UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 91-4806

FRANK and MARIANNE OWEN, JOHN A. and CLO R. HOLLAND, CHARNEY HERMANN, ROBERT and BOBBY CROCKER, ET AL.,

Petitioners,

VERSUS

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Appeal from a Decision of the United States Tax Court
(41476-86, 39079087, 13374-87, 18050-87,
18052-87, 32312-87 & 37014-87)

(November 30, 1992)

Before POLITZ, Chief Judge, SMITH, and BARKSDALE, Circuit Judges.

PER CURIAM:[1]

In issue is a decision of the United States Tax Court disallowing deductions for intangible drilling costs and imposing penalties. We **AFFIRM.**

I.

Frank and Marianne Owen, John A. and Clo R. Holland, Charney Hermann, Robert and Bobby Crocker, John P. and Polly A. Thomas, and Donald S. and Marjorie L. Henderson (the taxpayers) all claimed

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[1] Local Rule 47.5.1 provides: "The publication of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens on the legal profession." Pursuant to that rule, the court has determined that this opinion should not be published.

deductions from income for prepaid intangible drilling costs (IDCs), which were disallowed by the Commissioner.[2] Each of them invested in one or both of two partnerships, Willow Drilling, Ltd., and Carnegie Drilling, Ltd., whose stated purposes were primarily to engage in development drilling for natural gas. Both partnerships were established near the end of the tax years in which the deductions at issue were claimed -- Willow in 1980, Carnegie in 1981 -- and were managed by the same general partner and represented by the same law firm.

To purchase a partnership unit in either, an investor had to pay a specified amount in cash ($10,000 for Willow, $8,000 for Carnegie), pledge a specified amount in the form of promissory notes ($10,000 for Willow, $12,000 for Carnegie), and pay additional amounts for organizational expenses ($500 for Willow, $1,200 for Carnegie, per unit). Only Holland and Henderson invested in Willow,[3] but all of the taxpayers, except Holland, invested in Carnegie.[4]

On its 1980 partnership tax return, Willow claimed $240,636 in IDCs, representing amounts paid to a driller with whom it executed a turnkey drilling contract on December 29, 1980. These funds were

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[2] Except for Charney Hermann, all of the taxpayers filed joint returns for the years at issue.

[3] Holland purchased four units; Henderson, one.

[4] Crocker invested $4,275 cash, $6,000 in promissory notes, and $275 for organizational costs; Owen, $111,150 cash, $156,000 in notes, and $7,150 for costs; Hermann, $2,137 cash, $3,000 in notes, and $137 for costs; Henderson, $17,000 cash, $24,000 in notes, and $1,000 for costs; and Thomas, $8,550 in cash, $12,000 in notes, and $550 for costs.

comprised of the cash contributed to Willow by the taxpayers and amounts acquired in exchange for the assignment of their promissory notes to K & S Associates, Inc.[5] The Willow taxpayers -- Holland and Henderson -- each claimed their proportional share of the deductions on their individual returns. Neither made any payment of principal or interest on the notes contributed to Willow, nor was a demand or request for payment ever made.

On its 1981 partnership tax return, Carnegie deducted $1,102,500 in IDCs paid to a driller with whom it had executed a turnkey drilling contract on December 30, 1981, an amount also comprised of the taxpayers' cash contributions and notes. The Carnegie taxpayers each claimed their proportional share of the deductions on their 1981 individual returns. Again, no payments were ever made on the promissory notes, nor demand for payment ever made.

The Commissioner determined deficiencies in each of the taxpayers' individual income tax with respect to their IDC deductions, and imposed penalties with respect to some of the deficiencies for negligence and substantial underpayments of tax attributable to tax motivated transactions, under I.R.C. §§ 6653(a) and 6621(c).[6] The taxpayers filed petitions with the tax court,

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[5] K & S Associates was partially owned by Mortimer Kass, who was both an investor in Willow and an attorney with the law firm that represented Willow and Carnegie.

[6] With respect to Carnegie, the Commissioner determined deficiencies against Hermann, Crocker, Thomas, Henderson, and Owen. Penalties were imposed against them under I.R.C. §§ 6653(a)(1), (a)(2), and 6621(c). With respect to Willow, deficiencies were determined against Holland and Henderson, and

contesting the determinations of the Commissioner. The cases were consolidated for decision and submitted without trial on stipulated facts, pursuant to Tax Ct. Rule 122. The tax court issued its Memorandum Findings of Fact and Opinion in March 1990, finding in favor of the Commissioner on all issues.

II.

The taxpayers contend that the tax court erred in disallowing the IDC deductions and in imposing the penalties under I.R.C. §§ 6653(a) and 6621(c).[7]

A.

