Tax Treatment of Losses on Securities Acquired in the Normal Course of Business

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NOTES

TAX TREATMENT OF LOSSES ON SECURITIES
ACQUIRED IN THE NORMAL COURSE OF BUSINESS

Taxpayers, whether they be corporate or individual, often find themselves in circumstances wherein it becomes necessary to acquire securities for purposes other than investment. This may occur when securities are purchased as a condition precedent to obtaining other property, when they are required as a deposit to secure contract performance, or when they are received by a taxpayer for goods sold or services performed. Often the terms and circumstances under which these securities are acquired are such that upon their sale a loss is extremely probable. The problem that arises is whether securities so acquired take on the same character as the underlying transaction which required their acquisition, or whether they retain their character as capital assets irrespective of some other basic purpose in their procurement. The question is hardly moot since the solution to this problem determines whether a loss is limited as a capital loss,\(^1\) or, on the other hand, whether it is deductible in full.\(^2\)

The "capital gain" provision of the tax structure, which was first introduced into the federal revenue legislation by the 1921 Act,\(^3\) was originally intended to exempt from high surtaxes profits of individuals derived from the sale or exchange of capital assets which had increased in value over a period of two years or more.\(^4\) Although this original purpose seems to have been completely invalidated when the holding period required for capital gains treatment was reduced to six months,\(^5\) the capital gains provisions still play a major part in present income tax legislation. The 1921 Act had no provisions restricting the deductibility of capital losses, but such restrictions arose shortly thereafter in the 1924 Act.\(^6\)

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1. Int. Rev. Code of 1954, § 1211. Limitation on Capital Losses.—(a) Corporations—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges. (b) Other Taxpayers.—In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or $1,000, whichever is smaller.
3. Revenue Act of 1921, § 206, 42 Stat. 232. Under the 1918 Act and previous laws, the profits on sales of capital assets were taxed at the regular normal and surtax rates in the year of realization.
5. The Revenue Act of 1942, § 150(a), 56 Stat. 843 provided for this change by striking out "18 months" and inserting in lieu thereof "6 months."
6. Revenue Act of 1924, § 208(c), 43 Stat. 263. This act limited the deduction for losses sustained by one other than a corporation upon the sale or exchange of capital assets held over two years to a maximum credit against the tax upon ordinary net income of 12\(\frac{1}{2}\)% of such loss.
of these limitations was to put the deductibility of capital losses on somewhat the same basis as the taxability of capital gains. However, the 1934 Act abandoned the previous theory of taxing capital gains separately and provided that capital gains and losses were to be taken into account in computing net income. The limitation on capital losses was also changed to allow their deductibility to the extent of $2,000 plus the amount of gains from the sales or exchanges of capital assets. This limitation has remained in one form or another down to the present law and is the limitation taxpayers are forced to avoid in order to obtain full deduction for losses sustained on security transactions which they contend occur in the ordinary course of business. Taxpayers have attempted to avoid this restriction on the deductibility of such security losses by several methods. These have varied from labeling the loss part of the goods sold, to classifying them as ordinary and necessary business expenses, with an occasional taxpayer contending his loss was deductible as a business loss not compensated for by insurance or otherwise.

Capital assets are defined not by what they are, but rather what they are not. It describes not the doughnut but the hole, so to speak, by enumerating certain classes of property, the sale of which gives rise to ordinary income and provides that all other property falls into the 'capital asset' category. Ordinarily, securities are considered to be capital assets unless they are in the hands of a dealer. Nevertheless, courts will occasionally attach different labels to

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7. See 1939-1 Cum. Bull. 255, § 208(c). See also the Supplemental Report on Capital Gains and Losses to Joint Committee on Internal Revenue Taxation (1929) at 2, quoted in Hendricks, Federal Income Tax: Capital Gains and Losses, 49 Harv. L. Rev. 262, 266 (1935), where it is stated, "The tax on capital gains should approximate the tax which would have been paid if the gain had been realized in uniform annual amounts over the period during which the asset was held. In the same way, the reduction in tax due to capital losses should approximate the reduction in tax which would have resulted if the loss had been incurred uniformly over a period during which the asset was held."


