***3 T.C. 648 (1944)***

Expenses incurred in connection with the earning of income that is exempt from federal income tax are not deductible from gross income, regardless of whether the income is specifically excluded by statute or is otherwise deemed non-taxable.

**Summary**

James Curtis, a notary public, received fees that were deemed non-taxable under the Public Salary Tax Act of 1939. He sought to deduct expenses related to earning those fees and a state income tax paid on similar fees from the previous year. Additionally, Curtis exchanged debentures of an insolvent corporation for stock in a new corporation and warrants in a third. Finally, Curtis was part of a joint venture involving the purchase of debentures. The Tax Court held that neither the expenses nor the state income tax allocable to the non-taxable notarial fees were deductible. It further held that the gain realized from the exchange of securities was recognizable to the extent of the fair market value of the warrants. It also determined Curtis was taxable on his share of gains realized by the joint venture regardless of how the assets were distributed.

**Facts**

Curtis, a notary public, received notarial fees of $18,007.35 in 1936. These fees were later deemed non-taxable under the Public Salary Tax Act of 1939. He also allocated work to other notaries, who remitted excess earnings to his law firm, adding $2,535.02 to his gross income. Curtis incurred $9,112.02 in expenses related to all notarial work. He also paid New York State income tax of $4,138.50 in 1936 based on his 1935 income, including notarial fees. Curtis also exchanged debentures from General Theatres Equipment, Inc. for stock and warrants in other companies as part of a reorganization. He was also part of a joint venture to purchase debentures of the same company.

**Procedural History**

Curtis filed his 1936 tax return and excluded the notarial fees, but deducted related expenses and the full state income tax payment. The Commissioner of Internal Revenue disallowed these deductions and determined a deficiency. Curtis petitioned the Tax Court for review.

**Issue(s)**

1. Whether expenses allocable to income that is exempt from federal tax are deductible?

2. Whether the portion of New York state income tax paid that is attributable to income exempt from federal tax is deductible?

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3. Whether the gain realized on the exchange of securities from a corporation in receivership for stock and warrants in other corporations is recognizable, and if so, in what amount?

4. Whether gains realized through a joint venture are taxable to a member, regardless of the method of distribution of assets?

**Holding**

1. No, because Section 24(a)(5) of the Revenue Act of 1936 disallows deductions for expenses allocable to income exempt from federal income tax.

2. No, because Section 24(a)(5) disallows deductions for any amount allocable to income that is non-taxable for federal income tax purposes, regardless of its treatment under state law.

3. Yes, the gain is recognized to the extent of the fair market value of the warrants, because Section 112(c)(1) of the Revenue Act of 1936 (as amended) requires recognition of gain when "other property" (here, the warrants) is received in addition to property permitted to be received without recognition (the stock).

4. Yes, because partners are liable for income tax on their proportionate share of partnership income, regardless of the form or manner of distribution.

**Court's Reasoning**

The court reasoned that Section 24(a)(5) of the Revenue Act of 1936 clearly disallows deductions for expenses tied to income exempt from federal taxation, regardless of the reason for the exemption. The court rejected Curtis's argument that the notarial fees were merely "not collectible" rather than truly "exempt." The Court emphasized that the Public Salary Tax Act effectively prevented taxation of the fees, thus triggering Section 24(a)(5). As for the exchange of securities, the court applied Section 112(c)(1), stating that "if an exchange would be * * * within the provisions of subsection (l) of this section if it were not for the fact that property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property * * *, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of * * * the fair market value of such other property." The court found the warrants were "other property". Regarding the joint venture, the court highlighted that annual taxable profits are determined for partnerships, and partners are liable for their share of the income, irrespective of how it's distributed. The court cited legislative history, noting that the amendment was to make certain the text of the bill disallowing deduction of expenses incurred in the production of non-taxable income.

**Practical Implications**

This case reinforces the principle that taxpayers cannot deduct expenses related to

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income that is not subject to federal income tax. It clarifies that the reason for the exemption (statutory, constitutional, or otherwise) is irrelevant. The ruling emphasizes the importance of carefully allocating expenses between taxable and non-taxable income sources. This case also clarifies the tax implications of corporate reorganizations, particularly when “other property” like warrants are involved. Finally, the case underscores that partners and joint venturers cannot avoid taxation on their share of profits by delaying distribution or receiving assets in non-cash forms.

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