

## ***Capek v. Commissioner, 86 T. C. 14 (1986)***

The court ruled that investors must have a genuine profit motive and be at risk to claim tax deductions from activities like coal leasing programs.

### **Summary**

In *Capek v. Commissioner*, investors participated in a coal leasing program promising a 4:1 tax deduction. The IRS challenged the deductions, arguing the investors lacked a profit motive and were not at risk. The Tax Court found that the investors did not engage in the program with a profit objective and their liabilities were protected by penalty provisions, thus not at risk. The court's decision disallowed the deductions, emphasizing the need for genuine economic activity and risk in tax shelters.

### **Facts**

Investors Richard Capek, Paul Reaume, Gene Croci, and Arthur Spiller entered Price Coal's coal leasing program, which promised a \$4 tax deduction for every \$1 invested. The program involved leasing coal lands with royalty payments, partly paid in cash and partly by notes. No coal was mined, and the investors relied on nonrecourse or recourse notes for most of their royalty payments. The program also included penalty provisions in mining contracts with Price Ltd. , which were designed to offset the investors' liabilities on the notes.

### **Procedural History**

The Commissioner determined deficiencies in the investors' federal income taxes due to disallowed royalty deductions. The cases were consolidated as test cases for other investors in the Price Coal program. The Tax Court severed and tried only the at-risk issue for Croci and Spiller, while addressing the profit motive and minimum royalty issues for Capek and Reaume.

### **Issue(s)**

1. Whether petitioners Capek and Reaume engaged in the Price Coal leasing program with an actual and honest objective of making a profit.
2. Whether advanced royalties "paid" by petitioners Capek and Reaume constitute advanced minimum royalties within the meaning of section 1. 612-3(b)(3), Income Tax Regs.
3. Whether petitioners Croci and Spiller were at risk within the meaning of section 465(b) with respect to their investments in the Price Coal leasing program.

### **Holding**

1. No, because the court found that the petitioners' primary motivation was tax sheltering rather than profit.

2. No, because the court determined that the nonrecourse and recourse notes did not constitute payment under the regulation, and the program lacked a valid minimum royalty provision.
3. No, because the court concluded that no funds were actually borrowed and the penalty provisions in the mining contracts acted as stop loss agreements, protecting the investors from economic loss.

### **Court's Reasoning**

The court analyzed the investors' lack of profit motive by considering the absence of profit projections in the program materials, the investors' reliance on tax preparers without conducting their own due diligence, and the unrealistic nature of the coal mining operation. The court applied the factors listed in section 1. 183-2(b) of the regulations, concluding that the investors' actions and the structure of the program indicated a tax shelter rather than a profit-driven enterprise. For the minimum royalty issue, the court relied on section 1. 612-3(b)(3) of the regulations, determining that the notes did not constitute payment and the program did not meet the regulation's requirements. On the at-risk issue, the court found that no actual funds were borrowed and the penalty provisions in the mining contracts constituted stop loss agreements, thus the investors were not at risk under section 465(b).

### **Practical Implications**

This decision underscores the importance of a genuine profit motive and actual economic risk in tax shelter arrangements. Legal practitioners must ensure clients understand that tax deductions from activities like coal leasing programs require a legitimate business purpose beyond tax savings. The ruling also highlights the scrutiny applied to nonrecourse financing and penalty provisions in tax shelters, emphasizing that such arrangements must reflect real economic activity. Subsequent cases involving similar tax shelter schemes have cited *Capek* to disallow deductions where investors lacked a profit motive or were not at risk.