10. The Int. Rev. Code of 1939, 53 Stat. 869, § 212, amended Int. Rev. Code, § 117(d), and removed the $2,000 limitation previously applicable to the capital losses of corporation. The present law, Int. Rev. Code of 1954, § 1211 provides that in the case of corporations capital losses shall be allowed only to the extent of capital gains. Taxpayers other than corporations are allowed losses to the extent of gains from such sales, plus the taxable income of the taxpayer, or $1,000, whichever is smaller. However, in both cases, Section 1212 allows a net capital loss of one year to be carried over for the next 5 years as a short-term capital loss, deductible to the extent that it exceeds any net capital gains of such year.


12. Ibid.
certain securities which are not the stock in trade of a dealer, and find completely different consequences to flow from their sale.

Securities Acquired to Guarantee Contract Performance

One of the more recent cases in this borderline area is Commissioner v. Bagley & Sewall Co., which involved a security purchase as a necessary requisite to an ordinary business transaction. That company, which was engaged in the manufacture and sale of paper-making machinery, was required to deposit $800,000 of United States bonds, in lieu of a surety bond, to guarantee performance of a contract to sell two large paper-making machines. The taxpayer owned no such bonds at the time, and was forced to purchase the bonds at a premium. The interest earned upon the bonds during the period they were held in escrow was reported as income received by the taxpayer. Upon release from escrow they were sold at a loss, which was deducted as an ordinary and necessary business expense. The taxpayer contended "that the whole transaction [was] merely an incident required and made necessary in the performance of a contract undertaken in the regular course of the taxpayer's business and [was] deductible from gross income in its entirety by reason of the provision of Section 23(a) (1) of the Internal Revenue Code of 1939." The Commissioner contended that "the bonds constituted capital assets, as the term is defined in Section 117(a) (1) of the Internal Revenue Code and that the loss sustained upon their sale [was] to be treated as a capital loss to the extent of offsetting capital gains, none of which [were] reported by the taxpayer and therefore the whole item [was] subject to elimination."

The Tax Court felt compelled to find that the property was not a capital asset, but fell within the category of "property held . . . primarily for sale to customers in the ordinary course of his trade or business." In labeling the securities as "held primarily for sale to customers in the ordinary course of business," the Tax Court

13. 221 F. 2d 944 (2d Cir. 1955).
14. The section provides in part, "In computing net income there shall be allowed as deductions . . . all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . " Now Int. Rev. Code of 1954, § 162.
had classified these particular securities as non-capital and had accomplished the result it wanted. However, the court went on to fortify its decision by talking in terms of the loss constituting "an ordinary and reasonable expense." The court of appeals referred to it as a "business expense." The phrase, "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," was clearly not intended to be construed as the Tax Court here used it. This exception was added in 1924\textsuperscript{19} and amended into its present form in 1934\textsuperscript{20} by adding the words "to customers" and "ordinary." The terminology was designed to cover the transactions of "dealers in securities" and to make clear the fact that property held for resale was not a capital asset.\textsuperscript{21} Probably a better rational would have been to term the loss a part of the cost of goods or services sold, on an ordinary and necessary business expense,\textsuperscript{22} without considering the transaction as a separate sale. In so doing the court could have held that the security purchase was so tied to the contract that it was impossible to divide or atomize the transaction into its component parts so as to treat each part separately.\textsuperscript{23} Therefore, inasmuch as the entire transaction was part of the taxpayer's normal course of business any gain or loss on any part of the component parts of the transaction would be ordinary.

