Munroe v. U.S.

16 AFTR 2d 5170 , 65-2 USTC ¶9495 (DC NY, 6/16/1965)

OPINION

Judge: LEVET, District Judge:

This is an action for the recovery of federal income taxes in the amount of $3,536.14, plus interest, which plaintiff claims were illegally and erroneously collected. Plaintiff's claim is based upon the theory that he incurred certain business expenses in 1958 which entitled him to a loss carry-back to the year 1955.

The plaintiff had been a member of the New York Stock Exchange. On September 19, 1957, he was suspended from the Exchange for a period of five years. The suspension was based upon the fact that the plaintiff had understated his income in his federal returns and New York State returns for 1954, 1955 and 1956.

During the period from the time of his suspension until reinstatement on December 1, 1961, and particularly during the year 1958, plaintiff incurred certain expenses in entertainment, telephone, automobile, etc. for which he claims deduction.

The Issues

Thus, the issues presented are:

(1.) Whether the taxpayer was engaged in a trade or business in 1958?

(2.) Whether the taxpayer has proved that the expenses incurred were business-related rather than non-deductible personal or living expenses?

The case was tried to the court without a jury. After hearing the testimony of the parties, examining the exhibits, the pleadings, the briefs and the proposed Findings of Fact and Conclusions of Law submitted by counsel, this court makes the following Findings of Fact and Conclusions of Law:

Findings of Fact

(1.) Plaintiff John Munroe became a member of the New York Stock Exchange in February 1947. He conducted a general floor brokerage business until September 19, 1957, at which time he was suspended from the Exchange for a period of five years. (2)

(2.) The Exchange, in its disciplinary proceedings against him, alleged that although he had received commissions aggregating not less than $20,238, $26,896 and $19,468 in 1954, 1955 and 1956, respectively, in his federal and New York State income tax returns for those years he had reported total receipts of only $13,496, $15,584 and $12,788 respectively. He was charged with (1) fraud, and (2) conduct inconsistent with just and equitable principles of trade. In ordering his suspension, the Exchange found him guilty only of the latter charge by virtue of the understatements of income in his tax returns. (2-3)

(3.) Plaintiff, since January 1956, had been registered with the Securities and Exchange Commission as a broker and dealer and had been a member of the National Association of Securities Dealers, Inc. (NASD), a registered securities association. As a result of the Exchange suspension his NASD membership was automatically cancelled by operation of its bylaws. Although still registered as a broker-dealer, plaintiff did not act as a broker of securities and did not earn any income as a broker from the time of his suspension to the end of 1958. (3)

(4.) In October 1957, following plaintiff's suspension, he retained two attorneys, William E. Murray and Boris Kostelanetz, to advise him relative to his tax deficiencies. William. E. Murray, a specialist in tax matters, from October 1957 through 1958 represented the plaintiff before the Internal Revenue Service and the New York Stock Exchange in activities designed to obtain plaintiff's reinstatement to active membership on the Exchange or to the NASD as soon as possible.

(5.) The Internal Revenue Service commenced an audit of plaintiff's amended returns in late 1957. This audit continued through 1958 and resulted in an additional tax deficiency for 1955 of $2,381.54 and plaintiff was advised of this fact.

(6.) No criminal proceedings were instituted against plaintiff and no civil fraud penalties were assessed against him. (21). [pg. 5172]

(7.) Murray advised plaintiff on November 12, 1957 and December 23, 1957 that he was of the opinion that upon presentation of the case to the Treasury Department no criminal proceedings or civil fraud penalties would result. Mr. Kostelanetz, who was not of the same opinion, withdrew from the case early in 1958. (25) Murray did not convey to plaintiff Kostelanetz' opinion because he wanted to encourage plaintiff's hopes for reinstatement. (24-26) Murray's services in 1958 apparently were devoted mainly, if not entirely, to negotiations with the Internal Revenue Service and he submitted his bill for these services on December 12, 1958. (30)

(8.) Not until December 10, 1958 did Murray attempt to secure plaintiff's reinstatement to the Stock Exchange. The efforts of plaintiff and Murray in respect to this were as follows:

(a) On December 10, 1958 Murray telephoned Mr. Deegan of the Stock Exchange with respect to presentation of an application for reinstatement and was advised by letter of February 25, 1959 that the proper procedure was to apply to the Board of Governors (30-33);

(b) Plaintiff filed his first application for reinstatement to the Exchange in April 1959, which application was denied;

(c) Plaintiff filed another application in January 1960 and this was denied (36);
(d) Subsequently, plaintiff applied to the NASD for reinstatement and this application was denied (34).

(9.) Plaintiff appealed to the Securities and Exchange Commission which directed the NASD to reinstate him (35) and he was reinstated on December 1, 1961. (145, 146)

(10.) During 1958, Murray had certain conversations with officers and counsel for the New York Stock Exchange (39-43) but no one connected with the Exchange stated that plaintiff would be reinstated if the Internal Revenue Service imposed no civil fraud or criminal penalties. (39-43, 142-143) Keith Funston, President of the Exchange, refused to meet with Murray with respect to reinstatement (68-69) and counsel for the Exchange cautioned Murray not to get his hopes too high. (70)

(11.) During the period of his suspension plaintiff earned no commissions as a stock broker. He did maintain his membership on the Exchange and in the so-called "Exchange Luncheon Club." He entertained his former customers. He maintained a telephone at his house. He claims to have used his automobile in connection with business matters.

