lease.

24. Petitioner admitted seeing a CD of promotional information and seeing copies of promissory notes. However, he did not recall signing any notes in connection with the McNerney partnerships, and denied seeing any venture documents. Other investors in the same partnerships, interviewed by the Division, indicated that they were advised directly by the promoter (Dennis 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 tax refunds as described.[6]

25. 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 "backed into" based upon the other information on a given investor's tax return.[7]

26. After its audit of petitioner's returns, and in view of the information gleaned from its audits of the McNerny 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 Reid Hocking 2003 were partnerships for tax purposes, and that petitioner was a partner in both NAV 2003, Reid Hocking 2003 and US O & G (***see*** Finding of Fact 40).

27. Mikel Morris, a petroleum engineer, testified at the hearing for the Division. Mr. Morris was qualified without objection as an expert witness with regard to the oil and gas

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[6] Transcripts of the Division's interviews of the other investors, and of a deposition taken of Dara Lis, are included in the record as Exhibits V, W and X.

[7] 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.

industry generally, and with regard to IDC issues in particular.[8] His testimony concerned the various methods by which oil and gas well ventures are typically structured and carried out, as well as his observations and conclusions with respect to the manner in which the McNerney ventures were structured.

28. Mr. Morris first generally described the manner in which oil and gas exploration activities are undertaken based upon the types of organizations or entities involved. In general, such 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 1980's, involve ventures engaged in abusive tax avoidance or evasion schemes, typically centered on creating IDCs to be available for immediate deductibility. These schemes often involve illegitimate ("bogus") promissory notes coupled with prospectuses carrying highly inflated and nonspecific IDCs. These ventures typically employ high note-to-cash ratios aimed mainly at gaining large tax deductions for investors based on such up-front deductibility of (inflated) IDCs, while simultaneously raising a

[8] At hearing, Mr. Morris provided a summary description and chronology of his extensive educational credentials and his public and private sector employment experiences in the oil and gas exploration and production industry. In addition, his full curriculum vitae was included in the record as Exhibit Z. Since he was accepted as an expert witness without objection, it is not necessary to recite the same herein.

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.

29. Mr. Morris explained further, with particular respect to oil and gas exploration partnership ventures, that 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 on 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 12), based on 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.

30. 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 on the driller's daily billing rate for the drilling rig and crew. A footage

contract for drilling, as the name implies, is based on 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.

31. 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 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.

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

33. Factors considered by turnkey drilling contractors when pricing a turnkey contract might include the estimated cost of the drilling rig and crew; project management and supervision; required drilling and support services; the depth of the well; anticipated bottom

pressures; potential technical risks; opportunities for unexpected cost overruns; overhead; insurance; and target profit margins. 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. Dennis 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.

34. Mr. Morris explained that 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. He noted that 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.

35. According to Mr. Morris, 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. He noted that the NAV 2003 and NAV 2004 Placement Memos contain none of this information.

36. Mr. Morris noted that such a prospectus would also include an AFE, prepared by the well Operator to reflect proposed well costs (***see*** Finding of Fact 29). 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 of such partnerships breaking down the estimated costs to be incurred by each partnership for review and approval by the WIOs. According to Mr. Morris, without an AFE, or the names and locations of the proposed wells, or the other information typically included in an AFE and a prospectus, it is not possible 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.

37. As noted earlier, Mr. Morris explained that the Operator of an oil or 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. Mr. Morris testified that he has analyzed other oil and gas drilling ventures where the turnkey drilling price was inflated to as much as 500% over the estimated cost of drilling set forth in the AFE. He stated that 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%).

38. Mr. Morris noted that the point of using notes (as here) to result in a high note-to-cash ratio is to present a means of allowing, and an apparent justification for, overstated ("fluffed up") IDCs available for immediate deduction. He opined that high note-to-cash ratios, based on highly marked-up drilling cost rates, are not unusual in abusive tax shelter cases. He stated

flatly, however, that such markups and note-to-cash ratios are unusual in the legitimate oil and gas industry "because they do not exist." 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."

39. 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. Dennis 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 as a 30.3% pure profit on Tax Savings re-directed to purchase your Working Interest in NAV 2005." It states, further, that:

> "[y]our Economic Tax gain of $7,132.00 invested each year for 10 years at 15% annual yield will accumulate to $163,700.00 of personal wealth, all from Pure Tax Savings. Further, your participation [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'."

40. 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 25). Under these circumstances, it is very difficult to ascertain in what year and in which venture an investment may have actually been made.

41. The Receipt for Placement Memorandum and Representations contained in the Placement Memo for NAV 2003, 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 drilling promoter would be important considerations for a potential investor, as would seeking out an industry expert to review the investment package and its materials.

42. 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 McNerny, 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 McNerny 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.

