13 T.C. 355 (1949)

When a broker purchases stock at a discount for resale, acting on its own account rather than as an agent of the issuing company, only the amount received by the corporation from the broker is includible in its equity invested capital.

Summary

The Gabriel Co. sought to increase its equity invested capital for excess profits tax purposes by including the full market value of stock issued to acquire a business, even though the stock was sold at a discount to an underwriter. The Tax Court held that only the amount the company effectively received from the sale of its stock, which was the amount paid for the acquired business, plus the value of the stock issued to the former business owners, could be included in equity invested capital. The underwriter acted on its own behalf, not as an agent of Gabriel Co.

Facts

Foster, an individual, agreed to sell his business to The Gabriel Co. for $4,000,000 plus the federal income tax he would incur on the sale, totaling $4,358,705.70. Four executives of the Foster organization were to receive 1,000 shares of Gabriel Co.'s Class B voting stock. Otis & Co. was to underwrite the transaction by purchasing Gabriel Co.'s Class A stock and selling it to the public. Otis & Co. would retain the difference between the sale price of the stock and the amount paid to Foster as its commission. The Class A stock was sold to the public for $4,950,000. Foster dictated the terms of the sale in his contract with Otis & Co. Gabriel Co. directly conveyed its Class A stock to Otis & Co., and Foster directly conveyed his business to Gabriel Co.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in The Gabriel Co.'s excess profits tax. The Commissioner limited the amount includible in Gabriel Co.'s equity invested capital to $4,358,705.70. The Gabriel Co. petitioned the Tax Court for a redetermination. The Tax Court addressed the sole question of the amount the petitioner could include in computing its equity invested capital under section 718(a) of the Internal Revenue Code.

Issue(s)

Whether the petitioner can include the fair market value of stock sold to the public by an underwriter in its equity invested capital when the underwriter purchased the stock from the petitioner at a discount and resold it on its own account, rather than as an agent of the petitioner?

Holding

No, because when a broker purchases stock at a discount for resale on its own

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account, only the amount received by the corporation from the broker is includible in its equity invested capital, regardless of the price the broker ultimately secures upon resale to the public.

Court's Reasoning

The court reasoned that the transaction was a single, integrated transaction among Foster, Otis & Co., and The Gabriel Co. Foster intended to sell his business to The Gabriel Co. for a set price, paid for with the proceeds of the sale of Gabriel Co.'s stock to the public. Otis & Co. acted as an underwriter, purchasing and reselling the petitioner's stock on its own account, not as the petitioner's agent. The court relied on established precedent, citing *Simmons Co.*, which held that only the amount received by the corporation from the broker is includible in its equity invested capital. The court emphasized that Foster controlled the terms of the agreement and could cancel the contract if the terms were not met. The court also determined that the 1,000 shares of Class B stock issued to the Foster executives had a fair market value of $25,000, which was also includible in the petitioner's equity invested capital.

Practical Implications

This case clarifies the calculation of equity invested capital for tax purposes when a company uses an underwriter to sell its stock. It establishes that the amount includible in equity invested capital is limited to the amount the company actually receives from the underwriter, not the ultimate sale price to the public. This ruling prevents companies from artificially inflating their equity invested capital by using underwriters who sell stock at a premium. This case highlights the importance of carefully scrutinizing the relationship between a company and its underwriter to determine whether the underwriter is acting as an agent or on its own account. The case also serves as a reminder to consider the fair market value of all consideration paid for acquired assets, including stock issued to key employees of the acquired entity.

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