1947 Tax Ct. Memo LEXIS 19 (T.C. 1947)

A securities dealer who uses the inventory method of accounting must obtain permission from the Commissioner of Internal Revenue before changing to a different method; otherwise, securities held in inventory are not considered capital assets, and profits from their sale are taxed as ordinary income.

Summary

The petitioners, partners in a securities firm, sought to treat profits from the sale of certain securities as capital gains. The Tax Court ruled against them, holding that because the securities had been inventoried by the partnership and no permission was obtained from the Commissioner to change from the inventory method, the securities were not capital assets. The court emphasized that the partnership continued to operate and report as such, making the inventory method applicable and precluding capital gains treatment.

Facts

Hewitt and Lauderdale were partners in a securities business. They used the inventory method to account for their securities. In 1942, Hewitt entered military service, and Warne became a partner to represent Hewitt on the Stock Exchange. The new partnership (Hewitt, Lauderdale, and Warne) continued to deal in securities, including those previously dealt with by the original partnership. The securities from the "old partnership" were held in an account labeled "old accounts." The petitioners sold some of these securities in 1943 and sought to treat the profits as capital gains.

Procedural History

The Commissioner of Internal Revenue determined that the profits from the sale of the securities should be taxed as ordinary income, not capital gains. The taxpayers petitioned the Tax Court for a redetermination.

Issue(s)

Whether profits from the sale of securities, previously inventoried by a partnership, can be treated as capital gains when the partnership continues to operate and has not obtained permission from the Commissioner to change from the inventory method of accounting.

Holding

No, because the partnership continued to operate and report as such without obtaining permission to change from the inventory method, the securities remained part of the inventory and were not capital assets.

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Court’s Reasoning

The court reasoned that the burden was on the petitioners to show that the securities were not inventory assets. The evidence indicated that the “old partnership” continued to exist, even after the formation of the new partnership with Warne. Partnership returns were filed reflecting the income of both partnerships. The court stated, “The intention as to continuation of the old partnership is plain. It was not dissolved. Its property was not distributed.” Because the partnership did not secure permission to change from the inventory method, as required by regulations, the securities could not be considered capital assets. The court cited Internal Revenue Code sections 117(a)(1) and 22(c), as well as Regulations 111, section 29.22(c)-5, emphasizing that assets properly includible in inventory are not capital assets. The court distinguished *Vaughan v. Commissioner*, noting that in that case, the activity in the stocks passed from Vaughan to a newly formed partnership, whereas here, the same entity continued to buy and sell.

Practical Implications

This case highlights the importance of adhering to accounting methods and obtaining proper authorization for changes. For securities dealers, it underscores the requirement to seek permission from the Commissioner before abandoning the inventory method. Failure to do so will result in the profits from the sale of securities being taxed as ordinary income rather than capital gains. The case also demonstrates that a mere intention to treat securities as investments is insufficient to overcome the statutory and regulatory requirements for changing accounting methods. Later cases will cite this to enforce consistent application of accounting methods unless explicit permission to change has been granted.

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