***13 T.C. 521 (1949)***

A corporation qualifies as a personal service corporation under Section 725 of the Internal Revenue Code 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 where capital is not a significant income-generating factor.

**Summary**

Farnham Manufacturing Corporation sought classification as a personal service corporation for tax purposes, arguing its income primarily stemmed from the skills of its shareholder-employees. The Tax Court ruled in favor of Farnham, finding that while the corporation employed contact men who were well compensated, the core income-generating activities were the engineering and design work performed by the shareholder-employees. The court also found that capital was not a material income-producing factor for Farnham.

**Facts**

Farnham Manufacturing Corporation was engaged in designing and engineering specialized machinery. Its four shareholders, Dubosclard, Reimann, Georger and Boutet, owned at least 70% of the company's stock and actively managed the company. Farnham employed three contact men, stationed at strategic locations, who facilitated sales and provided customer support. These contact men were compensated on a commission basis. Farnham's initial capital was $10,000. The company rented all equipment, including drafting tools.

**Procedural History**

Farnham Manufacturing Corporation petitioned the Tax Court for a determination that it qualified as a personal service corporation under Section 725 of the Internal Revenue Code. The Commissioner of Internal Revenue opposed the classification. The Tax Court reviewed the facts and arguments presented by both sides.

**Issue(s)**

1. Whether Farnham Manufacturing Corporation's income was primarily attributable to the activities of its shareholders, as opposed to its other employees, specifically the contact men.
2. Whether capital was a material income-producing factor for Farnham Manufacturing Corporation.

**Holding**

1. Yes, because the success of petitioner's business was due primarily to the skills and expertise of its shareholder-employees, Dubosclard, Reimann, and Georger, in designing and engineering specialized machinery.

 

2. No, because the corporation's initial capital was small and not a significant factor in generating income.

**Court's Reasoning**

The court focused on whether the income was "to be ascribed primarily to the activities of shareholders." While acknowledging the substantial compensation paid to the contact men, the court emphasized that their role was primarily sales and customer support, not the core design and engineering work that generated the income. The court stated that the word "primarily" and the word "substantially" are not interchangeable equivalents. "One might admit that the three contact men contributed "substantially" to the production of income without denying or negating the fact that the income was nonetheless to be "ascribed primarily" to the activities of the stockholders." The court highlighted the unique skills and expertise of Dubosclard, Reimann, and Georger, noting they were difficult to replace and essential to the company's success. Regarding capital, the court found that the initial capital was minimal and that Farnham's business model relied on renting equipment and paying expenses from revenues, indicating that capital was not a material income-producing factor.

**Practical Implications**

This case clarifies the criteria for determining whether a corporation qualifies as a personal service corporation for tax purposes. It highlights the importance of focusing on the primary source of income generation, even if other employees contribute substantially. The case demonstrates that high compensation for non-shareholder employees does not automatically disqualify a corporation from personal service classification if the core income-generating activities are performed by the shareholder-employees. This ruling provides guidance for businesses with highly skilled shareholder-employees and substantial revenue derived from their expertise. It also illustrates that minimal capital investment can support a finding that capital is not a material income-producing factor. Later cases applying this ruling should carefully analyze the specific activities contributing to income and the relative importance of shareholder contributions.

 