\begin{itemize}
\item[\textsuperscript{19}] Revenue Act of 1924, § 208(a)(8), 43 Stat. 263.
\item[\textsuperscript{20}] Revenue Act of 1924, § 117(b), 48 Stat. 714.
\item[\textsuperscript{21}] The House Report on the 1924 Act, H. R. Rep. No. 179, 68th Cong., 1st Sess. 19 (1924), quoted in 3 Mertens, Federal Income Taxation, § 22.08 n. 68, states: "The last part of the definition of capital assets is changed to remove any doubt as to whether property which is held primarily for resale constitutes a capital assets, whether or not it is the type of property under good accounting practice would be included in the inventory." The 1921 Act did not exclude property "held by the taxpayer primarily for sale in the course of his trade or business" from the definition of capital assets. Revenue Act of 1921, § 206(a) (6).
\item[\textsuperscript{22}] See Welch v. Helvering, 290 U. S. 111, 113-114 (1933) where it is said, "...[W]hat is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstances. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often.... The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part." Also in A. Harris & Co. v. Lucas, 48 F. 2d 187, 188 (5th Cir. 1931) it is said, "...[I]t is clear that Congress intended the statute [ordinary and necessary expenses] to be broadly construed to facilitate business generally, so that any necessary expense, not actually a capital investment, incurred in good faith in a particular business, is to be considered an ordinary expense of that business."
\item[\textsuperscript{23}] For cases in other contexts where courts have refused to divide transactions into their component parts see, e.g., Mather v. Commissioner, 149 F. 2d 393 (6th Cir.), cert. denied, 336 U. S. 767 (1945); Helvering v. New Haven & S. L. R. Co., 121 F. 2d 985 (2d Cir. 1941), cert. denied, 315 U. S. 803 (1942); Commissioner v. Ashland Oil & Refining Co., 99 F. 2d 588 (6th Cir. 1938), cert. denied, 306 U. S. 661 (1939); Prairie Oil & Gas Co. v. Motter, 66 F. 2d 309 (10th Cir. 1933). 
\end{itemize}
income or ordinary expense, rather than gain or loss from the sale or exchange of a capital asset. Such a construction, in turn, would avoid the question of the extent to which these holders of non-capital securities would be treated as "dealers." It appears this was what the circuit court was doing when it analogized the cost of the bonds deposited in this case to the premiums paid surety companies by regular contracting companies, but it affirmed the Tax Court's decision without making the point clear.

**Securities Acquired as a Requisite to Obtaining Scarce Merchandise**

The chief cases relied on in the Bagley case lie in a somewhat different category, although they concern essentially the same problem. In both the Charles A. Clark and the Western Wine and Liquor Co. cases, the taxpayers were in the business of buying and selling liquor. When a national distilling company announced that it planned to sell its liquor inventory at book cost to its stockholders in relation to their shareholdings, both taxpayers purchased stock with the avowed purpose of obtaining an allotment of liquor. In both cases the losses on the sale of stock were added to the cost of liquor, and included as part of the cost of goods sold. Again the court held that the stock must be considered as held by the taxpayer for sale in the regular course of its business of buying and selling liquor. Again it was Section 117(a)(1)(A) that was applied to transform capital assets into non-capital assets.

Several factors appear to be controlling in the Western Wine Co. case which preceded the Clark case. First of all, the taxpayer disposed of its stock almost immediately, which although not conclusive was given considerable weight. Secondly, the transaction was handled on the books as part of the cost of whiskey rather than as an investment and this theory was followed all the way through the transaction. Thirdly, the court was further impressed with the genuineness of the transaction inasmuch as the company in which the stock was purchased was so financially unsound. The last contentions made to the court, although somewhat weaker, urged the

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24. U. S. Treas. Reg. 118 § 39.22(c)-5 (1953) permits dealers in securities to value unsold securities (a) at cost (b) at cost or market, whichever is lower, or (c) at market value.
The absolute necessity of acquiring the liquor for the continuance of the taxpayer's business, and the presumption that the stock purchase was a necessary incident to the purchase of the liquor since liquor was offered in the same ratio as the number of shares purchased.

