16 T.C. 1026 (1951)

A securities trader, who buys and sells for speculation or investment, is distinct from a dealer, who holds securities primarily for sale to customers in the ordinary course of business; only the latter's profits are taxed as ordinary income.

Summary

The United States Tax Court addressed whether a partnership, Lilley & Co., was a securities "dealer" or "trader" for tax purposes. The IRS argued that Lilley & Co. was a dealer, meaning profits from securities sales should be taxed as ordinary income. The partnership argued they were traders, entitling them to more favorable capital gains treatment. The court held that Lilley & Co. acted as a trader with respect to securities held for more than six months, and thus those gains qualified for capital gains rates.

Facts

Lilley & Co., a partnership, bought and sold unlisted securities for its own account, engaging in approximately 7,000-8,000 transactions annually. The firm also conducted some brokerage business. Lilley & Co. primarily dealt in low-priced, unmarketable securities of real estate corporations, often involving defaulted bonds or stocks paying no dividends. The firm's activities were conducted via phone, telegraph, and teletype, dealing mostly with other broker-dealers or security houses.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax, arguing that the securities sold by Lilley & Co. were not capital assets, making the gains taxable as ordinary income. The petitioners contested this determination, claiming capital gains treatment. The Tax Court reviewed the case to determine the proper tax treatment.

Issue(s)

Whether the securities sold by Lilley & Co. were "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" under Section 117(a)(1) of the Internal Revenue Code, thus disqualifying them as capital assets eligible for capital gains treatment.

Holding

No, because with respect to securities held for more than six months, Lilley & Co. acted as a trader holding them primarily for speculation or investment, and not as a dealer holding them for sale to customers in the ordinary course of business.

Court's Reasoning

© 2025 SCOTUSreports.com. All rights reserved.

The court distinguished between “dealers” and “traders” in securities. Dealers act like merchants, purchasing securities with the expectation of reselling them at a profit due to market demand. Traders, conversely, depend on factors like a rise in value or advantageous purchase to sell at a profit. The court noted that the term “to customers” was added to the definition of capital assets by amendment in 1934 to prevent speculators trading on their own account from claiming the securities they sold were other than capital assets. The court emphasized that Lilley & Co. often bought securities in small lots and sold them in large blocks, accumulated certain securities to force reorganization, and sometimes refused to sell even when offered a profit. The court reasoned: “The activity of Lilley & Co. with regard to the securities in question conformed to the customary activity of a trader in securities rather than that of a dealer holding securities primarily for sale to customers.” Despite the firm having two places of business, being licensed as a dealer, advertising itself as such, and transacting a high volume of business, these factors were counterbalanced by the absence of salesmen, customer accounts, a board room, and advertising securities for sale.

Practical Implications

This case provides a framework for distinguishing between securities dealers and traders for tax purposes, influencing how similar businesses are classified. The ruling clarifies that a firm can be a dealer for some securities and a trader for others, depending on holding periods and business practices. This distinction affects tax liabilities, impacting investment strategies and financial planning. The *Kemon* test remains a key element in determining eligibility for capital gains treatment. Later cases often cite *Kemon* to emphasize the importance of examining the specific activities and intent of the taxpayer concerning particular securities.

© 2025 SCOTUSreports.com. All rights reserved.