(12.) Plaintiff claimed the following deductions on his federal income tax return for the year 1958 (Ex. 1):

New York Stock Exchange	$1,299.80
Telephone	106.57
Entertainment Expense, Flowers, etc.	1,747.84
Automobile Expense	550.44
Loss on Sale of Auto	2,044.80
Depreciation on Auto	1,340.95

	$7,090.40

(13.) The claimed deduction of $1,299.80, representing plaintiff's New York Stock Exchange dues, was allowed by the Internal Revenue Service as an amount expended for the conservation of property held for the production of income (Section 212, Internal Revenue Code of 1954) and is, therefore, not in issue (76-78). The balance of the deductions was disallowed.

(14.) All of plaintiff's alleged former customers were his personal friends (113-114) and he conceded that he would have socialized with these persons even if he had no business with them. (114) These persons took plaintiff to dinner and entertained him more often than he entertained them. (118-119) When meeting with them, they would generally discuss news topics and matters of general interest. (115) From January through March 1958, plaintiff was a house guest of friends, Mr. and Mrs. Stephen Sanford, in Palm Beach, Florida. (116-118, 120) The largest part of plaintiff's claim for his Florida deductions relates to the Sanfords. (117)

(15.) It is clear that plaintiff has failed to establish that in 1958 he was engaged in a trade or business. He has also failed to establish that his expenditures for entertainment were for entertaining existing customers of any trade or business carried on by him at that time. Plaintiff has also failed to establish that his claimed deductions for automobile expenses, loss on the sale of his automobile and telephone expenses [pg. 5173] were ordinary and necessary and related to any trade or business carried on by him in 1958.

Discussion

Section 162 of the Internal Revenue Code of 1954 provides that there shall be allowed as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business *** ."

Thus, for an expense to be deductible under this section three basic essentials must be met. The expense must be:

(1) Incurred in carrying on a trade or business;

(2) An ordinary and necessary expense;

(3) Paid or incurred during the taxable year.

Whether or not plaintiff carried on a trade or business under Section 162 is a question of fact. Morton v. Commissioner, 174 F.2d 302, 303 [37 AFTR 1411] (2d Cir. 1949). Moreover, the rule seems to be clear that an expense is deductible only if it relates to a presently existing business then carried on by the taxpayer. Expenses incurred in contemplation of a future business are not deductible under the statute. John F. Koons, 35 T.C. 1092, 1101 (1961); Frank B. Polachek, 22 T.C. 858, 863 (1954); Edward R. Godfrey [¶ 63,001 P-H Memo TC], 22 T.C.M. 1 (1963).

As the Tax Court said in Edward R. Godfrey, supra:

"Before a taxpayer can be said to be engaged in a business, we believe that at least two conditions must be met: (1) He must have a motive and intention of realizing a profit; and (2) his activities must be of that type or character which will constitute the present carrying on of a business, rather than those of preparing to enter and carry on a business at some future time." 22 T.C.M. at 4. See also Kaufman v. United States, 233 F. Supp. 123 [13 AFTR 2d 1207] (E.D. Pa. 1964); Henry G. Owen, 23 T.C. 377 (1954); Benjamin Miggins, 8 T.C.M. 82 [¶ 49,016 P-H Memo TC] (1949).

Apparently plaintiff here relies upon the case of Harold Haft, 40 T.C. 2 (1963). In that case a costume jewelry salesman was temporarily unemployed and was allowed to deduct expenses relating to the entertainment of his erstwhile customers. However, at that time the taxpayer was under no legal disability, was actively seeking new employment and the court found that this was merely a reasonable period of transition and the expenses should be allowed. The Tax Court in its opinion in the Haft case distinguished the Owen case, supra, in which an employee of the Department of Justice was denied a deduction for the expense of maintaining his law office in North Dakota while he was living and working in Washington, D.C. on the ground that Owen incurred his expenses in anticipation of resuming his law practice "at some indefinite future

time." In the present case, plaintiff was under a suspension which imposed legal disability. The removal of the disability was not within the plaintiff's control and the expenses of entertainment related to a possible resumption of a trade or business "at some indefinite future time." It was based merely upon a hope, the realization of which was entirely inchoate.

It may also be doubted whether or not the expenses for which deductions were claimed were ordinary and necessary expenses of any trade or business. Even in the Haft case, supra, Haft was not allowed to deduct expenses of a Florida trip at the height of the winter season.

The plaintiff has failed to prove by a fair preponderance of the evidence that he is entitled to recovery of the taxes paid.

Provisions for tax deductions are strictly interpreted. The taxpayer who asserts the deduction must demonstrate the application of the pertinent section to his own affairs. See White v. United States, 305 U.S. 281, 292 [21 AFTR 1000] (1938); B&L Farms Co. v. United States, 238 F. Supp. 407 [15 AFTR 2d 457] (S.D. Fla. 1965).

Conclusions of Law

(1.) This Court has jurisdiction over the matters herein and over the parties hereto pursuant to 28 USC § 1346(a)(1).

(2.) To permit the deduction of an expense under Section 162 of the Internal Revenue Code of 1954, it must be incurred in carrying on a trade or business and it must be ordinary and necessary. The plaintiff here was not carrying on a trade or business. [pg. 5174]

(3.) To deduct any such expenses, they must relate to a presently existing business. Expenses relating to a future business or a contemplated resumption of a past business are not deductible under the statute.

(4.) Plaintiff had been suspended from the New York Stock Exchange for a period of five years; his suspension continued during the entire year 1958. Any expenses incurred during 1958 are not deductible as expenses incurred in connection with an existing trade or business under Section 162, Internal Revenue Code of 1954.

(5.) The fact that plaintiff may have been engaged in attempts to be reinstated is not sufficient to sustain the deduction because such intent does not result in plaintiff being engaged in a trade or business within the contemplation of the statute.

The complaint must be dismissed and judgment entered for the defendant with costs.

Settle judgment on notice in accordance herewith.