The dissent in the above case presented several bothersome questions:

1. "... Where would the same reasoning lead us if circumstances were such that the stock was sold at a profit[?]"29

2. "... Assume the stock was held for more than a year during which time the whiskey was all disposed of by petitioner and the tax returns had been filed accounting for the same, to what item of petitioner's accounting for such later year would the gain or loss be attached as part of the cost of goods sold[?]"30

3. "... How can [the majority] either directly or by necessary inference hold that the stock was sold to customers in the ordinary course of his business? Petitioner was in the whiskey business, not in the business of buying and selling securities. Its customers were customers for whiskey, not customers for securities."31

All three queries are reasonable and point out some of the problems that may arise by such statutory construction of a Code section not designed to cover these situations. It appears, however, that each question has a reasonable solution. As to the first question, it is rather doubtful that the situation will arise where a taxpayer will receive a gain on stock purchased under these circumstances. However, should such a situation arise where a gain is realized, nothing more serious would result than requiring the taxpayer to prove his holding of the stock as an investment to classify it as a capital asset or else have the gain subjected to ordinary income rates.32 Thus, in either instance, by placing the burden of proof upon the taxpayer as to his motives in acquiring the securities, it appears that a fair result could be reached. As to the second query of matching revenue and expense for accounting purposes, the value of the securities could be determined at the year's end just as dealers in

29. Western Wine and Liquor Co., 18 T. C. 1090, 1100 (1952) (dissenting opinion).
30. Ibid.
31. Ibid.
32. See Harry Dunitz, 7 T. C. 672 (1946) where this problem did arise. The Tax Court applied the test as to the reason the securities were acquired, found them to be acquired as a component part of their ordinary trade or business, and taxed the income as ordinary income.
securities value their stock inventory. Any writedown could be taken then through the inventory, with subsequent adjustments made later. The third question harks back to the problem that runs all through these cases of how such a tortured construction of a statute can be justified. Of course, it is only the result that can justify such a construction. As pointed out, the court could have employed a more direct reasoning to reach the same conclusion, but has successfully reached the desired result by somewhat stretching its imagination.

In Hogg v. Allen, another case in which shares of stock were purchased to acquire whiskey, the court employed another line of thought. In that case the court allowed the loss on the sale of the stock as an ordinary and necessary expense incurred in carrying on trade and business, or as a loss not compensated for by insurance or otherwise. Although the court did not specify on which of these two grounds it was recognizing the deduction, it appears that allowing it as an ordinary and necessary business expense would have been a sound rationale, but to classify the deduction as a loss not compensated for by insurance or otherwise seems almost as far afield as 117(a)(1)(A).

Securities Purchased to Obtain a Concession

The Exposition Souvenir Corp. case at first seems to be entirely inconsistent with the foregoing cases, but upon closer examination appears to be clearly distinguishable. The taxpayer in that case as a condition precedent to obtaining concessions at the New York World's Fair purchased Fair debentures for cash. The debentures were treated as investments on the taxpayer's books and in its tax return. Interest paid on the bonds was reported as income and payments made on account of principal were shown as reductions. If the court is going to classify these taxpayers as "dealers" for purposes of taking the securities out of the capital asset category, it does not seem to be unreasonable to allow these same "dealers" to value their securities as regular dealers in securities are allowed to do. This would at least prevent any gain, if such occur, from being taxed at capital gains rates. It might provide the taxpayer with an opportunity to take the loss when he gets the largest benefit, however, since he can use market value to get the loss in the first year, or use cost to postpone the loss until later.

33. See note 24 supra. If the court is going to classify these taxpayers as "dealers" for purposes of taking the securities out of the capital asset category, it does not seem to be unreasonable to allow these same "dealers" to value their securities as regular dealers in securities are allowed to do. This would at least prevent any gain, if such occur, from being taxed at capital gains rates. It might provide the taxpayer with an opportunity to take the loss when he gets the largest benefit, however, since he can use market value to get the loss in the first year, or use cost to postpone the loss until later.


