7 T.C. 1300 (1946)

A corporation's equity invested capital for excess profits tax purposes does not include the fair market value of stock issued to a broker as a commission for selling the corporation's stock, because such stock issuance is considered compensation for services rather than money or property paid in.

Summary

Palomar Laundry issued shares of its preferred stock to a broker as a commission for the broker's services in securing subscriptions for the Laundry's stock. When calculating its excess profits tax, Palomar Laundry included the fair market value of the commission stock in its equity invested capital. The Commissioner of Internal Revenue disallowed this inclusion. The Tax Court upheld the Commissioner's decision, reasoning that the stock was issued for services, not for money or property, and therefore did not qualify as equity invested capital under Section 718 of the Internal Revenue Code. This case clarifies that commissions paid in stock do not increase invested capital.

Facts

Palomar Laundry, a California corporation, engaged a stockbroker to obtain subscriptions for 1,600 shares of its preferred stock at $100 per share.
In return for these services, Palomar Laundry agreed to issue the broker 400 shares of its preferred stock as a commission.
The broker successfully secured subscriptions, and Palomar Laundry received $159,500 in cash for 1,595 shares actually sold.
The fair market value of the 400 shares issued to the broker was $40,000 at the time of issuance.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Palomar Laundry's excess profits tax for 1941 and 1942, disallowing the inclusion of the $40,000 stock commission in the company's equity invested capital. Palomar Laundry petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court upheld the Commissioner's determination, finding that the stock issued for services was not includible in equity invested capital.

Issue(s)

Whether the fair market value of preferred stock issued by a corporation to a broker as a commission for selling the corporation's stock can be included in the corporation's equity invested capital under Section 718 of the Internal Revenue Code for the purpose of calculating excess profits tax.

Holding

No, because the stock was issued in exchange for services, not for money or property, and therefore does not meet the statutory requirements for inclusion in equity invested capital. Services are not equivalent to “money paid in” or “property paid in”.

Court’s Reasoning

The Tax Court relied on the principle established in *Simmons Co. v. Commissioner*, which held that invested capital cannot be increased by commissions paid for the sale of a corporation’s stock. The court reasoned that Section 718 of the Internal Revenue Code allows for the inclusion of “money paid in” or “property paid in” for stock in the calculation of equity invested capital.
The court stated, “We are certain that under no circumstances can invested capital be *increased* by the amount of a commission which a corporation pays for the sale of its stock to those who thereby become stockholders.” The court distinguished the case from others where stock was issued in exchange for the cancellation of debt or for specific contributions to capital assets. In this case, the stock was issued as compensation for services, not as a direct investment of money or property.
The court emphasized that although the commission might be considered a capital expenditure, not all capital expenditures qualify as invested capital under the statute.

Practical Implications

This case clarifies that corporations cannot increase their equity invested capital for excess profits tax purposes by including the value of stock issued as commissions for services related to the sale of their own stock. This ruling informs how corporations should calculate their excess profits tax credit using the invested capital method.
Practitioners must distinguish between stock issued for services (not includible in invested capital) and stock issued for money or property (includible). This case reinforces the importance of properly classifying transactions and understanding the specific requirements of Section 718 of the Internal Revenue Code and similar provisions in subsequent tax laws. Later cases have cited Palomar Laundry for the proposition that

