9 T.C. 700 (1947)

A corporation qualifies as a personal service corporation if its income is primarily attributable to the activities of its shareholders who actively manage the business, own at least 70% of the stock, and capital is not a material income-producing factor.

Summary

H. Newton Whittelsey, Inc., a naval architecture and marine engineering firm, sought classification as a personal service corporation to reduce its excess profits tax. The Tax Court determined that despite having numerous employees, the company's income was primarily derived from the expertise and activities of its principal stockholder, H. Newton Whittelsey. Whittelsey's specialized knowledge, client relationships, and oversight of all projects were critical to the company's success, distinguishing it from cases where employee contributions were more significant. The court also addressed the deductibility of undisbursed vacation wages and certain disallowed contributions.

Facts

H. Newton Whittelsey, Inc. was engaged in providing naval architectural and marine engineering services to the U.S. Navy under cost-plus-fixed-fee contracts. The company's stock was primarily owned by H. Newton Whittelsey and his family, with Whittelsey himself holding a controlling share. Whittelsey secured the contracts, supervised their performance, directed employees, and possessed the unique scientific knowledge required for the projects. The company also had numerous employees, including draftsmen, engineers, and clerical staff. During the tax year, the Navy paid "vacation wages" to the petitioner. However, at the end of the year, a portion remained undisbursed.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Whittelsey, Inc.'s excess profits tax for the fiscal year ended November 30, 1942. Whittelsey, Inc. petitioned the Tax Court for a redetermination. The Tax Court considered whether the company qualified as a personal service corporation under Section 725(a) of the Internal Revenue Code, whether the Commissioner erred in restoring certain "vacation wages" to the company's taxable income, and whether certain disallowed contributions were deductible as business expenses.

Issue(s)

1. Whether Whittelsey, Inc. qualifies as a personal service corporation under Section 725(a) of the Internal Revenue Code.

2. Whether the Commissioner erred in restoring $3,458.90 of "vacation wages" to Whittelsey, Inc.'s taxable income, given that the company was on a cash receipts

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and disbursements basis.

3. Whether certain disallowed contributions, totaling $90, are deductible as ordinary and necessary business expenses.

Holding

1. Yes, because the company's income was primarily attributable to the activities of its principal stockholder, H. Newton Whittelsey, who actively managed the business and possessed specialized knowledge critical to its operations.

2. Yes, because Whittelsey, Inc., using the cash receipts and disbursements method, could only deduct the vacation wages when paid, not when accrued.

3. No, because the company failed to provide sufficient evidence that the contributions were advertising expenses, an ordinary and necessary expense of its trade or business.

Court's Reasoning

The Tax Court reasoned that Whittelsey's expertise in naval architecture, his client relationships, and his supervision of the company's projects were the primary drivers of its income. While the company had numerous employees, their contributions were deemed subordinate to Whittelsey's. The court distinguished this case from others where non-stockholder employees played a more significant role in generating income. The court cited *Fuller & Smith v. Routzahn*, noting that the law was "directed at absentee stock ownership" and intended to provide similar tax treatment to corporations performing personal services as partnerships. Regarding the vacation wages, the court upheld the Commissioner's decision, stating that a cash-basis taxpayer can only deduct expenses when they are actually paid. Finally, the court found that Whittelsey, Inc. failed to demonstrate that the disallowed contributions were actually advertising expenses, and therefore, the deduction was properly disallowed.

Practical Implications

This case illustrates the importance of demonstrating that the income of a corporation seeking personal service classification is primarily derived from the expertise and activities of its principal shareholders. It highlights that merely securing contracts and providing overall supervision may not be enough; the shareholder's specialized knowledge and active involvement in the core business activities must be evident. For cash-basis taxpayers, this case reinforces the principle that deductions are generally allowed only when expenses are actually paid. Furthermore, taxpayers bear the burden of proving that claimed deductions meet the requirements of the Internal Revenue Code, emphasizing the need for sufficient documentation to support such claims. Later cases may cite this to determine if key employees are truly subordinate or if their contributions are so

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significant that they disqualify the company from being a personal service corporation.

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