23 T.C. 1040 (1955)

A nonresident alien's investment activities in U.S. securities, conducted through an agent, do not constitute a "trade or business" if they primarily serve as a personal investment account, thereby exempting capital gains from U.S. taxation under the Internal Revenue Code.

Summary

The United States Tax Court considered whether Chang Hsiao Liang, a nonresident alien, was engaged in a U.S. "trade or business" through a resident agent managing his securities portfolio, thereby subjecting his capital gains to U.S. income tax. The court found that Liang's investment activities, characterized by long-term holdings and income generation rather than short-term trading, were not a trade or business. The court emphasized that the agency relationship primarily served to manage Liang's investment account, preserving his capital and generating income, rather than conducting a business. Therefore, Liang was not subject to tax on capital gains from his security transactions within the United States.

Facts

Chang Hsiao Liang, a nonresident alien residing outside the U.S., engaged Lamont M. Cochran to manage his investments in U.S. securities starting in 1928. Cochran, a U.S. citizen, was initially employed by the National City Bank. In 1932, Liang and Cochran formalized their agreement, with Cochran managing Liang's investments for a salary and commission. Cochran made investment decisions, including the purchase and sale of securities, through a custodian account at Guaranty Trust Company. In 1946, the year in question, Liang's account had substantial capital gains from security transactions, but he reported no such income on his tax return. Cochran exercised sole discretion as to the management of the account and the agent was not involved in any other occupation aside from supervising Liang's account. The agent's objectives in managing the account were to obtain a large income to meet heavy drawings and at the same time to protect and preserve the principal. Liang was under "protective custody" by Generalissimo Chiang Kai-shek during 1946 and was not present in the U.S. during this period.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Liang's income taxes for 1946, asserting that Liang was engaged in a U.S. trade or business. Liang petitioned the Tax Court, challenging this determination. The Tax Court reviewed the facts, including the nature of the investment activities and the agency relationship, and decided in favor of Liang. The Court found that Liang was not engaged in a trade or business in the United States during 1946.

Issue(s)

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1. Whether Chang Hsiao Liang, a nonresident alien, was engaged in a trade or business within the United States during 1946 through his resident agent, Lamont M. Cochran, as a result of his security transactions?

2. Whether the omission of capital gains from Liang's 1946 return, if taxable, triggered the five-year statute of limitations under section 275(c) of the 1939 Code due to the omission exceeding 25% of reported gross income?

Holding

1. No, because Liang's security transactions, managed by a resident agent, did not constitute a trade or business within the United States, as the transactions were primarily for investment purposes.

2. The court did not address this issue. Because Liang was not engaged in a trade or business in the United States, the five-year statute of limitations was not applicable.

Court's Reasoning

The court applied Section 211(b) of the Internal Revenue Code of 1939 which was intended to exempt capital gains realized by nonresident aliens from transactions in commodities, stocks, or securities effected through a resident broker or commission agent, unless such transactions constitute the carrying on of a trade or business. The court considered the nature of Liang's activities. It noted that Liang was not present in the U.S. and that his agent, Cochran, managed the investments with discretion, holding the securities for long periods. The court distinguished Liang's investment strategy from a trading operation. The court stated, "The absence of frequent short-term turnover in petitioner's portfolio negatives the conclusion that these securities were sold as part of a trading operation rather than as investment activity." The court referenced prior cases, such as *Higgins v. Commissioner*, to underscore that whether activities constitute a trade or business depends on the specific facts. The court emphasized that Liang's primary objective was to preserve capital and generate income, not to profit from short-term market fluctuations.

Practical Implications

This case clarifies the definition of "trade or business" for nonresident aliens engaged in U.S. securities transactions through agents. It provides guidance on distinguishing between investment activities, which are generally exempt from tax, and activities that constitute a trade or business, which are taxable. This case suggests that the nature of the investments and the agent's activities will be considered. A key consideration is the frequency of trading, the length of time the securities are held, and the overall purpose of the investment strategy. Legal professionals should evaluate these factors when advising nonresident aliens on their U.S. tax liabilities related to securities transactions. It underscores the importance of properly structuring investment activities to avoid being classified as

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engaging in a trade or business, particularly in the context of tax planning for nonresident aliens. Subsequent cases will analyze similar factual scenarios based on the principles set forth in this case.

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