tions in the amount of investment. The taxpayer contended the debentures as "property" fell within the exceptions as (1) "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" or (2) "property used in the trade or business, of a character which is subject to the allowance for depreciation" or, finally that it should be treated as additional consideration to obtain a concession, and therefore an ordinary and necessary business expense. The court rejected all three contentions and resorted to the plain words of the statute in justifying its holding that the loss was a long-term capital loss. This result, however, which is contrary to the holding in the whiskey cases where the loss on the securities was held deductible in full, appears to be distinguishable for the following reasons. First of all, the taxpayer filed his tax return originally treating the debentures therein as investment securities, and secondly, his books treated the securities throughout as an investment. The court was unwilling to allow the taxpayer to reverse his position when the tax consequences became obvious, but the court did seem to indicate that it might have been willing to allow allocation of the cost between the debentures and the concession contract, had there been sufficient evidence as to the debentures' market value at the date of purchase. A further factor and probably equally significant was the extended holding period which continued even after the securities fulfilled their avowed purpose of obtaining a concession. Nevertheless, had the taxpayer taken the position on its tax return and records that it held in the litigation it is highly possible that the court would have reached the same result it reached in the Bagley, Clark, and Western Wine cases.

Securities Acquired to Improve Business Conditions and Relations

In Commissioner v. The Hub, Inc., a clothing corporation made several payments on a subscription to stock of a non-profit corporation organized to bring new industry into the community and

39. See note 18 supra.
41. 163 F. 2d 283, 285 (1947). The taxpayer analogizes the loss on the securities to the payment of a bonus to secure a lease, and thus an ordinary business expense.
43. Exposition Souvenir Corp. v. Commissioner, 163 F. 2d 283, 286 (2d Cir. 1947).
44. 68 F. 2d 349 (4th Cir. 1934).
to rehabilitate existing manufacturing plants. The taxpayer made the payments for the purpose of indirectly benefiting his business which was suffering along with other businesses in the community. The court there allowed the deduction as an ordinary and necessary expense analogizing the payments to advertising and donations. Probably similar to this case, and not necessarily inconsistent with it despite the opposite result, is Logan & Kanawha Coal Co. There the petitioner was engaged in selling coal. It acquired shares of the capital stock of certain coal-mining companies and a transportation company for the primary purposes of maintaining favorable relations and securing a supply of coal for the successful conduct of its business. The taxpayer, in determining its excess profits tax for the year 1941, treated the loss from the sale of certain of such shares as an ordinary loss and treated its remaining shares as non-capital assets in determining its invested and average invested capital.

When the Commissioner attacked this treatment, the court held such shares of stock constituted "capital assets" under Section 117 and hence "inadmissible" assets under Section 720(a)(1)(A). The crucial element in the taxpayer's case may have been the questionable business necessity connected with the purchase. At any rate the court did not allow such tenuous business reasons to transform the character of the securities into non-capital assets. Possibly the court was afraid that if it allowed the deduction, it would be opening the door to such claims whenever taxpayers holding interests in their suppliers or purchasers suffered a loss on their purchase. Nevertheless, ten years later in 1955, the court allowed the deduction in an analogous case wherein the taxpayer purchased debentures of his manufacturer-supplier of plywood lumber. Here the court followed the trend of the most recent cases, and again reiterated the reason as being "that business expense . . . has been many times determined by business necessity without a specific consideration of Section 117," and went on to say that insofar as the Logan & Kanawha Coal case was inconsistent therewith it was overruled.

45. 5 T. C. 1298 (1945).
47. Excess Profits Tax Act of 1940, § 720(a)(1)(A), as amended, 55 Stat. 29 (1941) (repealed 59 Stat. 568 (1945)). Section 720 provided that for purposes of admissible and inadmissible assets—
   "(1) The term 'inadmissible assets' means—
   "(A) Stock in corporations except stock in a foreign personal-holding company; and except stock which is not a capital asset. . . ." (Such as stock held primarily for sale to customers by a dealer in securities.)
49. Id. at ¶ 24-633.
SECURITIES ACQUIRED IN SUPPLIER CORPORATIONS TO CIRCUMVENT OPA CEILING PRICES