The tax court found that the taxpayers failed to prove their entitlement to the IDC deductions. Section 263(a) of the Internal Revenue Code generally disallows deductions for expenses that increase the value of property. Section 263(c) provides an exception to this rule, however, allowing taxpayers an option to deduct (expense) intangible drilling and development costs in the case of oil and gas wells if they do so in accordance with treasury regulations. Those regulations permit only "operators" to deduct IDCs, and define an operator as "one who holds a working or operating interest in any tract or parcel of land either as a fee

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Henderson was assessed penalties under I.R.C. § 6621(c) for that year.

[7] A deficiency regarding a disallowed charitable contributions carryover was also determined against Owen for 1982. Owen contends that the tax court erred in finding the issue abandoned. The tax court so held because the issue was not addressed in the briefs submitted to it. Owen disputes this only by pointing to a one-sentence requested finding of fact contained in a non-argument portion of the brief. We agree with the tax court that this was not sufficient to preserve the issue.

owner or under a lease or any other form of contract granting working or operating rights". Treas. Reg. § 1.612-4(a).

The tax court found that the taxpayers did not present sufficient evidence to prove that either of the partnerships had operator status during the years in question (1980 for Willow, 1981 for Carnegie). The Commissioner's notices of deficiency carried a presumption of correctness, *see* ***Brown v. United States,*** 890 F.2d 1329, 1334 (5th Cir. 1989); ***United States v. Janis,*** 428 U.S. 433, 441 (1976), which the taxpayers had the burden of overcoming by presenting evidence illustrating their entitlement to the deductions, Tax Ct. Rule 142(a); ***Greenberg v. Commissioner,*** 63 T.C.M. (CCH) 3042 (1992). Obviously, that burden did not change because the case was submitted on fully stipulated facts. *See* Tax Ct. Rule 122(b). A determination that the taxpayers failed to come forward with sufficient evidence to support a deduction is a factual finding that we review only for clear error. ***Sandvall v. Commissioner***, 898 F.2d 455, 458 (5th Cir. 1990).

The only evidence supporting the taxpayers' claim to operator status was statements contained in the preambles to the Willow and Carnegie turnkey drilling contracts to the effect that Willow and Carnegie both subleased certain unspecified drilling sites.[8] The

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[8] As noted, the turnkey drilling contracts were executed at the end of 1980 and 1981. They were entered into evidence by means of a joint stipulation and a request for admission, each stating that the attached documents (the contracts) were "true and correct cop[ies]" of the turnkey contracts. The taxpayers assert that by virtue of the stipulation and the admission, the Commissioner conceded the factual truth of the contents of the documents; specifically, the statements regarding the leases. The tax court rejected this argument, as do we. Agreeing that a

taxpayers submitted no evidence, documentary or otherwise, to corroborate these statements.[9] Furthermore, the record contained evidence indicating that the partnerships did *not* hold leases on the drilling sites during the respective years in question.[10] We acknowledge that the taxpayers need not necessarily have obtained formal lease assignments before incurring the IDCs. *See* Treas.

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document is "a true and correct copy" means nothing more than that. By its plain language, such an agreement applies only to the authenticity of the document. "It, of course, would have been more cautious for [the Commissioner] to state ... that he was stipulating only to the authenticity", but it was not necessary. *See* ***Wolfson v. Commissioner,*** 37 T.C.M. (CCH) 1847-14 (1978).

[9] In their reply brief, the taxpayers state that a principal in the two partnerships was prepared to testify that the drilling sites had been acquired even before the partnership prospectuses were issued, but that the tax court refused to leave the record open in order for them to depose the witness. If, by this contention, the taxpayers intend to raise a point of error, the issue was not presented in their initial brief, and is therefore waived. *E.g.,* ***United Paperworkers Int'l Union v. Champion Int'l Corp.,*** 908 F.2d 1252, 1255 (5th Cir. 1990).

[10] The taxpayers stipulated that a document entitled "Assignment of Oil and Gas Lease" represented Willow's ownership interest in the drilling sites referred to in the turnkey contract. That assignment, however, was executed in August 1981, well after the December 1980 execution of the turnkey contract and after the close of the 1980 tax year. Moreover, the Willow prospectus, dated December 5, 1980, stated that Willow did not have a binding agreement for acquisition of a drilling site at that time, and no documents were submitted showing that any sublease was acquired before the close of the year.

In January 1982, Carnegie's driller sent Carnegie a letter indicating that no lease assignments had yet been filed, accompanied by a copy of a purported assignment of an oil and gas lease dated January 8, 1982. In October 1982, Carnegie's general partner wrote a letter stating: "To this date, I have not received leases or any other information relating to the drilling." Finally, Carnegie's only evidence regarding a recorded lease indicates that one was not assigned or delivered to Carnegie until April 1983.

