T.C. Memo. 1986-210

Taxpayers must demonstrate a genuine profit objective to deduct business expenses, and advanced royalty deductions in tax shelters are scrutinized for compliance with minimum royalty provisions and at-risk rules.

Summary

In this test case for investors in Price Coal programs, the Tax Court disallowed deductions claimed for advanced coal mining royalties. The court found that the petitioners lacked a genuine profit motive, primarily seeking tax benefits rather than economic gain from coal mining. Furthermore, the advanced royalty payments did not qualify as 'minimum royalties' under tax regulations because there was no enforceable obligation for annual payments, and nonrecourse notes did not constitute actual payment. Finally, the court held that investors were not truly 'at risk' for amounts purportedly borrowed due to sham loan arrangements and stop-loss penalty clauses in mining contracts, limiting deductible losses to their cash investments.

Facts

Petitioners invested in coal leasing programs promoted by Rodman G. Price, designed to generate tax deductions through advanced minimum royalties. The programs involved subleases of coal rights, advanced royalty payments (partially in cash, partially through notes), and mining contracts with Price Ltd. promising future mining. Promotional materials emphasized tax write-offs, not profit projections. Coal Funding Corp., formed by Price's associates, purportedly loaned funds for royalty payments, but no money actually changed hands. Mining permits were not obtained, and no mining ever occurred. Mining contracts included penalty clauses payable to investors if mining did not commence, designed to offset investor liabilities on promissory notes.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' Federal income taxes for various years (1978-1983), disallowing claimed royalty deductions. Petitioners brought their cases to the U.S. Tax Court. This case was consolidated as a test case for numerous other investors in the Price Coal programs.

Issue(s)

1. Whether petitioners Capek and Reaume engaged in their coal mining activities with a profit objective within the meaning of section 183 of the Internal Revenue Code.
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 Regulations.

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 petitioners primarily sought tax deductions and lacked a genuine objective of making a profit from coal mining.
2. No, because the advanced royalty payments were not made pursuant to a 'minimum royalty provision' requiring substantially uniform annual payments, and nonrecourse notes did not constitute payment.
3. No, except to the extent of their cash investments, because the purported loans from Coal Funding lacked economic substance, and penalty clauses in mining contracts constituted stop-loss arrangements protecting them from actual economic risk beyond their cash investments.

Court's Reasoning

The court reasoned that deductions are only allowed for activities engaged in for profit. Objective facts, such as the program's emphasis on tax benefits, lack of profit projections, investors' lack of mining expertise, and superficial investigation, outweighed petitioners' self-serving statements of profit motive. The court cited *Dreicer v. Commissioner*, 78 T.C. 642, 646 (1982), emphasizing the need for an 'actual and honest objective of making a profit.' Regarding advanced minimum royalties, the court applied Treasury Regulation § 1.612-3(b)(3), which requires 'a substantially uniform amount of royalties be paid at least annually.' The court found that nonrecourse notes and the lack of enforced annual payments did not meet this requirement, citing *Wing v. Commissioner*, 81 T.C. 17 (1983). The court also determined that the 'loans' from Coal Funding were a sham, lacking economic substance, and that the penalty clauses in the mining contracts were 'stop loss agreements' under section 465(b)(4), as they were designed to offset investor liabilities, referencing the legislative intent of section 465 to limit deductions to amounts truly at risk. The court quoted Senate Report 94-938 (1976), stating, 'a taxpayer's capital is not "at risk"… to the extent he is protected against economic loss… by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer.'

Practical Implications

Capek serves as a strong warning against tax shelters promising disproportionate deductions without genuine economic substance. It reinforces the IRS's scrutiny of advanced royalty deductions, particularly in mining and energy ventures. Legal professionals should advise clients that: (1) a demonstrable profit motive is crucial for deducting business expenses, and tax benefits alone are insufficient; (2) advanced royalty arrangements must strictly adhere to 'minimum royalty provision' requirements, including enforceable annual payment obligations; and (3) 'at-risk' rules will be rigorously applied to limit losses from activities where investors are protected from genuine economic risk through guarantees or similar arrangements. Later cases have consistently cited *Capek* to disallow deductions in similar tax shelter schemes, emphasizing the importance of economic substance over form in tax-advantaged investments. This case highlights the need for thorough due diligence beyond promotional materials and tax opinions when considering investments marketed primarily for tax benefits.