In another category are the "OPA" cases, in which taxpayers purchased stock in their supplier corporations in order that they could obtain merchandise from them. The latest of these cases is McGhee Upholstery Co., in which the taxpayer had difficulty obtaining springs for the manufacture of furniture, and in order to obtain them was required to buy $5,000 worth of the supplier corporation stock. About a year after its purchase the stock was sold back to the supplier corporation at a loss of $4,250, which loss was then transferred from a "security" account to a "cost of goods sold" account and deducted on the tax return as such. The court disallowed the deduction upon the basis that nothing in the record established this purchase and sale of stock as other than a capital transaction. Again the court seemed to indicate that if the evidence were sufficient they would allow the transaction as an ordinary loss, but, on the other hand, the court was similarly concerned with the proper year for deduction of the loss had they allowed it.

In two other "OPA" cases the taxpayers purchased stock in lumber supplier corporations at $100 per share for each 10,000 board feet of lumber purchased. The transferor of the stock had an option to repurchase the stock at $1 per share, which option was exercised a short time after the stock purchase. In both cases the court said the payments were actually for the purchase of lumber, and although in violation of OPA ceilings were includable in the cost of goods sold. Both of these cases cited Lela Sullenger, in which the court allowed over-ceiling payments for meat as part of the cost of goods sold. The court arrived at the decision in that case on the basis that the Sixteenth Amendment gave Congress the power to tax no more than gross income. The Commissioner contended the overpayment must be considered from the standpoint of deductions which are a matter of grace and not of right, and to allow these amounts as deductions would be contrary to public policy. The court, however, rejected his contention saying that

52. 11 T. C. 1076 (1948). However, in Harry Sackstein, 14 T. C. 556 (1950) where the petitioner was allowed to buy meat at OPA ceiling prices in proportion to the amount of stock-purchased, the court said the payments for stock were not part of the cost of goods sold, and not ordinary and necessary expenses, but capital contributions by a stockholder.
53. Lela Sullenger, 11 T. C. 1076, 1077 (1950). However, in Commissioner v. Pacific Mills, 207 F. 2d 177 (1st Cir. 1953), the court held that the fundamental policy of the Emergency Price Control Act had not been violated where a taxpayer entered into a settlement with the government
this was part of the cost of goods sold and, although Section 2351 makes no provision for the cost of goods sold, the Commissioner must allow it in order to stay within the Constitution, and must deduct the cost of goods sold from gross receipts to arrive at gross income. Nevertheless, in other cases the court has not hesitated to disallow the deduction by saying the evidence did not warrant such an allowance.55 Thus the inconsistency in the OPA cases seems to stem largely from the economic fact that these were expenses of doing business on one hand, while, on the other hand allowing the expenses would tend to uphold the inflation the OPA sought to prevent.

**Securities Acquired to Extinguish Outstanding Liabilities**

In another class of cases we have a situation where taxpayers, in order to acquire assets or extinguish liabilities, have purchased stock in other corporations. In *Pressed Steel Car Co.*56 the taxpayer, in order to extinguish its liability under a contract, purchased all of the stock of a corporation which held as assets only this contract with the taxpayer purchaser; the taxpayer then dissolved the corporation. The court in an earlier case allowed capital gains treatment to the stockholders who were receivers of the payments,57 but when the Commissioner cited the earlier holding in favor of the stockholders as conclusive support for his position that the payment was for the purchase of stock, the Tax Court disagreed. It saw the true nature of the event, would not be bound by the determination in the prior proceeding that the corporation had not realized income, and thus found from the evidence that the expenditure was clearly made to discharge the contract. Similarly the amount paid by a corporation for stock of an agency in order to procure cancellation of an agency contract for sale of the corporation’s stock has been held to be deductible as an ordinary expense or loss.58

