Estate of Henry J. Richter v. Commissioner, 59 T. C. 971 (1973)

Income from sales of securities by a dealer can be classified as passive investment income under Section 1372(e)(5), even if derived from active business operations.

Summary

In Estate of Henry J. Richter v. Commissioner, the Tax Court addressed whether gains from securities trading by an active securities dealer, Richter & Co. , constituted passive investment income under Section 1372(e)(5), potentially terminating its subchapter S status. The court ruled that such gains were passive investment income, emphasizing the plain language of the statute over the nature of the business activity. This decision impacted the tax treatment of securities dealers and clarified the scope of passive investment income for subchapter S corporations.

Facts

Richter & Co. , a Missouri corporation, was engaged in the securities business, including trading, brokerage, and underwriting. It maintained an inventory of 50 to 100 over-the-counter securities and actively traded them. For its fiscal year ending October 31, 1966, more than 20% of its gross receipts were derived from profits on securities trading. Richter & Co. had elected to be taxed as a subchapter S corporation, and the issue was whether these profits constituted passive investment income, potentially terminating its subchapter S status.

Procedural History

The case originated with the Commissioner determining deficiencies in the federal income taxes of the shareholders of Richter & Co. for the years 1963 through 1967. The taxpayers petitioned the Tax Court, which heard the case and issued its opinion in 1973.

Issue(s)

1. Whether gains from the sale of securities by an active securities dealer constitute passive investment income under Section 1372(e)(5) of the Internal Revenue Code.

Holding

1. Yes, because the plain language of Section 1372(e)(5) includes gains from sales or exchanges of stocks or securities in the definition of passive investment income, without distinguishing between active and passive business operations.

Court’s Reasoning

The Tax Court focused on the statutory language of Section 1372(e)(5), which defines passive investment income to include gains from sales or exchanges of stocks or securities. The court rejected the argument that the income's nature should be determined by the level of business activity involved, stating that "the standard used by the Code and the regulations does not permit us to look behind the normal characterizations of a corporation's receipts in order to classify them as active or passive. " The court also noted that the IRS regulations explicitly applied Section 1372(e)(5) to regular dealers in stocks and securities. The decision was influenced by the court's prior ruling in Buhler Mortgage Co. , where similar income was classified as passive despite active business efforts. The court declined to follow the Fifth Circuit's decision in House v. Commissioner, which had taken a different approach to the classification of interest income from small loan companies.

Practical Implications

This decision clarifies that for subchapter S corporations, the source of income rather than the nature of the business activity determines whether it is passive investment income. Securities dealers must be cautious that gains from trading, even if part of their regular business, can lead to the termination of subchapter S status if they exceed 20% of gross receipts. This ruling affects how securities dealers structure their businesses and manage their income to maintain subchapter S status. It also influenced later cases, such as I. J. Marshall, where the Tax Court reaffirmed its stance on passive investment income. Legal practitioners advising securities firms should consider this case when planning tax strategies and structuring corporate entities.