Reg. 1.612-4. The taxpayers, however, failed to submit evidence of even informal lease agreements in the stipulations submitted to the tax court, and "[i]t is too late now for [the taxpayers] to carry [the] burden of proof that [they] failed to carry in the Tax Court". *See* ***Lake Superior Dist. Power Co. v. Commissioner***, 701 F.2d 695, 701 (7th Cir. 1983). In sum, the tax court's findings of non-operator status were not clearly erroneous.

B.

The taxpayers next contend that the tax court erred in imposing a negligence penalty against all but Holland. If any part of the underpayment is due to negligence or intentional disregard of rules and regulations, § 6653(a)(1) of the Internal Revenue Code imposes an addition to tax equal to five percent of an underpayment plus an amount equal to 50 percent of the interest due on the portion of any underpayment that is attributable to negligence.[11] Negligence, for purposes of this section, includes any failure to make a reasonable attempt to comply with the tax code, including the failure to do what a reasonable person would do under similar circumstances. ***Heasley v. Commissioner,*** 967 F.2d 116, 120 (5th Cir. 1992).

The Commissioner's determinations that certain taxpayers were liable for additions to tax pursuant to § 6653(a)(1) were presumptively correct. *See* ***Freytag v. Commissioner,*** 904 F.2d

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[11] The Omnibus Budget Reconciliation Act of 1989 amendments to the Internal Revenue Code, replacing the negligence penalty with an accuracy-related penalty, *see* Pub. L. No. 101-239, 103 Stat. 2106 (codified at 26 U.S.C. § 6662), do not apply to the years in issue.

1011, 1017 (5th Cir. 1990), *aff'd*, ___ U.S. ___, 111 S. Ct. 2631 (1991). Accordingly, those taxpayers had the burden of "establishing the absence of negligence". ***Id.***; *see* ***Sandvall v. Commissioner,*** 898 F.2d 455, 459 (5th Cir. 1990). The tax court concluded that the taxpayers failed to prove that the underpayments of tax were not due to negligence. We review this finding only for clear error. *See* ***Portillo v. Commissioner,*** 932 F.2d 1128, 1135 (5th Cir. 1991); ***Sandvall,*** 898 F.2d at 459.

In asserting the absence of negligence, the taxpayers cite only the fact that they relied on a nationally known accounting firm to prepare their tax returns and on the prospectuses provided by the promoters of the investments.[12] They rely on ***Heasley***, 967 F.2d at 116, in support of their contention that these facts "as a matter of law negate negligence for income tax purposes".

Heasley does not support this contention. "As a general rule, the duty of filing accurate returns cannot be avoided by placing responsibility on a tax return preparer." ***Metra Chem Corp. v. Commissioner,*** 88 T.C. 654, 662 (1987). ***Heasley*** involved moderate income investors, neither of whom had a high school education or much investment experience. 967 F.2d at 119. In addition to hiring a certified public accountant to prepare their tax return, the Heasleys relied on a financial advisor whom they believed to be trustworthy, and they personally monitored their investment. We

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[12] They also assert that they, "as was stipulated, monitored their investments"; but they do not cite to the record, nor do we find it in the record. In any event, this would not result in showing an absence of negligence.

did not state that the Heasleys' reliance on their accountant alone "negated" any negligence on their part. Rather, we held that "[u]nder these circumstances" imposing a negligence penalty was improper. ***Id.*** at 121.

The circumstances of this case differ significantly from those in ***Heasley***. The taxpayers did not demonstrate that they were inexperienced investors or uneducated. Moreover, the prospectuses stated that only inquirers who had "knowledge and experience in financial and business matters [and who were] capable of evaluating the merits and risks of [the] investment" would be eligible to purchase partnership units. Furthermore, the prospectuses contained several caveats regarding the possible tax consequences of investing in the partnerships, and warned: "each investor is strongly advised to consult his own personal tax advisor for independent tax advice as to ... the tax aspects and risks of the entire transaction and investment ...." In these circumstances, we hold that the tax court did not err in imposing negligence penalties under § 6653(a).

C.

Finally, the taxpayers contend that the tax court erred in imposing interest on the tax deficiency at the rate set forth in I.R.C. § 6621(c) against all but Holland. Section 6621(c)(1) provides for an increased rate of interest (120 percent of the statutory rate otherwise imposed on underpayments) on substantial underpayments attributable to tax motivated transactions. A substantial underpayment is defined as one in excess of $1,000.

I.R.C. § 6621(c)(2). Tax motivated transactions include activities with respect to which losses are disallowed by reason of the at-risk provisions of I.R.C. § 465(a). I.R.C. § 6621(c)(3)(A)(ii).

