T.C. Memo. 1972-50

Taxpayers cannot deduct personal losses as business losses or casualty losses, and net operating loss carryovers are subject to specific time limitations and must originate from deductible business losses.

Summary

Ellery and Helen Newton claimed a net operating loss carryover, a casualty loss for car damage, and excessive business auto expenses on their 1968 tax return. The Tax Court disallowed the net operating loss carryover because it stemmed from non-deductible personal losses (goodwill sale and home foreclosure) and was not carried back and forward within the statutory periods. The casualty loss for the car was denied as the engine damage was due to progressive deterioration, not a sudden casualty. However, the court allowed a larger business auto expense deduction than the IRS, based on estimated business mileage. The court emphasized that personal losses are not deductible and that casualty losses require a sudden, external event, not gradual wear and tear.

Facts

Petitioners, Ellery and Helen Newton, operated an insurance agency which Mr. Newton sold the goodwill of in 1963 for $10,000, claiming a $15,000 loss based on an estimated goodwill value. In 1964, they lost their personal residence to foreclosure, claiming a $10,000 loss. In 1968, they claimed a net operating loss carryover from these prior losses. Also in 1968, their 10-year-old car's engine failed due to "metal fatigue," and they claimed a casualty loss. They also deducted $1,200 for business car use, estimating 12,000 business miles out of 15,000 total miles.

Procedural History

The IRS determined a deficiency in the Newtons' 1968 federal income tax return, disallowing the net operating loss carryover, casualty loss, and part of the business auto expense deduction. The Newtons petitioned the Tax Court to dispute the IRS's determination.

Issue(s)

1. Whether the petitioners are entitled to a net operating loss deduction for 1968 based on losses from 1963 and 1964?
2. Whether the damage to the petitioners' automobile constituted a deductible casualty loss in 1968?
3. Whether the petitioners are entitled to a business automobile expense deduction exceeding the amount allowed by the IRS?

Holding

1. No, because the claimed losses were either personal and non-deductible (home foreclosure) or the carryover period had expired (goodwill sale).
2. No, because the engine failure was due to progressive deterioration ("metal fatigue"), not a sudden casualty.
3. Yes, in part. The court allowed a deduction for 10,000 business miles, more than the IRS allowed but less than claimed, based on estimated business use.

Court's Reasoning

Net Operating Loss: The court found the claimed 1963 goodwill loss questionable due to lack of basis evidence, but even assuming deductibility, it could not be carried over to 1968 as the carryover period expired. Net operating losses must be carried back three years and forward five years from the loss year. The 1964 home foreclosure loss was deemed non-deductible as losses from personal residence sales or foreclosures are not deductible. The court cited Income Tax Regs. Sec. 1.165-9(a) and various cases like *Seletos v. Commissioner* and *Wilson v. Commissioner*. Therefore, neither loss could contribute to a 1968 net operating loss carryover.

Casualty Loss: The court stated that a "casualty" requires "an accident, a mishap, some sudden invasion by a hostile agency; it excludes the progressive deterioration of property through a steadily operating cause," citing *Fay v. Helvering* and *United States v. Rogers*. "Metal fatigue" is progressive deterioration, not a sudden event, thus not a casualty loss under Section 165(c)(3) of the I.R.C.

Automobile Expenses: While substantiation was imperfect, the court, applying *Cohan v. Commissioner*, allowed a deduction for 10,000 business miles, acknowledging some business use beyond the IRS's allowance but not the full amount claimed by petitioners. The court found 10,000 miles to be a reasonable estimate of business use.

Practical Implications

This case reinforces several key tax principles: Personal losses are generally not deductible, and specifically, losses on the sale or foreclosure of a personal residence are not deductible. Net operating loss carryovers are strictly limited by time and must arise from deductible business losses. Casualty losses require a sudden, unexpected event, distinguishing them from losses due to wear and tear or progressive deterioration. Taxpayers must properly characterize losses and adhere to carryover rules. While strict substantiation is required for deductions, the *Cohan* rule allows for reasonable estimations when precise records are lacking, especially for business expenses like auto mileage, provided there is a reasonable basis for the estimate.