Bernard McMenamy, Contractor, Inc. v. Commissioner, 54 T. C. 1057 (1970)

A profit-sharing plan that allocates contributions based on years of past service discriminates in favor of prohibited group members if it results in a higher contribution-to-compensation ratio for them than for other employees.

Summary

Bernard McMenamy, Contractor, Inc. established a profit-sharing plan that allocated employer contributions based on employee compensation weighted by years of past service. The IRS challenged the plan's qualification under IRC § 401(a)(4) due to alleged discrimination in favor of Bernard McMenamy, the company's sole shareholder and executive officer. The Tax Court held that the plan discriminated against non-prohibited group members because McMenamy's allocation ratio exceeded that of other employees, despite arguments that the weighting was intended to encourage employee retention. The decision emphasized strict adherence to anti-discrimination rules in profit-sharing plans, regardless of business justification.

Facts

Bernard McMenamy, Contractor, Inc. established a profit-sharing plan in 1961, with contributions allocated based on employee compensation weighted by years of past service. Bernard McMenamy, the company's president, treasurer, sole shareholder, and general manager, received a higher percentage of employer contributions relative to his compensation than other employees due to his longer service. The plan required a minimum annual contribution of $1,000, with additional discretionary contributions. Employees were required to contribute between 3% to 6% of their compensation.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the company's income tax for the years 1961, 1963, and 1964, asserting that the profit-sharing plan discriminated in favor of McMenamy, disqualifying it under IRC § 401(a)(4). The company and the plan's trustee petitioned the United States Tax Court for a redetermination of the deficiencies. The Tax Court issued its decision in 1970, finding the plan to be discriminatory.

Issue(s)

1. Whether the allocation of employer contributions under the profit-sharing plan, based on years of past service, discriminates in favor of Bernard McMenamy, the sole shareholder and principal executive officer, in violation of IRC § 401(a)(4).

Holding

© 2025 SCOTUSreports.com. All rights reserved.

1. Yes, because the allocation formula results in a higher contribution-to-compensation ratio for McMenamy than for other employees, which constitutes prohibited discrimination under the statute and applicable regulations.

Court's Reasoning

The Tax Court relied on IRC § 401(a)(4), which prohibits discrimination in contributions in favor of shareholders, officers, supervisors, and highly compensated employees. The court noted that while contributions based solely on compensation are not discriminatory, the inclusion of past service as a weighting factor led to a higher contribution-to-compensation ratio for McMenamy. The court upheld the IRS's interpretation of the regulations, which disallows such allocations if they result in discrimination. The court rejected arguments that the weighting was justified by business reasons, emphasizing that the statute's purpose is to prevent any form of discrimination, not just invidious or rank discrimination. The majority opinion dismissed comparisons to other cases, like Ryan School Retirement Trust, where discrimination was not evident at the plan's inception.

Practical Implications

This decision underscores the strict interpretation of anti-discrimination rules in profit-sharing plans under IRC § 401(a)(4). Employers must carefully design plan allocation formulas to avoid favoring prohibited group members, even if based on seemingly neutral factors like years of service. The ruling may discourage small businesses from using past service as an allocation factor, potentially limiting the use of such plans as retirement vehicles. It also highlights the need for ongoing monitoring of plan operations to ensure compliance with non-discrimination rules. Subsequent cases have reinforced this decision, often citing it when evaluating the qualification of profit-sharing plans.

© 2025 SCOTUSreports.com. All rights reserved.