16 T.C. 295 (1951)

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A securities dealer can hold securities for investment purposes (capital assets) separate from those held for sale to customers in the ordinary course of business, and the character of the asset determines its tax treatment.

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Summary

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Stern Brothers & Co., a securities dealer, disputed deficiencies in its excess profits tax. The core issue was whether certain securities were capital assets, which would allow for preferential tax treatment of dividends and gains. The Tax Court determined that securities held primarily for sale to customers were not capital assets, while those held for investment were. The court emphasized that a dealer can hold securities for both purposes and can change the purpose for which securities are held. The court also addressed the proper accounting method and the accrual of contested taxes.

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Facts

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Stern Brothers & Co. was an investment banking firm that acted as both a dealer and a broker in securities. Prior to March 20, 1943, all securities were carried in inventory, regardless of whether they were held for sale, investment, or as an agent for customers. On March 20, 1943, the company established a separate investment account. Certain securities were then transferred to this account. Some securities acquired before that date remained in inventory, while others acquired after were directly entered into the investment account.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies in Stern Brothers' declared value excess-profits tax and excess profits tax for the years 1942-1945. Stern Brothers contested these deficiencies, arguing that certain securities were improperly classified. The Tax Court reviewed the Commissioner's determinations.

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Issue(s)

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1. Whether certain securities owned by the petitioner were capital assets under Section 117(a)(1) of the Internal Revenue Code during the relevant tax years, thus allowing the dividends received to be credited when computing the petitioner's excess profits net income.

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2. Whether gains from the sales or liquidating dividends of certain securities were excludable when computing the petitioner's excess profits net income due to the securities being capital assets.

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3. If Lehman Corporation stock is not a capital asset, did a dividend qualify as a capital gain dividend under Section 362(b)(7) of the Code?

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4. Whether the Commissioner erred by adjusting items on the petitioner's tax returns to reflect the accrual basis?

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5. Was it proper for the Commissioner to accrue the excess profits tax liability for the years in question and subtract that liability from the petitioner's accumulated earnings and profits?

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6. Was the petitioner entitled to accrue the postwar refund credit as an asset?

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Holding

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1. The court held that some securities were capital assets and some were not, depending on whether they were held primarily for sale to customers or for investment. Some securities changed status during the tax years. Therefore, the determination depends on the specific facts regarding each security. Yes, because if securities were held for investment purposes rather than for sale to customers, the dividends could be credited.

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2. Same as above. Yes, because if securities were held for investment purposes rather than for sale to customers, the gains could be excluded.

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3. Yes, because the Lehman Corporation was a regulated investment company under Section 361 and that $735.05 of the dividend was a capital gain dividend.

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4. Yes, because the petitioner was predominantly on the accrual basis of accounting.

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5. Yes, because the Regulations required such accrual regardless of any contest.

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6. Yes, because it is a corollary to the proper calculation of tax liability.

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Court’s Reasoning

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The court emphasized that a taxpayer can be a dealer in some securities and hold others for investment. The critical factor is the purpose for which the securities were held during the taxable years. The court noted that securities held for investment must be treated differently from those held for sale to customers. While segregation is significant, its absence is not conclusive. The court looked at several factors to determine the taxpayer’s intent, including whether the securities were listed on position sheets, whether they were available for sale to customers, and whether the taxpayer dealt in that type of security with its customers. The court referenced previous cases like *E. Everett Van Tuyl*, *Carl Marks & Co.*, and *Stifel, Nicolaus & Co.* to support these principles. The court also relied on Regulation 111,

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section 29.22(c)-1 and 29.41-2 regarding the necessity of inventories and use of the accrual method when using inventories.

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Concerning the accrual basis, the court found that Stern Brothers used a hybrid system of accounting. Since the method employed did not clearly reflect income, the Commissioner was authorized to adjust the returns.

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