8 T.C. 557 (1947)

A corporation is not a personal service corporation exempt from excess profits tax if its capital is a material income-producing factor, even if the income is primarily derived from the activities of its shareholders.

Summary

Graham Flying Service, a flying school, sought exemption from excess profits tax as a personal service corporation. The Tax Court ruled against the company, finding that its capital (airplanes, facilities) was a material income-producing factor. Although E.L. Graham's expertise was crucial, the court emphasized that the business heavily relied on substantial capital investment. The court reasoned that the tuition fees were directly related to the use of the petitioner's equipment. The decision highlights the importance of capital in determining personal service corporation status.

Facts

E.L. Graham, owning 96% of Graham Flying Service, ran a flying school. The school had contracts with the Civil Aeronautics Administration (CAA) to provide flight instruction. Graham was the chief instructor and flight examiner. The school required significant capital investment in airplanes, facilities, and equipment. Graham Flying Service purchased Rickenbacker Field for approximately $21,000 after the Army took over the Sioux City Municipal Airport. Depreciation schedules showed ownership of 13 airplanes in 1941 ($34,960.42) and 26 airplanes in 1942 ($77,707.80).

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Graham Flying Service's declared value excess profits tax and excess profits tax for 1941 and 1942. Graham Flying Service contested the determination, claiming exemption as a personal service corporation. The Tax Court ruled in favor of the Commissioner, denying the exemption.

Issue(s)

Whether Graham Flying Service qualified as a personal service corporation under Section 725(a) of the Internal Revenue Code, specifically whether its income was primarily ascribed to the activities of its shareholders and whether capital was a material income-producing factor.

Holding

No, because Graham Flying Service's capital was a material income-producing factor. The court determined that the company's income was earned in large part by

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the use of the airplanes in which it had invested substantial capital.

Court's Reasoning

The court considered whether Graham Flying Service met the statutory conditions for personal service corporation status, focusing on two factors: (1) whether income was primarily due to shareholder activities, and (2) whether capital was a material income-producing factor. The court acknowledged Graham's expertise but emphasized the significance of the capital investment in airplanes and facilities. The court cited *Atlanta-Southern Dental College v. Commissioner*, highlighting the direct relationship between tuition fees and the use of the school's equipment. The court noted, "As to the tuition fees, it is perfectly plain that they were earned and produced by the use of a plant and equipment without which, no matter how eloquent the teaching of the stockholding professors might have been…no single student could have been drawn to the school…" In Graham Flying Service's case, compensation was directly tied to flight time, demonstrating that income was significantly derived from the use of capital assets.

Practical Implications

This case demonstrates that even if a business's success is heavily reliant on the expertise and activities of its principal owner(s), it may not qualify as a personal service corporation if capital plays a material role in generating income. It is a reminder that substantial capital investment in assets like equipment and facilities can disqualify a business from personal service corporation status. Later cases must carefully analyze the proportion of income derived from capital versus personal services to determine eligibility for this exemption. This ruling clarifies that the direct connection between capital assets and revenue generation weighs heavily against personal service corporation designation.

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