

Appeal of Robert S. and Mary O. Fadem

The sole issue is whether appellants have established error in respondent's proposed assessments.

Pursuant to the provisions of the Internal -Revenue Code section 6103(d), respondent received an audit report from the Internal Revenue Service (IRS) on December 14, 1971, disclosing the disallowance of appellants' claimed deductions **for** intangible drilling and development costs in the amounts of \$15,000 and **\$25,320.82** for 1968 and 1969, **respectively.**^{1/} As appellants had claimed corresponding deductions in their state returns, respondent issued notices of proposed assessment for 1968 and 1969 on which it applied the federal adjustments **for** state purposes. Appellants protested,, claiming the federal adjustments on which respondent based its proposed assessments to be in error. After due consideration, respondent **affirmed** the proposed assessments and this appeal followed.

Appellants oppose respondent's actions for **several** reasons. **They first argue** that such actions are barred by the statute of limitations. Appellants also state that their only reason for choosing not to contest the federal adjustments was because the expense that would have been involved exceeded the total amount. of the proposed federal adjustments. Appellants additionally indicated that the federally disallowed deductions were related to an oil well investment and that the disallowances resulted from a determination that there had been no **actual** investment. **This finding** was said to be based on the drilling company's practice of using money from current investors to pay amounts due previous investors. In a post-hearing memorandum, appellants amplified their position. They outlined the history of their involvement in the subject oil and gas exploration investment. They stated that they signed contracts for three separate drilling projects and that they regularly received business progress reports. They also stated that they received royalties., They additionally acknowledged that, as a result of investigations by the Securities and Exchange Commission, the drilling company's activities were restricted in 1971, leading the company to eventually declare bankruptcy later that same year. Following the drilling **company's** demise, the IRS apparently took action against appellants, disallowing the **above-**referenced deductions that they had claimed. Appellants' **acquiescence** to those disallowances followed, although they had maintained that the **fact** that they acted *in* good faith when they made their oil and gas well investments was enough to entitle them to their claimed

^{1/} The federal report also indicated adjustments to appellants' 1970 taxable income, but since these latter adjustments resulted in a **reduction** of appellants' 1970 tax liability, and respondent incorporated **them** in allowing a resulting state income tax refund, the 1970 adjustments are not in issue.

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deductions. They now rely on that same argument in opposing the assessments proposed by respondent. For the following reasons, we believe respondent's actions should be upheld.

We first conclude that there is no merit to appellants' procedural contention that the proposed assessments under review are barred by the statute of limitations. Pursuant to section 18586.2 of the Revenue and Taxation Code, when the IRS, and not the taxpayer, notifies respondent of a federal redetermination; respondent has four years from the date of such redetermination in which to issue a notice of proposed deficiency assessment. Since the federal audit report disclosing the federal changes is dated December 14, 1971, and since respondent's notices were issued on May 19, 1972, respondent's proposed assessments were well within the allowable limitations period.

Appellants' remaining contentions must also be rejected. Pursuant to section 18451 of the Revenue and Taxation Code, a taxpayer is **required to** report to the Franchise **Tax Board any federal audit** adjustments resulting in a redetermination of the taxpayer's gross income. The taxpayer is required to concede the accuracy of such redetermination or state wherein it is erroneous. The burden of proof is on the taxpayer to overcome the presumptive correctness of the federal determination by **supplying** affirmative evidence to the contrary. (Appeal of Rudolph, Jr., and Mary M. Como, Cal. St. Bd. of Equal., April 10, 1979; Appeal of Charles O. and Gail P. Spencer, Cal. St. Bd. of Equal., Feb., 3, 1977; Appeal of Thomas and Vera Wills, Cal. St. Bd. of Equal., Dec. 15, 1976.) Appellants have advanced no arguments or facts in this appeal which would support a finding that the IRS determination was erroneous, even though they explain their failure to litigate the IRS **actions** as due solely to financial considerations. Nonetheless, a taxpayer's claim that he only acquiesced in the federal adjustments because of coercion and economic reasons only explains the taxpayer's motivation. It does not have any bearing on whether the federal determination was **correct**. (Appeal of Robert J. and Evelyn A. Johnston, Cal. St. Bd. of Equal., April 22, 1975; Appeal of Charles O. and Gail P. Spencer, supra; Appeal of Carl H., Jr. and Madonna Gross, Cal. St. Bd. of Equal., Aug. 16, 1979; Appeal of Ronald J. and Eileen Bachrach, Cal. St. Bd. of Equal., Feb. 6, 1980.) In view of appellants' failure to present any evidence in support of their deductions, they have not shown the federal determination to be erroneous. On that basis alone, we must uphold respondent's proposed assessments.

In any event, contrary to the belief espoused by appellants, there is ample case law supporting the IRS position. Appellants' **situation** is akin to that of several other taxpayers who have contested similar disallowances. (See, e.g. Lloyd L. Cottingham, 63 T.C. 695 (1975); Erwin H. Haass, 55 T.C. 43 (1970); Bruce A. Sanderson, ¶ 77,040

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P-H Memo. T.C. (1977); Dale L. Gardner, ¶ 76,337 P-H Memo. T.C. (1976); Donald L. Heberer, ¶ 74,139 P-H Memo, T.C. (1974).) These other cases involved investors, mostly Southern Californians such as appellants, who invested in gas and oil well projects during 1968 and 1969. In all those cases, deductions comparable to those claimed **by** appellants were disallowed for failure to establish the requisite "economic interest" in the property in respect of which the deductions had been claimed. "Economic interest," in that context, requires, at **a minimum**, a "link [between] specific contracts . . . [and] specific wells and drilling operations . . ." (Lloyd L. Cottingham, supra.) It **was** found in those cases that the contracts and production reports falsely indicated that individual wells **were** assigned to specific investors, Despite the good intentions to the contrary when the projects were initially promoted, in practice investors **were** rarely linked to specific wells, and production reports were routinely sent to investors on wells- not yet drilled or on wells assigned to more than one investor. **The** investor "good faith" argument advanced by appellants was also **specifically** addressed **and** rejected **in Bruce A. Sanderson**, supra. Since appellants have presented no information which would place them in any better position than the taxpayers in the cases **referenced** above, those cases compel the conclusion that respondent's actions in this matter were entirely proper.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Robert S. and Mary O. **Fadem** against proposed assessments of additional personal income tax in the amounts of **\$1,364.62** and **\$2,434.10** for the years 1968 and 1969, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this **1st** day of March , 1983, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Nevins and Mr. Harvey **present.**

_____, Chairman
Ernest J. Dronenburg, Jr. , **Member**

Conway H. Collis _____, Member
Richard Nevins _____, Member
Walter Harvey* _____, Member

*For Kenneth Cory, per Government Code Section 7.9