Section 465(a) allows investors engaged in oil and gas exploration to deduct losses from those activities "only to the extent of the aggregate amount with respect to which the taxpayer is at risk ... for such activity at the close of the taxable year". I.R.C. §§ 465(a)(1), (c)(1)(D). A taxpayer generally is considered to be at risk for an activity to the extent of the cash and the adjusted basis of property contributed to the activity, as well as any amounts borrowed for use in the activity to the extent that the taxpayer is personally liable for the repayment of such amounts. I.R.C. §§ 465(b)(1), (2).

The tax court found that the taxpayers were at risk only with respect to their cash contributions, and not with respect to amounts pledged through promissory notes; thus, part of their losses was disallowed. The court made the following findings with respect to the Willow promissory notes: (1) they were held by a person with an impermissible interest in the activity and thus disallowed under I.R.C. § 465(b)(3)(A), (2) there was never any intent to enforce the recourse nature of the notes, and (3) the Willow partners were protected by drilling risk insurance and thus, under I.R.C. § 465(b)(4), were not at risk up to the amount of insurance coverage. With respect to Carnegie, the tax court found that the promissory notes were shams.

1.

The Willow taxpayers contend that the tax court erred in applying the interested creditor rule of I.R.C. § 465(b)(3). They assert that only "related persons", as defined in I.R.C. §§ 465(b)(3)(C) and 267(b), are prohibited from serving as creditors, and that this definition does not apply to the Willow notes.

The taxpayers misread § 465(b)(3) and the tax court's opinion. That section provides: "amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who has an interest in such activity *or* from a related person to a person ... having such an interest". I.R.C. § 465(b)(3)(A) (emphasis added). Mortimer Kass, an owner of K & S Associates (the entity to which the promissory notes were assigned), was also a limited partner in Willow. Accordingly, the tax court found that Kass was a creditor with an interest in Willow. It did *not* find that he was a *related person* to a person having such an interest. The related person prohibition is *alternative* to the interested creditor prohibition by virtue of the "or" in § 465(b)(3)(A). Thus, the related person prohibition is irrelevant here; it was the interested creditor prohibition that the tax court relied on in finding that the taxpayers were not at risk with respect to the promissory notes.

The taxpayers' only other argument regarding the at-risk provisions is the same one they made to the tax court; namely, that K & S Associates acquired the promissory notes as a result of a sale rather than a loan. The tax court found that the taxpayers

failed to prove that any sale had occurred. The taxpayers devote only two sentences to this argument in their briefs, and fail to explain why the tax court's finding that no sale occurred is clearly erroneous. Furthermore, they have not cited either to the tax court or to us any authority for their proposition that the interested creditor prohibition would not apply even if some type of sale had occurred. In these circumstances, we see no reason to question the tax court's conclusion.

Because we uphold the tax court's finding that the Willow investors were not at risk with respect to the promissory notes because of the interested creditor prohibition, we need not address the taxpayers' alternative arguments regarding the at-risk provisions.[13]

2.

With respect to the Carnegie notes, the taxpayers state only that "the Tax Court held the assignment [of the notes] to the driller ... did not generate funds, therefore the investors were not at risk. This was error." The tax court made no such finding. Rather, it concluded that the notes were shams because they were never transferred to an independent lender, they were never converted into amounts that could be used for Carnegie, and there was never any effort to collect on them. Furthermore, we cannot

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[13] It is unclear exactly what these arguments are in any event. The taxpayers spend over three pages in their brief arguing that the drilling investments were not shams, but the tax court never found that they were. Rather, it found only that the Carnegie promissory notes were shams, and thus did not constitute amounts at risk.

address the merits of the taxpayers' flat assertion of error when they fail to explain the grounds for such assertion. Again, we see no reason to question the tax court's finding.

3.

Finally, the taxpayers contend that the substantial underpayment penalty provisions do not apply because a tax motivated transaction is defined as one not engaged in for profit. Again, the taxpayers misread the Internal Revenue Code. Section 6621(c)(3) describes five different types of transactions that are considered tax motivated, and provides regulatory authority by which additional types of transactions may be specified as tax motivated. Transactions not engaged in for profit (the definition urged by the taxpayers) are merely one category of transactions, among several, that are considered tax motivated. *See* I.R.C. § 6621(c)(3); Temp. Treas. Reg. § 301.6621-2T.

Transactions for which losses are disallowed by reason of the at-risk provisions discussed above are included specifically in the definition of tax motivated transactions. *See* I.R.C. § 6621(c)(3)(A)(ii). This definition provided the basis for the tax court's imposition of the additional interest penalties; it was not also required to determine whether the Willow and Carnegie investments were engaged in for profit. Because we affirm the tax court's finding that the IDC deductions were disallowed in part by the at-risk provisions, the imposition of the additional interest penalty under § 6621(c) was proper.

III.

For the foregoing reasons, the decision of tax court is

AFFIRMED.