Finkel v. Commissioner, 80 T. C. 389 (1983)

A partnership must have a primary objective of making a profit to be entitled to deduct expenses as business expenses.

Summary

Finkel v. Commissioner involved limited partners seeking to deduct their share of losses from coal-mining partnerships. The partnerships had paid out significant sums for royalties, management fees, and other expenses without mining any coal. The court held that the partnerships lacked a profit motive, focusing instead on tax deductions. Consequently, the partnerships could not deduct advanced royalties or management fees as business expenses, though individual partners could deduct accounting fees for tax return preparation. The decision emphasized that tax avoidance motives cannot substitute for a genuine profit objective in claiming business expense deductions.

Facts

Ted Finkel formed eight limited partnerships to mine coal in Kentucky and Tennessee. Each partnership subleased coal property and paid substantial advanced royalties, management fees, and other costs before any mining occurred. The partnerships were structured to provide investors with tax deductions, with most funds paid to the promoter, attorney, and lessor rather than used for mining. No coal was mined in 1976, and minimal mining occurred in subsequent years. The IRS disallowed the partnerships' claimed deductions, leading to this dispute over the deductibility of various expenses.

Procedural History

The Tax Court initially tried the case before Judge Sheldon V. Ekman, who passed away before issuing a decision. The case was reassigned to Judge William M. Drennen. The court addressed the deductibility of advanced royalties, management fees, accounting fees, interest, offeree-representative fees, and tax advice fees claimed by the partnerships for the tax years 1976 and 1977.

Issue(s)

1. Whether the partnerships are entitled to deduct advanced royalties as business expenses?
2. Whether the partnerships are entitled to deduct payments to the general partner as business expenses?
3. Whether the partnerships are entitled to deduct accounting fees for tax return preparation as business expenses?
4. Whether the partnerships are entitled to deduct interest on nonrecourse notes as business expenses?
5. Whether the partnerships are entitled to deduct offeree-representative fees as

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business expenses?
6. Whether the partnerships are entitled to deduct attorney fees allocated to tax advice as business expenses?

Holding

1. No, because the partnerships lacked a primary objective of making a profit.
2. No, because the partnerships were not engaged in a trade or business, and the fees were organizational or syndication expenses.
3. No, the partnerships cannot deduct, but yes, individual partners can deduct under section 212(3) because the fees were for tax return preparation.
4. No, because the nonrecourse notes were shams and lacked substance.
5. No, because the fees were not ordinary and necessary business expenses of the partnerships.
6. No, because the fees were incurred to promote the sale of partnership interests and must be capitalized.

Court's Reasoning

The court applied the rule that to deduct expenses under section 162, a partnership must be engaged in a trade or business with a primary objective of making a profit. The court found that the partnerships' dominant motive was tax avoidance rather than profit, as evidenced by the structure of the partnerships, the excessive royalties, and the lack of actual mining activity. The court relied on cases like Hersh v. Commissioner and Brannen v. Commissioner, which emphasize that a bona fide profit motive is necessary for business expense deductions. The court also distinguished between expenses that must be capitalized, such as syndication fees, and those that can be deducted, like tax return preparation fees under section 212(3). The court's decision was supported by the lack of genuine indebtedness for the nonrecourse notes and the promotional nature of the attorney fees for tax advice.

Practical Implications

This decision underscores the importance of establishing a genuine profit motive in partnership ventures to claim business expense deductions. Practitioners should advise clients to ensure that partnerships have a viable business plan and sufficient capital for their stated purpose, not just for generating tax deductions. The case also highlights the need to carefully distinguish between deductible expenses and those that must be capitalized, such as syndication costs. Subsequent cases like Wing v. Commissioner have reaffirmed the principle that tax avoidance alone cannot justify business expense deductions. This ruling serves as a cautionary tale for tax shelters and similar arrangements, emphasizing that the IRS and courts will scrutinize the economic substance of transactions beyond their tax benefits.

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