H.R. Mallison & Co., Inc. v. Commissioner, 19 T.C. 72 (1952)

A corporation is not a personal service corporation under Section 725(a) of the Internal Revenue Code if capital is a material income-producing factor, even if the corporation's income is primarily derived from the activities of its shareholders.

Summary

H.R. Mallison & Co., Inc., a corporation primarily engaged in selling on commission, also manufactured hosiery during the tax years in question. The company argued it qualified as a personal service corporation under Section 725(a) of the Internal Revenue Code, which would have exempted it from excess profits tax. The Tax Court disagreed, holding that the use of capital, specifically a floating inventory and advances to contractors, was a material income-producing factor, disqualifying the company from personal service corporation status. The court emphasized that even if the company contracted out manufacturing processes, the inventory in production belonged to it, making the capital invested material and essential.

Facts

H.R. Mallison & Co., Inc. was engaged in two lines of business: selling goods on commission and manufacturing hosiery.
The company contracted out the various manufacturing processes.
Cash or borrowed capital of $6,500 was required in at least one month.
A floating inventory ranging from $1,500 to $20,000 was maintained, averaging $15,000 over the two years.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the company's excess profits tax. H.R. Mallison & Co. petitioned the Tax Court for a redetermination, arguing it was a personal service corporation exempt from the tax.

Issue(s)

Whether H.R. Mallison & Co., Inc. qualifies as a personal service corporation under Section 725(a) of the Internal Revenue Code, given its manufacturing activities and use of capital.

Holding

No, because capital was a material income-producing factor in the company's hosiery manufacturing business, even though the manufacturing processes were contracted out, and the company's income was primarily derived from the activities of its shareholders.

Court's Reasoning

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The court reasoned that manufacturing corporations are not normally considered personal service companies because the employment of capital is usually an essential element of such businesses. The court found that even though H.R. Mallison & Co. contracted out the manufacturing processes, it still required a substantial floating inventory and made advances to contractors, which constituted the use of capital.

The court noted that a cash or borrowed capital of $6,500 was required, and a floating inventory ranging in cost from $1,500 to $20,000 was also essential. Even though the company avoided capital requirements for plant and machinery by contracting out the processes, the inventory in production belonged to it, and the capital invested in it was material and essential.

The court cited George A. Springmeier, 6 B. T. A. 698, and Denver Livestock Commission Co. v. Commissioner (C. C. A., 8th Cir.), 29 Fed. (2d) 543, to support its conclusion that the use of capital was a material income-producing factor.

The court stated, “Even if we assume, as petitioner so strenuously contends, that the use of current earnings does not constitute ‘capital,’ the fact remains, as petitioner concedes, that in at least one of the months before us cash or borrowed capital of $6,500 was required; and, in addition, a floating inventory ranging in cost from about $1,500 to $20,000, and apparently averaging over the two years about $15,000, was likewise essential.”

Practical Implications

This case clarifies that even when a corporation contracts out its manufacturing processes, the capital invested in inventory and required for operations can disqualify it from being considered a personal service corporation. This decision highlights the importance of analyzing the actual economic substance of a business’s operations, rather than merely its formal structure. Later cases have cited this ruling to emphasize that the determination of whether capital is a material income-producing factor is a factual one, dependent on the specific circumstances of each case. Attorneys should consider not only the source of a company’s income but also the extent to which capital is necessary for generating that income when determining eligibility for personal service corporation status.

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