43. Petitioner admitted he did not have any understanding of his investment in the subject ventures, or of the risks and responsibilities that accompanied the same, and did not undertake any efforts to gain any such understanding. Petitioner conceded that he did not question the turnkey drilling contract price, or make any attempt to investigate it on his own or by the retention of any advisors.

SUMMARY OF THE PARTIES' POSITIONS

44. Petitioner correctly points out that the Division of Taxation's proposed adjustments to his 2004, 2005 and 2006 personal income tax 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. At the same time, petitioner does not specifically dispute the propriety of applying the six-year statute of limitations upon the position that the investments in issue represented abusive tax avoidance transactions. Instead, petitioner complains that the statutory notices for the years at issue were sent to him all at one time, as opposed to on an

ongoing yearly basis. Petitioner asserts this was undertaken by the Division as a means of keeping the period of limitation on assessment open, while simultaneously overwhelming him and depriving him of the opportunity to address any of the asserted deficiencies one year at a time. Petitioner describes this as "underhandedly slipping the burden of proof" to him. Further, while petitioner does not specifically contest his liability for the tax at issue (assuming the six-year statute of limitations properly applies), he does contest the imposition of interest and penalties.

45. 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 chief purpose of the subject partnerships, and of petitioner's involvement therein, was to avoid or evade tax. The Division points out that petitioner provided no evidence at hearing, or otherwise, and is thus unable to establish that the entities in issue and his investments therein had any economic substance or any valid nontax purpose. 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 acquisition 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. Finally, 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. Petitioner contends that the notices of deficiency issued to him for the years 2004, 2005 and 2006 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 returns for years 2004, 2005 and 2006 were filed on or before April 15 of each succeeding year. 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 April 15 of 2008, 2009 and 2010, respectively). There is no dispute that the notices of deficiency were all issued on February 28, 2011, and thus the notices for the years 2004, 2005 and 2006 were in fact issued beyond the three-year statute of limitations under Tax Law § 683(a).[9]

B. 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 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 falls well within this six-year statute of limitations. 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.

C. 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

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[9] The Notice of Deficiency for the year 2007 was also issued on February 28, 2011, a date falling within three years after the April 15, 2008 filing due date for petitioner's 2007 return. Such notice is thus clearly not barred by the statute of limitations on assessment in any event.

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]; italics added).

D. 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.

E. Review of the record in this case 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). The terms of the offering materials for the partnerships, the letters from the promoter, and the information provided upon the Division’s interviews of other participants in the ventures (***see*** Findings of Fact 24 and 25), and petitioner’s own testimony, 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*** Finding of Fact 23). 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 notes, nor any evidence that payments have been made on any of these notes.

F. 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 36). 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. As testified to by the Division's expert witness, without objection or challenge, all of 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).

G. It is also noteworthy that there is no proof that the promissory notes in this case constituted genuine or bona fide debt. The general 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, 1230 [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.***). Apart from the existence of the notes themselves (which petitioner denied signing) and the recitation therein that interest was charged at the rate of six percent (albeit simple, *nonrecourse* interest), none of the foregoing factors of genuine indebtedness are present here. Moreover, the notes are long-term (15 to 30 year) notes not typically used in turnkey drilling operations. As described in Mr. Morris's testimony, 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 to. 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.[10]

H. Petitioner was clearly not a savvy or experienced investor or businessman. His testimony revealed that he did no investigation, either on his own or via the retention of others with expertise in oil and gas drilling ventures, before investing. Petitioner did not perform any level of "due diligence," and even a cursory reading of the materials concerning the ventures in question 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, 2005 and 2006). 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

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[10] With no evidence that any leases were acquired or any drilling was undertaken (***see*** Finding of Fact 42), 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 IDCs (***see*** Finding of Fact 12). 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' intent.

promissory notes accompanying the ventures did not represent amounts of genuine and bona fide 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.

I. Finally, the Division has imposed penalties pursuant to Tax Law § 685(b)(1) and (2) for each year at issue, and also imposed a penalty for 2004 (only) under the Voluntary Compliance Initiative (***see*** Finding of Fact 8). 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. It cannot be said that petitioner acted without negligence in this matter. Rather, he clearly failed to act with ordinary care and prudence. 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. Thus, petitioner is determined to have been negligent, such that penalties were properly imposed pursuant to Tax Law §§ 685(b)(1) and (2) (***Matter of Murray***, Tax Appeals Tribunal, December 14, 1995). Such penalties, as well as that asserted for the year 2004 (only) pursuant to the provisions of the Voluntary Compliance Initiative (L 2005, ch 61, Part N, § 11), are sustained.

J. The petition of Joseph and Nancy Francoforte is denied and the notices of deficiency date February 28, 2011, together with interest and penalties, are sustained.

DATED: Albany, New York
February 19, 2015

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE