6 T.C. 1279 (1946)

A securities dealer who uses the inventory method of accounting must obtain permission from the Commissioner of Internal Revenue before changing to a non-inventory method to treat securities as capital assets.

Summary

Hewitt v. Commissioner addresses whether profits from the sale of securities by a partnership are taxable as ordinary income or capital gains. The Tax Court held that because the partnership had been dealing in securities, inventoried them, and did not obtain permission from the Commissioner to change from the inventory method, the securities were not capital assets when sold. The court emphasized the importance of consistent accounting methods and the requirement for prior approval to switch from inventory to a non-inventory method, rejecting the argument that the partners' intent to treat the securities as investments was sufficient.

Facts

Petitioners Hewitt and Lauderdale were partners in a securities business. The partnership inventoried its securities. On June 30, 1942, Hewitt entered military service, and a new partnership agreement was formed including Warne. The new partnership continued dealing in securities, including those previously held by the old partnership. Securities held by the "old partnership" were maintained in an account labeled "old accounts." Though some buying and selling occurred in this account, it was less extensive than the new partnership's activities. These securities were not distributed to Hewitt and Lauderdale.

Procedural History

The Commissioner of Internal Revenue determined that profits from the sale of securities should be taxed as ordinary income. The taxpayers petitioned the Tax Court, arguing the securities should be treated as capital assets subject to capital gains rates. The Tax Court ruled in favor of the Commissioner, upholding the ordinary income tax treatment.

Issue(s)

Whether the securities sold by the partnership in 1943 were capital assets, eligible for capital gains treatment, or were properly includable in inventory, making them subject to ordinary income tax rates.

Holding

No, because the partnership had been dealing in securities, inventoried them, and did not obtain permission from the Commissioner to change from the inventory

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method, the securities were not capital assets.

Court’s Reasoning

The court reasoned that the securities remained the property of the partnership. The petitioners failed to demonstrate a dissolution of the old partnership. The court noted that partnership returns filed for 1942 and 1943 indicated a continuation of the original partnership, separate from the one including Warne. The court emphasized that the intention of the partners to treat the securities as investments was insufficient to override the requirement to obtain permission to change from the inventory method. The court stated: “A mere desire by the partners to regard certain securities as no longer inventory, but as investments, and themselves as no longer dealers, can not suffice to meet the statute.” The court cited the necessity of prior permission to change accounting methods, supporting its decision with Stokes v. Rothensies. The court concluded that the statutes and regulations mandated the stocks be treated as non-capital assets.

Practical Implications

This case highlights the importance of adhering to established accounting methods, particularly the inventory method for securities dealers, unless explicit permission is obtained from the IRS to change. This decision clarifies that a taxpayer’s intent alone is not sufficient to reclassify assets from inventory to investments for tax purposes. It emphasizes the need for formal compliance with IRS regulations regarding changes in accounting methods. Later cases applying this ruling underscore the IRS’s authority to ensure consistent and accurate income reporting and the requirement for taxpayers to follow prescribed procedures when altering accounting practices.

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