Rousku v. Commissioner, 54 T. C. 1129 (1970)

Capital is a material income-producing factor in a business if a substantial portion of its gross income is attributable to capital, even if personal services are also significant.

Summary

George Rousku, a U. S. citizen residing in Canada, operated an automobile body repair shop. The issue before the court was whether capital was a material income-producing factor in his business, affecting his eligibility for a 30% earned income exclusion under Section 911 of the Internal Revenue Code. The Tax Court held that capital was material due to the significant portion of income derived from selling parts and the necessity of capital assets like equipment and a building. This ruling limited Rousku's exclusion to 30% of his net profits, emphasizing the factual nature of determining capital's role in business income.

Facts

George and Esther Rousku, U. S. citizens, resided in Canada since 1961. George operated an automobile body repair shop since 1962, repairing collision-damaged vehicles and selling parts. In 1967, his business had gross receipts of $121,253. 50, with $55,037. 61 from labor and $66,215. 89 from materials. He employed five workers, owned equipment valued at $4,023, and maintained an average inventory of $2,500. In April 1967, he purchased the shop building for $38,000 with monthly payments of $125 plus interest. His net profit for the year was $8,775. 07.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Rouskus' 1967 income tax and allowed a 30% exclusion of the business income, arguing that capital was a material income-producing factor. The Rouskus filed a petition with the Tax Court contesting this determination.

Issue(s)

1. Whether capital was a material income-producing factor in George Rousku's automobile body repair business, affecting the application of the 30% earned income exclusion under Section 911 of the Internal Revenue Code.

Holding

1. Yes, because a substantial portion of the business's gross income was derived from the sale of materials, and capital assets like equipment and the building were necessary for the business operation.

Court's Reasoning

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The court applied the principle that capital is a material income-producing factor if a substantial portion of a business's gross income is attributable to capital, as established in cases like Warren R. Miller, Sr. and Fred J. Sperapani. The court analyzed the factual nature of Rousku's business, noting that over 50% of gross receipts came from selling materials, and his equipment and building were essential for operations. The court rejected Rousku's argument that his business was a professional occupation exempt from the 30% limit, emphasizing the significant role of capital in his income generation. The decision was supported by previous cases like Edward P. Allison Co. and Graham Flying Service, which held that capital used for business operations, not just incidental expenses, materially contributes to income.

Practical Implications

This decision guides how businesses with both personal services and capital components should be analyzed for tax purposes, particularly under Section 911. It establishes that even if personal services are significant, capital can still be a material income-producing factor if it contributes substantially to gross income. Legal practitioners should assess the factual specifics of a business, including the proportion of income from capital-related activities and the necessity of capital assets for operations. This ruling affects how similar cases are approached, potentially limiting exclusions for businesses with significant capital involvement. Subsequent cases have continued to apply this principle, distinguishing businesses where capital's role is merely incidental from those where it materially contributes to income.

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