Drobny v. Commissioner, 86 T. C. 1326 (1986)

Deductions for research and development expenditures are not allowed if the activity lacks an actual and honest profit objective, even if structured as a tax shelter.

Summary

In Drobny v. Commissioner, the Tax Court denied deductions claimed by investors in two research and development programs due to the absence of a profit motive. The investors, including Sheldon Drobny, had claimed deductions based on expenditures for developing aloe-based products. However, the court found that the programs were primarily designed for tax avoidance, not profit. The transactions involved circular flows of loan proceeds that were used to repay loans rather than fund actual research. Drobny, a knowledgeable tax professional, was also found liable for fraud for claiming these deductions on his tax return, knowing the true nature of the transactions.

Facts

Sheldon Drobny and Louis Lifshitz invested in two research and development programs, Farm Animal Product Venture (FAP) and AloEase Partnership (AloEase), which promised a $5 deduction for every $1 invested. Each investor contributed $11,000 in cash and borrowed $45,000 from a bank, with the borrowed funds ostensibly transferred to a contractor for research but instead invested in commercial paper to repay the loans. The programs aimed to develop aloe-based products, but the court found that insufficient funds were allocated for actual research. Drobny, a CPA with IRS experience, was involved in promoting the programs and claimed deductions on his 1979 tax return.

Procedural History

The Commissioner of Internal Revenue disallowed the deductions and assessed a fraud penalty against Drobny. The case was heard in the United States Tax Court, where other related cases agreed to be bound by the decision in Drobny's case.

Issue(s)

1. Whether the petitioners are entitled to deductions for their proportionate share of losses resulting from alleged research and experimental expenditures by a joint venture and a partnership in 1979.
2. Whether Mr. Drobny is liable for the addition to tax for fraud under section 6653(b) for 1979.

Holding

1. No, because the programs' activities were not engaged in with the actual and

honest objective of making a profit.
2. Yes, because Mr. Drobny’s claiming of the deductions constituted fraud within the meaning of section 6653(b).

Court’s Reasoning

The Tax Court applied the rule that to qualify for deductions, an activity must be engaged in with an actual and honest objective of making a profit. The court found that the programs were unbusinesslike, with no genuine effort to develop products or generate revenue. The transactions were structured to artificially inflate the cost of services for tax purposes, while the funds were used to repay loans rather than fund research. The court emphasized the lack of arm’s-length negotiations, the absence of a managing investor, and the insufficient allocation of funds for research. The court also noted the expertise of the tax professionals involved compared to the lack of expertise among the research personnel. Drobny’s knowledge and involvement in the programs led the court to conclude that his claim of deductions constituted fraud.

Practical Implications

This decision impacts how similar tax shelter cases are analyzed, emphasizing the need for a genuine profit motive to claim deductions. It highlights the importance of substance over form in tax transactions and the scrutiny applied to circular fund flows. Legal practitioners must ensure that research and development programs have a legitimate business purpose and adequate funding for actual research. The case also serves as a warning to tax professionals about the potential for fraud penalties when promoting or participating in tax shelters without a profit objective. Subsequent cases, such as Karme v. Commissioner, have applied similar reasoning to deny deductions in sham transactions.

