13 T.C. 511 (1949)

A corporation qualifies as a personal service corporation for tax purposes if its income is primarily attributable to the activities of its shareholders, who actively manage the business and own at least 70% of the stock, and if capital is not a significant factor in generating income.

Summary

Farnham Manufacturing Company sought classification as a personal service corporation to reduce its excess profits tax. The company designed specialized machinery for manufacturing airplane wings, with its stock owned by four active shareholders. The Tax Court determined that Farnham met the statutory requirements for a personal service corporation because the income was primarily derived from the skills and efforts of its shareholders, and capital was not a material income-producing factor, distinguishing it from businesses reliant on capital investment.

Facts

Paragon Research, Inc. (later acquired by Farnham) designed specialized machinery for airplane wing manufacturing. Its capital stock was owned by four individuals actively involved in the business. The company's primary client was Farnham Manufacturing, and its income mainly came from designing spar millers and other specialized equipment. The shareholders, particularly Dubosclard, possessed unique engineering skills critical to the company's operations.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Farnham's excess profits tax liability, disputing its classification as a personal service corporation. Farnham petitioned the Tax Court for review. The Tax Court reversed the Commissioner's determination, holding that Farnham qualified as a personal service corporation.

Issue(s)

1. Whether Farnham Manufacturing Company qualifies as a personal service corporation under Section 725 of the Internal Revenue Code.
2. Whether capital was a material income-producing factor in Farnham's business.
3. Whether the income of the corporation was primarily attributable to the activities of its shareholders.

Holding

1. Yes, because Farnham met all the requirements of Section 725, including

© 2025 SCOTUSreports.com. All rights reserved.

active shareholder management and minimal reliance on capital.
2. No, because the company's operations relied primarily on the expertise of its shareholders rather than on invested capital.
3. Yes, because the unique engineering skills of the shareholders were the primary drivers of the company's income.

Court's Reasoning

The Tax Court emphasized that Farnham's income was primarily due to the specialized engineering skills of its shareholders, particularly Dubosclard. The court found that Dubosclard's expertise in designing aircraft manufacturing machinery was the driving force behind the company's success. While the company employed contact men who secured business, their role was secondary to the engineering and design work performed by the shareholders. The court also found that capital was not a material income-producing factor because the company leased most of its equipment and relied on payments from its primary client, Farnham, to cover its expenses. The court distinguished Farnham from businesses where capital investment plays a more significant role in generating income. The court stated, "The character of the services rendered by the contact men is a much more important test than the amount of money they received." The court concluded that the income was primarily attributable to the shareholders' activities, satisfying the requirements for personal service classification.

Practical Implications

This case provides guidance on how to determine whether a corporation qualifies as a personal service corporation for tax purposes, particularly regarding the roles of shareholder activity and capital investment. It clarifies that the income must be primarily attributable to the skills and efforts of the shareholders, rather than capital. This ruling impacts how similar businesses are structured and taxed, emphasizing the importance of actively involved shareholders with specialized skills. Subsequent cases have cited Farnham to support the classification of businesses where personal skills and services are the primary income drivers. It also underscores the importance of documenting the specific contributions of shareholders to demonstrate their central role in the company's income generation.

© 2025 SCOTUSreports.com. All rights reserved.