Ed & Jim Fleitz, Inc. v. Commissioner, 50 T. C. 384 (1968)

A pension plan is not qualified under IRC Section 401(a) if it discriminates in favor of officers, shareholders, or highly compensated employees in its operation.

Summary

Ed & Jim Fleitz, Inc. , a construction company, established a pension plan covering only its three salaried officers, who were also shareholders and highly compensated compared to the company's hourly union employees. The IRS disallowed the company's deductions for contributions to the plan, arguing it discriminated in favor of the prohibited group. The Tax Court upheld the IRS's determination, ruling that the plan was discriminatory in operation as it covered only the officers and shareholders, and did not include any of the hourly employees. The court emphasized that while a plan may cover only salaried employees, it must not discriminate in favor of officers, shareholders, or highly compensated individuals.

Facts

Ed & Jim Fleitz, Inc. , an Ohio-based mason contracting business, established a profit-sharing trust for its salaried employees on August 22, 1961. The plan covered only three salaried employees: Edward Fleitz (president and shareholder), James Fleitz (assistant treasurer and shareholder), and Robert Fleitz (vice president). These three were the only salaried employees and were highly compensated compared to the company's 12 to 11 permanent hourly union employees during the fiscal years 1962 to 1964. The company contributed 15% of the salaried employees' compensation to the trust, but the IRS disallowed these deductions, claiming the plan discriminated in favor of officers and shareholders.

Procedural History

The company requested a determination letter from the IRS regarding the plan's qualification under IRC Section 401(a), but the IRS declined to issue one due to potential discrimination in operation. The IRS later disallowed the company's deductions for contributions to the plan for the fiscal years ending November 30, 1962, 1963, and 1964. The company petitioned the Tax Court to challenge this disallowance. The Tax Court consolidated the cases involving the company and its individual shareholders and upheld the IRS's determination.

Issue(s)

1. Whether Ed & Jim Fleitz, Inc. 's profit-sharing plan was qualified under IRC Section 401(a) and thus eligible for deductions under IRC Section 404(a).

Holding

1. No, because the plan discriminated in favor of officers, shareholders, and highly

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compensated employees in its operation, covering only the three officers who were also shareholders and highly compensated compared to the hourly employees.

Court’s Reasoning

The court applied IRC Section 401(a)(3)(B) and (4), which prohibit discrimination in favor of officers, shareholders, or highly compensated employees. The court noted that while a plan may cover only salaried employees, it must not result in discrimination in favor of the prohibited group. In this case, the plan covered only the three salaried officers, who were also shareholders and highly compensated compared to the hourly union employees. The court found that the IRS’s determination of discrimination was not arbitrary, as the plan effectively excluded all hourly employees. The court cited Rev. Rul. 66-14, which states that discrimination might still result when the salaried-employees group includes the prohibited group and only a few other employees. The court also distinguished this case from Pepsi-Cola Niagara Bottling Corp. , where the plan was found not to discriminate despite covering the sole stockholder and officer, due to different factual circumstances.

Practical Implications

This decision emphasizes that the operation of a pension plan, not just its form, must be considered when determining qualification under IRC Section 401(a). Employers must ensure that their plans do not discriminate in favor of officers, shareholders, or highly compensated employees, even if the plan covers only salaried employees. This case highlights the importance of including a broader group of employees in the plan to avoid discrimination claims. It also underscores the IRS’s authority to disallow deductions for contributions to nonqualified plans. Subsequent cases, such as Duguid & Sons, Inc. v. United States, have followed this reasoning, reinforcing the principle that plans covering only a small number of officers and shareholders are likely to be deemed discriminatory.

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