7 T.C. 672 (1946)

Gains from the sale of mortgage bonds are taxed as ordinary income, not capital gains, when the taxpayer's primary purpose in holding the bonds is for sale to customers in the ordinary course of their trade or business, rather than as a long-term investment.

Summary

Harry and Max Dunitz, real estate developers, purchased land in 1927, erected an apartment building, and financed the project with mortgage bonds. Over time, they bought their own bonds at a discount and sold them to a corporation they controlled, Harry & Max Dunitz, Inc. The Tax Court had to decide whether the profits from selling these bonds should be taxed as ordinary income or capital gains. The court held that the gains were ordinary income because the Dunitzes' bond activities were integral to their real estate business, not passive investments.

Facts

In 1927, Harry and Max Dunitz bought land and built an apartment building, financing it with a $350,000 first mortgage and $125,000 in second mortgage notes. In 1931, they formed Harry & Max Dunitz, Inc., transferring the property to the corporation. Between 1934 and 1939, operating as the Pingree Investment Company, the Dunitzes purchased their own mortgage bonds at discounted prices. In 1939, they sold these bonds to their corporation, Harry & Max Dunitz, Inc., at a substantial profit.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Dunitzes' income tax, arguing the bond sale profits were ordinary income. The Dunitzes contested this, claiming the profits should be taxed as capital gains. The Tax Court reviewed the Commissioner's determination.

Issue(s)

1. Whether the profits from the disposition of mortgage bonds by Dunitz Bros. to Harry & Max Dunitz, Inc., should be taxed as ordinary income or capital gains under Internal Revenue Code Section 117.

2. Whether legal fees paid by Dunitz Bros. in connection with assessments and an indictment related to the bond purchases were deductible.

Holding

1. No, because the bonds were held primarily for sale to customers in the ordinary course of their business, fitting within the exceptions of Section 117.

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2. Yes, because the legal fees were related to managing property for income and defending against charges arising from business activities.

Court's Reasoning

The Tax Court reasoned that to qualify for capital gains treatment under Section 117, the bonds had to be capital assets. However, Section 117 excludes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The court emphasized that the Dunitzes' bond activities were an "essential and integral part of their business." The court found the Dunitzes bought the bonds to acquire and manage properties, trade for desired bonds, or sell for cash. Their activities, including frequent bond sales and purchases, showed they were "buying, trading, and selling property to customers in a course of procedure established by them as a component part of their ordinary trade or business." Citing *United States v. Chinook Investment Co.*, the court concluded the profits were ordinary income. The court also allowed the deduction of legal fees. The fees paid to Wood were for successfully fighting a proposed assessment and "clearly and properly related to the management, conservation, and maintenance of property held for the production of income." The fees paid to Gallagher for defending against an indictment were also deductible as ordinary and necessary business expenses under *Commissioner v. Heininger*.

Practical Implications

This case provides a crucial illustration of how the "primarily for sale" exception in Section 117 (now Section 1221) is applied. The key takeaway is that even if an asset appears to be a capital asset on the surface, the taxpayer's intent and the nature of their business activities determine its tax treatment. Legal professionals should carefully examine the taxpayer's business practices and purposes for holding assets to determine whether gains should be taxed as ordinary income. This case emphasizes the importance of documenting the intent behind asset acquisitions and dispositions. Later cases have cited *Dunitz* to emphasize that frequent transactions and a clear business purpose negate the possibility of capital gains treatment, even if the asset is not literally inventory.

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