40 T.C. 14 (1963)

Expenses incurred by a corporate director in a proxy fight are generally not deductible as ordinary and necessary business expenses, losses, or expenses for the production of income if the director's activities are not considered a trade or business and the expenses are not directly related to income production or property management.

Summary

R. Walter Graham, a director of New York Central Railroad, deducted $9,453 as a 'cost of proxy fight' on his 1957 tax return. This amount represented his share of a settlement payment related to expenses from a 1954 proxy contest where he and others successfully unseated the incumbent board. The Tax Court disallowed the deduction, holding that Graham's directorship, in the context of his other activities, did not constitute a trade or business. Furthermore, the court reasoned the expense was not a deductible loss or an expense for the production of income, as it originated from an effort to gain a corporate directorship, not to manage existing income-producing property or business.

Facts

Petitioner, R. Walter Graham, was a physician and held various positions, including comptroller of Baltimore and director of New York Central Railroad (Central). In 1954, Graham joined a group led by Alleghany Corp. to solicit proxies to challenge Central's incumbent management. They agreed to share proxy solicitation costs, initially advanced by Alleghany. The group succeeded in electing a new board, including Graham. Central's shareholders later approved reimbursing the proxy fight expenses. Derivative lawsuits ensued, challenging the reimbursement. These suits were settled, and Graham paid $9,453 as his share of the settlement, which he then attempted to deduct on his 1957 tax return.

Procedural History

The Commissioner of Internal Revenue disallowed Graham's deduction for the proxy fight expenses. Graham petitioned the Tax Court, arguing the expense was deductible as a business expense under Section 162, a loss under Section 165, or a nonbusiness expense under Section 212 of the Internal Revenue Code of 1954.

Issue(s)

1. Whether the expenditure of $9,453 by Graham is deductible as an ordinary and necessary business expense under Section 162 of the Internal Revenue Code of 1954.
2. Whether the expenditure of $9,453 by Graham is deductible as a loss under Section 165 of the Internal Revenue Code of 1954.
3. Whether the expenditure of $9,453 by Graham is deductible as a nonbusiness

expense for the production of income under Section 212 of the Internal Revenue Code of 1954.

Holding

1. No, because Graham's activities as a director of Central, in the context of his overall professional engagements, did not constitute carrying on a trade or business.
2. No, because the payment was not considered a 'loss' in the context of Section 165, but rather a settlement of a liability arising from the proxy fight.
3. No, because the expense was not incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

Court's Reasoning

The Tax Court reasoned that to deduct expenses under Section 162, the taxpayer must be engaged in a trade or business. The court found Graham's directorship, while compensated, was not shown to be a primary occupation constituting a trade or business, especially considering his other professional roles. The court distinguished Graham's situation from cases where taxpayers were full-time executives or consultants. Regarding Section 165, the court determined the $9,453 payment was not a 'loss,' but a partial fulfillment of Graham's initial liability for proxy fight costs, significantly reduced by the subsequent reimbursement and settlement. The court cited *Kornhauser v. United States*, stating, "We think it is obvious that the expenditure is not a loss * * *." Finally, concerning Section 212, the court applied the origin-of-the-claim doctrine, tracing the expense back to Graham's effort to become a director. The court likened it to *McDonald v. Commissioner*, where election campaign expenses were deemed non-deductible, emphasizing that Section 212 does not cover expenses to acquire new income or businesses, but rather to manage existing income-producing property. The court also referenced *Surasky v. United States*, which denied a deduction for proxy fight expenses aimed at changing corporate management to increase dividends, as too indirectly related to income production.

Practical Implications

Graham v. Commissioner clarifies the limitations on deducting proxy fight expenses, particularly for individuals who are not primarily engaged in the business of corporate directorship or investment management. It reinforces that expenses to attain a new business position are generally not deductible as business expenses or expenses for income production. The case highlights the importance of demonstrating that corporate directorship constitutes a trade or business for deductibility under Section 162. It also emphasizes the 'origin of the claim' doctrine in determining deductibility under Sections 165 and 212, requiring a direct nexus between the expense and current income production or loss from an existing business or investment, rather than the acquisition of a new business opportunity. Later cases applying this ruling would likely scrutinize the taxpayer's overall professional activities and the directness of the expense to existing income-producing activities versus future or potential income.