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53. 20 T. C. 198 (1953).
55. Helvering v. Community Bond & Mortgage Corp., 74 F. 2d 727 (2d Cir. 1935). See also Camloc Fastener Co., 10 T. C. 1024 (1948), where a damages settlement (in the form of a purchase of an agent’s “interest”) for termination of a sales contract was allowed as an ordinary and necessary business expense, and Olympia Harbor Lumber Company, 30 B. T. A. 114 (1934), where a payment for cancellation of an unsatisfactory contract was allowed similar treatment.
Securities Received for Goods or Services

In a final category are cases where securities are received as payment for goods or services in lieu of some other form of payment. Such is *Hercules Motors Corp.* in which the taxpayer received trade acceptances which matured at a later date with interest. Likewise, ordinary loss treatment has been allowed where the taxpayers received bonds in payment for services in lieu of cash, and where stock was received by a contracting firm as payment for constructing a building for a corporation. Of the same nature is *The Foundation Co.* case in which the taxpayer entered into a contract with a Peruvian corporation and received as payment Peruvian currency, which it was forced to sell at unfavorable exchange rates. In all of these cases the court found that the securities or currency received was "property held primarily for sale to customers in the ordinary course of trade or business" and thus excluded it from the capital asset category. The one case in this group that seems to be completely irreconcilable with the others is *Rockford Varnish Co.* in which secured notes were taken for accounts receivable which had been received in the ordinary course of business. Here the court held that the loss on such secured notes was a capital loss inasmuch as the normal custom was not for this business to take secured notes for accounts receivable. This seeming distinction led to an outlandish result, since the entire income represented by the notes had resulted from sales in the ordinary course of business. However, such a case will presumably not arise again since, by the addition of Section 1221(4) to the 1954 Code, such accounts and notes receivable acquired in the ordinary course of trade or business are specifically excluded from the capital asset category.

59. *Hercules Motors Corp.*, 40 B. T. A. 999 (1939).
60. 47 B. T. A. 158 (1942).
61. Gilbert v. Commissioner, 56 F. 2d 361 (1st Cir. 1932). At the date of this case the "dealer" exclusion to the capital asset category still read, " . . . property held by the taxpayer primarily for sale in the course of his trade or business."
63. See also Lawyers Title Company of Missouri, 14 T. C. 1221 (1950), where a title insurance company acting as escrow of funds advanced by mortgagees on a building contract, acquired title to uncompleted buildings and completed and sold them after the contractor had abandoned them. The loss was held to be an ordinary loss under Section 117(a) (1). *Contrary*, Thompson Lumber Company, 43 B.T.A. 726 (1941).
64. 9 T. C. 171 (1947). Thompson Lumber Co., *supra* note 63, arrived at the same result, but the case involved real property, not securities.
65. Int. Rev. Code of 1954, § 1221. "For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1). . . ."
CONCLUSION

Fortunately, this area of the law seems to be one where bad cases do not necessarily indicate bad law but merely that general rules, designed to achieve salutary results in the great majority of situations, must sometimes be given absurd constructions to reach just results when carried over into situations to which they were not designed to apply. The courts have been confronted with the task of solving problems that even a well-drafted statute, designed to cover the situation, would make difficult to settle. They have had to play a game of semantics coloring the securities as property held primarily for sale to customers in the ordinary course of business, or have had to resort to some other fiction.

The legislative history of the capital loss limitations shows a congressional purpose to prevent capital loss deductions incurred over several years from being taken all in one year, rather than a purpose to restrict losses resulting from ordinary operations. Phrases such as “ordinary and necessary,” “held primarily for sale to customers,” and “capital assets” refer to subtle categories which attempt to separate the minute and infinite variations of income or loss producing transactions, and such terms must of necessity be somewhat misapplied in this area, since they are the words which have been used to serve as the wall between the two types of gain or loss, ordinary or capital.

Thus, although disposition of “capital assets” presents a difficult problem, fairness in these cases, where the underlying purpose of the security purchase is other than investment, would require that losses of this type be reflected in taxable income to their full extent as are non-investment losses of other types, e.g., losses sustained in the operation of a business, and losses resulting from casualties such as fire and flood. Consequently, the question arises as to what should be done in circumstances where it becomes necessary to acquire securities for some reason other than investment purposes, and the holder wants to assure himself that a loss will be treated in accordance with the purpose for which the securities were purchased.

