T.C. Summary Opinion 1998-20

UNITED STATES TAX COURT

DONNA D. CAPKA, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3029-96S. Filed January 29, 1998.

Donna D. Capka, pro se.

Jason M. Silver, for respondent.

NAMEROFF, Special Trial Judge: This case was heard pursuant to the provisions of section 7463.[1] The decision to be entered is not reviewable by any other court, and this opinion should not be cited as authority.

Respondent determined a deficiency in petitioner's 1993 Federal income tax in the amount of $3,336 and an accuracy-related penalty under section 6662(a) in the amount of $667.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the year at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

After concessions,[2] the issues for decision are: (1) Whether petitioner is entitled to certain Schedule C deductions for expenses relating to her working interest in a methane gas and oil drilling operation (the operation); and (2) whether petitioner is liable for the accuracy-related penalty.

Background

Some of the facts have been stipulated, and they are so found. The stipulation of facts and the attached exhibits are incorporated herein by this reference. At the time she filed her petition, petitioner resided in Sherman Oaks, California.

Petitioner is a sport and clinical psychologist. Petitioner and Helen Baker (Ms. Baker) reside together in petitioner's house.

Jet Drilling Corp. (Jet) purportedly operates an oil and gas venture involving leased mineral interests in the State of Kansas. Jet sold investments of units represented to be working interests in the drilling operations. According to the unsigned copy of the prospectus stipulated by the parties, Jet provided two drilling "programs" (i.e., drilling sites) that were divided into 25 units and sold for $40,000 per unit to independent contractor investors. While the prospectus is silent on the matter, petitioner believed that, in return for her investment,

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[2] On her Schedule C-1 for her psychologist activity, petitioner claimed five categories of expenses which were adjusted by respondent. In the stipulation of facts, petitioner prevailed as to three of the categories and conceded the other two, resulting in a small adjustment to reported adjusted gross income.

she would be receiving a monthly check, initially as "return of capital" and ultimately as income. Robert Cornell (Mr. Cornell), as president of Jet, and Don Thompson, as driller/operator of Tyco, Inc., managed and operated the drilling program.

Sometime before the middle of 1993, Ms. Baker's son invested in Jet and then persuaded her to do the same. For reasons unsatisfactorily explained, Ms. Baker allegedly invested $50,000 (instead of $40,000) in Jet and began receiving monthly checks in excess of $500. Ms. Baker then persuaded petitioner to invest in Jet.[3] According to petitioner, she also invested $50,000 in Jet and received one "monthly" check for $562 in 1993.[4] Petitioner believes that she had purchased a fractional undivided working interest in a gas and oil drilling operation. She had no day-to-day involvement in the operation or management of her working interest.

Petitioner also believes that the drilling program had taken place at two lease locations, a Dye lease in Chautauqua County,

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[3] In fact, Ms. Baker handled most of the investment activity with Jet on petitioner's behalf. This included writing the checks from the joint account to purchase petitioner's interest in the operation, meeting with the principals involved with the operation, and handling most of the correspondence between petitioner and Jet.

[4] The record does not contain signed contracts or prospectuses substantiating petitioner's actual investments. Neither the canceled checks nor the bank account records in the record are persuasive on that issue. Although it is not relevant to our final disposition of the case, we are unable to make a finding of fact as to the exact amount of petitioner's investment.

Kansas, and a Warner lease in Montgomery County, Kansas, and that her $50,000 covered her share of the costs associated with drilling and completing 15 wells on one or both of the above locations.

Sometime after 1993, Jet began experiencing financial troubles. Petitioner provided little detail as to the exact nature of Jet's problems. She thinks that Jet's problems resulted from production delays caused by several factors, including a fire and a flood in or near the gas wells and health problems experienced by Mr. Cornell and an accountant, Mr. C. Rex Olson (Mr. Olson). At some point, petitioner stopped receiving monthly payments from Jet.

On her 1993 Schedule C-2 for the "Oil and Gas Working Interest", petitioner reported no income but showed expenses of $27,540, which consisted of $22,471 for "Intangible Drilling Costs", $3,684 for "Operating Expenses", and $1,385 for depreciation. Petitioner had her Federal income tax return prepared by her tax professional, with the exception of the Schedule C-2, which was prepared by Mr. Olson. In the notice of deficiency, respondent, inter alia, disallowed the Schedule C-2 deductions and determined that petitioner was liable for an accuracy-related penalty.

In response to respondent's audit, petitioner tried to obtain documentation that would substantiate the expenses at issue. Petitioner and Ms. Baker made numerous telephone calls and wrote several letters to both Mr. Cornell and Mr. Olson in

their attempt to obtain financial records that would support the claimed deductions. Despite these efforts, petitioner was unsuccessful in obtaining documentation.

