10 T.C. 499 (1948)

A company using substantial inventory or capital, even intermittently, cannot be exempt from excess profits tax as a personal service corporation because capital is a material income-producing factor.

Summary

Gus Grissmann Co., primarily a hosiery mill agent earning commissions, also engaged in manufacturing lace stockings. The Commissioner of Internal Revenue determined that Grissmann was not exempt from excess profits tax as a personal service corporation under Section 725 of the Internal Revenue Code, arguing that capital was a material income-producing factor. The Tax Court agreed with the Commissioner, finding that the use of substantial inventory and capital in the lace stocking business disqualified Grissmann from personal service corporation status, despite the commission-based income from the agency business.

Facts

Gus Grissmann Co. acted as a mill agent for hosiery manufacturers, earning commissions on sales. In 1939, it began supplying lace stockings to customers, which involved procuring lace, contracting fabrication and dyeing, and selling the finished product. Grissmann factored its accounts receivable to finance the lace stocking business, selling them to Meinhard Greeff & Co. at a discount. Substantial inventory of raw materials and finished goods was maintained. The company's three stockholders were actively involved in the business.

Procedural History

The Commissioner determined deficiencies in Grissmann's excess profits tax for 1942 and 1943, concluding that Grissmann did not qualify as a personal service corporation. Grissmann petitioned the Tax Court for review of the Commissioner's determination.

Issue(s)

Whether Gus Grissmann Co. qualified as a personal service corporation under Section 725(a) of the Internal Revenue Code, and specifically, whether capital was a material income-producing factor in its business activities during 1942 and 1943.

Holding

No, because Gus Grissmann Co.'s use of substantial inventory and capital in its lace stocking manufacturing business demonstrated that capital was a material income-producing factor, disqualifying it from personal service corporation status despite its commission-based income.

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Court’s Reasoning

The court reasoned that Grissmann’s activities extended beyond merely providing personal services as a commission agent, and included manufacturing hosiery. While Grissmann argued that it minimized capital requirements by contracting out manufacturing processes, the court emphasized that the inventory in the course of production belonged to Grissmann. The court found that capital invested in the inventory was both material in size, averaging around $15,000, and essential in character. The court noted that “One would not normally expect a manufacturing corporation, even though engaged in other lines of business, to be considered a personal service company.” The Tax Court also pointed to the need for cash or borrowed capital. The court rejected the argument that only the income from the commission business should be considered; the entire income was subject to tax because the company as a whole did not qualify as a personal service corporation.

Practical Implications

This case clarifies that a company engaged in both personal service activities and activities requiring significant capital investment will likely be ineligible for treatment as a personal service corporation for tax purposes. The presence of substantial inventory or the need for significant capital, even if intermittently used, can disqualify a company. Legal practitioners should analyze the totality of a company’s business activities and the extent to which capital is a necessary and material factor in generating income. This decision emphasizes that avoiding direct ownership of plant or machinery does not necessarily negate the importance of capital if the business requires a substantial investment in inventory or other assets. Later cases distinguish this ruling by focusing on the primary source of income and the relative importance of capital in generating that income.

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