9 T.C. 1029 (1947)

For purposes of determining personal holding company status, gross income from farming operations is calculated by subtracting the cost of farm production from gross receipts, not simply using gross receipts.

Summary

Garrett Holding Corp. owned securities, real estate, and engaged in farming. The Commissioner determined a deficiency in personal holding company surtax and a penalty for failure to file a personal holding company return. The Tax Court addressed whether Garrett was a personal holding company, whether the surtax was constitutional, and whether the penalty applied. The court held Garrett was a personal holding company because its dividend income exceeded 80% of gross income after subtracting farm production costs. The court found the surtax constitutional but reversed the penalty due to reliance on attorney advice.

Facts

Garrett Holding Corporation, a New York corporation, owned securities and approximately 1,200 acres of land. It operated three farms on 300 acres of the land, selling grapes, wheat, buckwheat, and potatoes. The corporation received $74,985 in dividends, primarily from Garrett & Co., and $19,115.71 in gross receipts from its farming operations. The cost of farm operations was $16,291.14. More than 50% of Garrett Holding Corp.’s stock was owned by or for no more than five individuals. The corporation did not file a personal holding company return for 1942 but did file a regular corporate income tax return.

Procedural History

The Commissioner determined a deficiency in personal holding company surtax and a penalty for failure to file a personal holding company return. Garrett Holding Corp. petitioned the Tax Court contesting the deficiency and penalty.

Issue(s)

1. Whether Garrett Holding Corporation was a personal holding company during 1942 as defined in Section 501(a) of the Internal Revenue Code.

2. Whether the personal holding company surtax is constitutional as applied to Garrett Holding Corporation.

3. Whether Garrett Holding Corporation is liable for the penalty for failure to file a personal holding company return.

Holding

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1. Yes, because Garrett Holding Corporation's dividend income constituted more than 80% of its gross income after subtracting the cost of its farm production from its gross receipts.

2. Yes, because the surtax is a tax on income, and the selection of January 1, 1934, as a dividing line for indebtedness deductions was reasonable.

3. No, because Garrett Holding Corporation relied on the advice of its attorney in not filing a personal holding company return, constituting reasonable cause.

Court's Reasoning

The court reasoned that the definition of gross income for personal holding company purposes requires subtracting the cost of farm production from gross receipts, aligning with its decision in *Woodside Acres, Inc.*, 46 B.T.A. 1124. The court rejected the argument that gross income should be interpreted as gross receipts based on a hypothetical case in a House Report, finding the example unpersuasive. The court also found the distinction between cash and accrual methods irrelevant without inventories. Regarding constitutionality, the court held the surtax was on income, not capital, and the January 1, 1934, dividing line for indebtedness deductions was reasonable, citing *Morris Investment Corporation v. Commissioner*, 134 F.2d 774. Finally, the court reversed the penalty, emphasizing Garrett Holding Corp.'s reliance on its attorney's advice, which constituted reasonable cause under Section 291 of the Internal Revenue Code. The court quoted the attorney's advice and the reliance upon it. The court distinguished *Tarbox Corporation*, 6 T.C. 35, where the failure to file was due to ignorance or insufficient information.

Practical Implications

Garrett Holding Corp. clarifies how gross income is determined for personal holding company status when a corporation engages in farming or similar production activities. Legal practitioners must calculate gross income by subtracting the cost of production from gross receipts. The case reinforces the principle that reliance on competent legal advice can constitute reasonable cause for failure to file a tax return, offering a defense against penalties. Later cases citing *Garrett Holding Corp.* often involve disputes over the calculation of gross income for personal holding company purposes, emphasizing the enduring relevance of this case in tax law.

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