A week or two before trial in this case, petitioner attempted to serve a subpoena on Mr. Cornell requiring him to appear before this Court on the trial date with "documents substantiating expences [sic] incurred for the working Interes [sic] in Jet Drilling for 1993 Schedule 'C'". Neither Mr. Cornell nor his representative appeared before this Court, and none of the requested documents were received at that time. We, therefore, left the record open to afford petitioner the opportunity to consider enforcement of the subpoena[5] and/or obtain and submit by stipulation or motion appropriate records not yet in her possession. Ultimately, petitioner did receive some additional documents from Mr. Cornell, and those items were made part of the record. These documents appear to be drilling reports of some sort and contain various headings, including "Notice of Intention to Drill" and "Application for Surface Pond". We note that most if not all of these reports relate to years other than 1993 and to properties other than the Dye and Warner leases.

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[5] We note that petitioner made no request for enforcement of the subpoena; it appears that the subpoena was not served in accordance with Rules 147 and 148.

Discussion

Section 162(a) permits the deduction of "ordinary and necessary" expenses paid or incurred during the taxable year in carrying on any trade or business. Deductions are a matter of legislative grace, and the taxpayer must prove that she is entitled to those claimed. Rule 142(a); INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). She also must maintain adequate records to substantiate deduction amounts. Sec. 6001; Meneguzzo v. Commissioner, 43 T.C. 824, 831-832 (1965).

Generally, except as provided by section 274(d), when evidence shows that a taxpayer incurred a deductible expense, but the exact amount cannot be determined, the Court may approximate the amount. Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir. 1930). The Court, however, must have some basis upon which an estimate may be made. Vanicek v. Commissioner, 85 T.C. 731, 742-743 (1985).

Respondent contends that petitioner failed to establish that she is entitled to the Schedule C-2 expenses claimed on her return. Petitioner, on the other hand, argues that she has furnished the Court with all the documents she could obtain and that these items establish that she is entitled to the claimed deductions.

Upon review of the record, we hold that petitioner is not entitled to the claimed Schedule C-2 expense deductions as she has failed to establish that the amounts claimed as deductions were, in fact, incurred and paid. Noticeably absent from

evidence were Jet's financial records, invoices, and/or receipts indicating how much money was expended on the operation during 1993. Hence, we have no basis on which to approximate the amount of the expenditures or the taxable years in which they were made. The drilling reports are not helpful to our determination as they do not pertain to the year before the Court. Accordingly, petitioner is not entitled to deduct the expense items claimed on her Schedule C-2.

Section 6662 imposes a penalty equal to 20 percent of the portion of the underpayment attributable to, inter alia, negligence or disregard of rules or regulations. "Negligence" includes failure to make a reasonable attempt to comply with the law, and the term "disregard" includes careless, reckless, or intentional disregard. Sec. 6662(c). Failure to maintain adequate records constitutes negligence. Crocker v. Commissioner, 92 T.C. 899, 917 (1989); Schroeder v. Commissioner, 40 T.C. 30, 34 (1963). Moreover, negligence includes failure to exercise due care of a reasonable and ordinarily prudent person under like circumstances. E.g., Allen v. Commissioner, 925 F.2d 348, 353 (9th Cir. 1991), affg. 92 T.C. 1 (1989); Neely v. Commissioner, 85 T.C. 934, 947 (1985).

The Commissioner's determination imposing the section 6662(a) accuracy-related penalty is presumed correct, and the taxpayer bears the burden of proving that she is not liable for the penalty. Rule 142(a); Tweeddale v. Commissioner, 92 T.C. 501, 505 (1989). No penalty, however, shall be imposed under

section 6662(a) with respect to any portion of an underpayment if it is shown that there was reasonable cause and the taxpayer acted in good faith with respect to that portion of the underpayment. Sec. 6664(c).

The disallowance of petitioner's Schedule C-2 deductions stems from her negligent handling of her tax affairs. Petitioner failed to maintain adequate records to sustain the Schedule C-2 deduction amounts. While it is true that petitioner did not have access to Jet's financial records and relied upon Mr. Olson's professional judgment in reporting her Schedule C-2 deductions, this fact alone is not an absolute defense to negligence. Freytag v. Commissioner, 89 T.C. 849, 888 (1987), affd. 904 F.2d 1011 (5th Cir. 1990), affd. 501 U.S. 868 (1991); Glassley v. Commissioner, T.C. Memo. 1996-206. Petitioner's actions do not satisfy the standard of care that a reasonable and ordinarily prudent person would have taken under the circumstances. Petitioner claimed the expenses without making even a threshold inquiry into the legitimacy of those deductions. Indeed, petitioner did not independently research the operation before investing in it. Rather, she relied upon Ms. Baker's and her son's recommendation. Petitioner knew very little about the aspects of her investment and the principals involved. Under the circumstances, petitioner has not demonstrated a good faith reliance on Mr. Olson's advice. No evidence was submitted with

respect to the causes for the other adjustments determined in the notice of deficiency and resolved by stipulation. See supra note 2.

In light of the above, we hold that petitioner is liable for the section 6662(a) accuracy-related penalty.

Reviewed and adopted as the report of the Small Tax Case Division.

To reflect the parties' concessions,

Decision will be entered under Rule 155.