Ed & Jim Fleitz, Inc. v. Commissioner, T.C. Memo. 1969-252

A profit-sharing plan that limits participation to salaried employees can be discriminatory in operation if it disproportionately benefits officers, shareholders, supervisors, or highly compensated employees, even if the classification is facially permissible under the Internal Revenue Code.

Summary

Ed & Jim Fleitz, Inc., a mason contracting business, established a profit-sharing trust for its salaried employees. The trust covered only the company's three officers, who were also shareholders and highly compensated. The IRS determined the plan was discriminatory and disallowed the corporation's deductions for contributions to the trust. The Tax Court upheld the IRS determination, finding that although salaried-only plans are not per se discriminatory, this plan, in operation, favored the prohibited group because it exclusively benefited the officers/shareholders and excluded hourly union employees. The court emphasized that the actual effect of the classification, not just its form, determines whether it is discriminatory under section 401(a) of the Internal Revenue Code.

Facts

Ed & Jim Fleitz, Inc. was formed from a partnership in 1961 and operated a mason contracting business. The corporation established a profit-sharing trust in 1961 for its salaried employees. The plan defined "Employee" as any salaried individual whose employment was controlled by the company. Eligibility was limited to full-time salaried employees with at least one year of continuous service. For the fiscal years 1962-1964, only three employees were covered by the plan: Edward Fleitz (president), James Fleitz (assistant treasurer), and Robert Fleitz (vice president). Edward and James Fleitz each owned 25 shares of the corporation's stock. These three officers were the only salaried employees and were compensated at roughly twice the rate of the highest-paid hourly employees. The company had 10-12 permanent hourly union employees and additional seasonal hourly employees who were excluded from the profit-sharing plan. The corporation deducted contributions to the profit-sharing trust for fiscal years 1962, 1963, and 1964.

Procedural History

The IRS determined deficiencies in the income tax of Ed & Jim Fleitz, Inc. for fiscal years 1962, 1963, and 1964, disallowing deductions for contributions to the profit-sharing trust. The IRS argued the trust was not qualified under section 401(a) and therefore not exempt under section 501(a). The Tax Court consolidated the corporation's case with those of the individual Fleitz petitioners, whose tax liability depended on the deductibility of the corporate contributions. The Tax Court reviewed the Commissioner's determination.

Issue(s)

1. Whether the profit-sharing trust established by Ed & Jim Fleitz, Inc. for its salaried employees qualified as an exempt trust under section 501(a) of the Internal Revenue Code.
2. Whether contributions made by Ed & Jim Fleitz, Inc. to the profit-sharing trust were deductible under section 404(a) of the Internal Revenue Code.

Holding

1. No, because the trust was discriminatory in operation, favoring officers, shareholders, and highly compensated employees, and thus did not meet the requirements of section 401(a)(3)(B) and (4).
2. No, because the trust was not exempt under section 501(a), a prerequisite for deductibility under section 404(a)(3)(A).

Court's Reasoning

The Tax Court reasoned that to be deductible, contributions must be made to a trust exempt under section 501(a), which in turn requires qualification under section 401(a). Section 401(a)(3)(B) and (4) prohibit discrimination in favor of officers, shareholders, supervisors, or highly compensated employees. While section 401(a)(5) states that a classification is not automatically discriminatory merely because it is limited to salaried employees, this does not mean such a classification is automatically non-discriminatory. The court emphasized, quoting Treasury Regulations, that "*the law is concerned not only with the form of a plan but also with its effects in operation.*" In this case, the salaried-only classification, in operation, covered only the three officers who were also shareholders and highly compensated. The court noted that the compensation of these officers was significantly higher than that of the hourly employees. The court distinguished this case from situations where salaried-only plans covered a broader range of employees beyond the prohibited group, citing *Ryan School Retirement Trust* as an example where a salaried plan covering 110 rank-and-file employees and 5 officers was deemed non-discriminatory. The court concluded that the Commissioner's determination of discrimination was not arbitrary or an abuse of discretion because the plan, in practice, exclusively benefited the prohibited group out of the company's permanent workforce. The court cited *Duguid & Sons, Inc. v. United States*, which reached a similar conclusion on comparable facts.

Practical Implications

Ed & Jim Fleitz, Inc. highlights that the IRS and courts will look beyond the facial neutrality of a retirement plan's classification to its actual operation and effect. Even a seemingly permissible classification like "salaried employees" can be deemed discriminatory if it primarily benefits the prohibited group. This case reinforces the principle that qualified retirement plans must provide broad coverage and not disproportionately favor highly compensated individuals or company insiders. When designing benefit plans, employers, especially small businesses, must carefully consider the demographics of their workforce and ensure that classifications do not result in discrimination in practice. Subsequent cases and IRS rulings continue to emphasize the operational scrutiny of plan classifications to prevent discrimination, ensuring that retirement benefits are provided to a wide spectrum of employees, not just the highly compensated.