13 T.C. 559 (1949)

When a corporation uses an underwriter to sell stock, the amount includable in the corporation's equity invested capital is limited to the amount the corporation actually receives, not the resale price obtained by the underwriter.

Summary

The Gabriel Company acquired a business from Foster in exchange for cash and stock, funded by an underwriting agreement with Otis & Co. Otis sold the company's stock to the public at a profit. The Tax Court addressed whether the company's equity invested capital, for excess profits tax purposes, should include the full resale price of the stock or only the amount the company received from Otis. The court held that the company's equity invested capital was limited to the cash paid to Foster plus the value of the stock transferred, excluding the underwriter's commission. This decision clarifies the treatment of underwriting commissions in determining equity invested capital.

Facts

Claude H. Foster operated a business as a sole proprietorship, Gabriel Manufacturing Co. On April 20, 1925, Foster offered to sell the business to Otis & Co., an investment banking firm, or a corporation formed by Otis, for $4,000,000 in cash plus taxes and 1,000 shares of the corporation's Class B voting stock for Foster's executives. Foster specified that the Class A stock should be offered to the public at no more than $25 per share. The Gabriel Company was incorporated on April 23, 1925. Otis sold 197,950 shares of Class A stock to the public at $25 per share. Foster received $4,358,705.70, which included the $4,000,000 purchase price and $358,705.70 for federal taxes on the sale. 1,000 shares of Class B stock were transferred to Foster's executives. Otis retained the excess from the stock sale above what was paid to Foster.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Gabriel Company's income tax, declared value excess profits tax, and excess profits tax for 1942, 1943, and 1944. The Gabriel Company contested the Commissioner's determination, arguing that its equity invested capital should include the full value of the stock sold to the public. The Tax Court reviewed the Commissioner's determination.

Issue(s)

Whether the Gabriel Company, in computing its equity invested capital under Section 718(a) of the Internal Revenue Code, is limited to the amount of cash paid for the business plus the value of the stock, or whether it can include the excess amounts realized by the underwriter from the resale of the company's stock.

Holding

No, because the excess amounts realized by the underwriter from the resale of the petitioner’s stock constitute brokerage commissions not properly includible in the petitioner’s equity invested capital.

Court’s Reasoning

The Tax Court characterized the transaction as a three-party agreement involving Foster, Otis & Co., and the Gabriel Company. Foster agreed to sell his business to the Gabriel Company for $4,000,000 plus taxes and 1,000 shares of Class B stock. The company funded this purchase by selling Class A stock to the public through Otis & Co. The court emphasized that Otis & Co. acted as an underwriter, retaining the difference between the price paid to Foster and the proceeds from the stock sale as a commission. Citing *Simmons Co., 8 B.T.A. 631*, the court stated that