Schaeffer v. Commissioner, 9 T.C. 304 (1947)

A securities dealer can hold some securities as capital assets for investment purposes while holding other similar securities as inventory for sale to customers, and the determination of which purpose controls depends on the specific facts and circumstances surrounding each security.

Summary

Schaeffer, a securities dealer, contested the Commissioner's assessment of excess profits taxes for 1942-1945. The central issue was whether certain securities held by Schaeffer were capital assets, which would qualify for favorable tax treatment regarding dividends and capital gains. The Tax Court ruled that a dealer can hold securities for investment, distinct from inventory. The court analyzed each of the 36 disputed securities, scrutinizing how they were handled on Schaeffer's books and whether they were segregated from securities held for sale to customers. The court's holding hinged on whether Schaeffer demonstrated a clear intent to hold particular securities for investment rather than for sale in its ordinary course of business.

Facts

Schaeffer was a securities dealer. During 1942-1945, Schaeffer received dividends and realized gains from the sale of certain securities. Schaeffer maintained an "investment account" separate from its general inventory of securities held for sale to customers. Some securities were transferred into this account at different times, while others remained in general inventory. The company president testified that the investment account was created to avoid the mistaken sale of investment securities to customers. There was some ambiguity as to which securities were listed on position sheets as available for sale.

Procedural History

The Commissioner determined deficiencies in Schaeffer's excess profits taxes. Schaeffer petitioned the Tax Court for a redetermination of these deficiencies. The case turned on whether certain securities were "capital assets" under Section 117(a)(1) of the Internal Revenue Code, affecting the computation of excess profits net income.

Issue(s)

1. Whether dividends received on certain securities should be allowed as a credit in computing Schaeffer's excess profits net income.
2. Whether gains realized from sales and liquidating dividends of certain securities should be excluded in computing Schaeffer's excess profits net income.
3. Whether the Commissioner was authorized to adjust certain items on the tax

returns to reflect the accrual basis of accounting.

Holding

1. Yes, in part, because some of the securities were held as capital assets for investment purposes during certain periods.
2. Yes, in part, for the same reason as above.
3. Yes, because Schaeffer used a hybrid accounting system, and the Commissioner has the authority to ensure the accounting method clearly reflects income.

Court's Reasoning

The court applied Section 117(a)(1) of the Internal Revenue Code, defining "capital assets." It emphasized that a securities dealer can hold securities for investment, citing *E. Everett Van Tuyl, 12 T. C. 900, Carl Marks & Co., 12 T. C. 1196, and Stifel, Nicolaus & Co., 13 T. C. 755*. The critical factor was the *purpose* for which each security was held during the taxable years. Segregation of securities into a separate investment account was strong evidence of intent, but the lack of segregation was not conclusive. The court stated that "[a] dealer's expressed intent to hold certain securities for purposes other than sale must be supported by conduct on his part in regard to such securities which is clearly consistent with that intent." The court examined the company's bookkeeping practices for each of the 36 securities. Regarding the accounting method, the court found Schaeffer used a hybrid system and that the Commissioner did not abuse his discretion in adjusting the returns to reflect an accrual basis. The court cited *Aluminum Castings Co. v. Routzahn, 282 U. S. 92*, noting, "The use of inventories, and the inclusion in the returns of accrual items of receipts and disbursements appearing on petitioner's books, indicate the general and controlling character of the account…"

Practical Implications

This case provides guidance on how to determine whether a securities dealer holds specific securities as capital assets for investment, entitling them to favorable tax treatment, or as inventory for sale to customers. It highlights the importance of segregation and consistent bookkeeping practices. The decision illustrates the Commissioner's broad discretion to ensure a taxpayer's accounting method clearly reflects income, especially when inventories are involved. Later cases have cited *Schaeffer* for the principle that a dealer's intent, supported by consistent conduct, is crucial in determining the character of securities held. This ruling informs tax planning for securities firms and emphasizes the need for clear documentation of investment intent.

