31 T.C. 441 (1958)

Under the personal holding company rules, income from a contract is considered personal holding company income if the contract designates an individual to perform services, or if a third party has the right to designate the individual, and that individual owns 25% or more of the company's stock.

Summary

The U.S. Tax Court considered whether income received by Allen Machinery Corporation from two service contracts qualified as personal holding company income, subjecting the corporation to a surtax. The court analyzed the contracts to determine if they designated an individual to perform services, as required by the personal holding company rules. The court found that one contract, though not explicitly naming an individual, effectively designated the services of the company's controlling shareholder, making the income from that contract personal holding company income. The other contract was found not to designate an individual. The court relied on the language of the contracts and prior case law, particularly the *General Management Corporation* case, to determine the nature of the service agreements.

Facts

F.J. Allen, a mechanical engineer, owned 96% of Allen Machinery Corporation's stock. The corporation entered into two service contracts with John T. Hepburn, Limited (Hepburn). The first, dated February 7, 1951, involved Allen Machinery assisting Hepburn with a contract with the Pakistan government. This agreement did not designate Allen personally to perform services. The second contract, dated July 1, 1951, assigned to Allen Machinery, provided for Allen to provide sales engineering and installation engineering services for Hepburn products. This second contract required Allen to supervise and coordinate the company's staff. During this period, Allen spent only approximately 3 months of the year in the United States. The IRS determined that income from both contracts constituted personal holding company income. Allen Machinery contested this, arguing it was not a personal holding company.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Allen Machinery's personal holding company surtax for the fiscal years ending January 31, 1952, 1953, and 1954. Allen Machinery contested these deficiencies in the U.S. Tax Court.

Issue(s)

1. Whether the income received under the February 7, 1951, contract constituted personal holding company income under section 502(e) of the Internal Revenue Code of 1939.

2. Whether the income received under the July 1, 1951, contract constituted personal holding company income under section 502(e) of the Internal Revenue Code of 1939.

Holding

1. No, because the February 7, 1951, contract did not designate Allen or give Hepburn the right to designate him to perform services.

2. Yes, because the July 1, 1951, contract designated Allen to perform services and/or provided Hepburn the right to designate him to perform services under the second contract.

Court's Reasoning

The court applied section 502(e) of the 1939 Internal Revenue Code, which defines personal holding company income. The court analyzed the two service contracts to determine whether they met the criteria of the statute. Regarding the February 7, 1951, contract, the court found that the language did not designate any specific individual to perform services, nor did it grant Hepburn the right to designate an individual. The court cited *General Management Corporation* as precedent. As for the July 1, 1951, contract, although Allen Machinery's staff performed most of the services, the court found that the contract's terms, requiring Allen to supervise and coordinate the sales and engineering staff, effectively designated Allen personally to perform services. Because Allen owned a controlling interest in Allen Machinery, this triggered the personal holding company income rules.

Practical Implications

This case highlights the importance of carefully drafting service contracts to avoid personal holding company status. The decision emphasizes that a contract need not explicitly name an individual to trigger the personal holding company rules; it is sufficient if the agreement, viewed as a whole, effectively designates an individual's services. Legal practitioners should closely examine service contracts, paying attention to whether they require the services of a specific, controlling shareholder. Also, the court distinguished between the two contracts based on their wording. The decision illustrates that the actual performance of services by others does not negate the designation of an individual in the contract. This case serves as a reminder that the substance of the agreement, not just the form, will determine the tax consequences.