First, the taxpayer must thoroughly consider the element of necessity involved in the acquisition of the securities. Is it to better business relations, or does the security purchase have a stronger business purpose that is so closely akin to the regular conduct of the business that without it normal operations would be virtually

66. See note 7 supra, and text thereto.
68. See Logan & Kanawha Coal Co., S T. C. 1298 (1945).
impossible? Courts are constantly in search of some long-range profit motive or other reason to classify the securities as purchased for investment rather than for ordinary business purposes. Consequently, to expect ordinary loss treatment, taxpayers must have extremely sound business-connected reasons for the purchase.

Secondly, the book treatment of the securities is very significant, and the tax consciousness in this respect should begin immediately upon acquisition. The taxpayer should enter the security purchase in his books according to the purpose of the acquisition, and, whether it be entered as an inventory item, additional consideration to acquire an asset, or in some other way, no digression should be made from that course in the bookkeeping.

Thirdly, the holding period is of considerable importance in these cases. Securities should therefore be disposed of as soon as their purpose in the underlying transaction has been fulfilled. In at least two cases where the decisions against the taxpayers were seemingly put on other grounds, the holding period was delayed for a considerable length of time after the securities could have been disposed of and still have accomplished their purpose. Again it must be said this is not conclusive, but it seems to have carried much weight with the courts.

Lastly, upon disposition of the securities, treatment consistent with that employed upon their acquisition should be followed. Although in the Bagley case the interest received was reported as income it appears that a better method of handling any return that may result from the securities would be to enter it as additional consideration received on the over-all contract, or alternatively as a reduction in the cost of the securities, thus reducing the cost of goods or services sold. Likewise, the loss on the disposition of the securities should be treated consistently with the purpose behind the purchase, whether it be as part of the cost of goods sold or as an ordinary business expense, but at any rate in such a manner that it is clear that no investment purpose is intended.

As to the most accurate method to follow in accounting for the loss, at least one writer advocates the allocation of cost of the securities between the wanted and unwanted asset, in the case of asset acquisitions along with the securities. Although the allocation method does have its problems and drawbacks, it appears that this may be the best method for all such types of security acquisi-
tions. However, a revaluation annually so as to include the total loss on the securities in the cost of goods sold or the cost of the individual asset will usually be necessary to obtain an accurate result. On the other hand, in cases where the acquisition was to extinguish some outstanding liability, or where the securities have been acquired for services, the classification of an ordinary and necessary business expense seems to be the most realistic category for such losses, since it is clear in these cases that the acquisition was to further the ordinary course of business either by reducing liabilities or by securing additional income through ordinary sales. These suggestions, although not necessarily determinative of the result courts may reach in the future, should be persuasive evidence of a taxpayer's intentions in acquiring and holding non-investment securities.

Nevertheless, the present method of handling such losses on securities acquired for other than investment purposes results in a somewhat unsatisfactory and unpredictable guide to the future. It is hoped that courts will turn to the rationale of the United States Supreme Court in *Corn Products Refining Co. v. Commissioner*,71 which involves a hedging rather than a security transaction as a normal part of operations. In that case the Court said:

"Admittedly, petitioner's corn futures do not come within the literal language of the exclusions set out in that section [117]. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision of § 117 must not be so broadly applied as to defeat rather than further the purpose of Congress. ... Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income. It was intended 'to relieve the taxpayer from ... excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' ... Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose."72

If courts follow this line of reasoning for gains and losses on non-investment securities, it appears that justice will be done when cases

72. Id. at 51-52.
reach litigation. However, although the results courts have reached to date indicate a clear appreciation of particular situations, a fresh approach appears to be vitally needed wherein the legislature or the Commissioner can spell out for tax planners the requirements of this judicially created exception to Section 1221.73

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