Robertson v. Commissioner, 61 T. C. 727 (1974)

A profit-sharing plan that allocates benefits based on shareholder's profits rather than uniform compensation discriminates against non-shareholder employees and fails to qualify under IRC Section 401(a).

Summary

Elgin B. Robertson, Inc. , a subchapter S corporation, established a profit-sharing plan where allocations to shareholder-employees were based on regular salary plus shares of the corporation's undistributed net profits, while allocations to non-shareholder employees were based solely on salary. The IRS argued this was discriminatory under IRC Section 401(a)(4). The Tax Court agreed, holding that the plan was not qualified because the allocations favored shareholders by including their profits, not just compensation. Additionally, the court ruled that a payment made to acquire customer lists and an exclusive sales agency was a non-deductible capital expenditure.

Facts

Elgin B. Robertson, Inc. , a subchapter S corporation, established a profit-sharing plan on May 5, 1965. The plan allocated contributions based on 'annual compensation,' defined as regular salary or commission, excluding special payments. Shareholder-employees received allocations based on their salary plus a share of the corporation's undistributed net profits, while non-shareholder employees received allocations based only on their salary. The corporation also paid $8,500 to Penzner Associates to acquire customer lists and the exclusive sales agency in Oklahoma for Burndy electronics products.

Procedural History

The IRS determined deficiencies in the petitioners' federal income taxes for 1967, arguing that the profit-sharing plan was discriminatory under IRC Section 401(a)(4) and disallowing the deduction of the $8,500 payment to Penzner Associates as a business expense. The cases were consolidated for trial, briefs, and opinion in the U. S. Tax Court, which ruled in favor of the Commissioner on both issues.

Issue(s)

1. Whether the profit-sharing plan of Elgin B. Robertson, Inc. , qualified under IRC Section 401(a) given that allocations to shareholder-employees included their shares of undistributed net profits?
2. Whether the $8,500 payment to Penzner Associates for customer lists and the exclusive sales agency was a deductible business expense under IRC Section 162?

Holding

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1. No, because the plan discriminated in favor of shareholder-employees by including their shares of the corporation's undistributed net profits in the allocation formula, which did not constitute compensation under IRC Section 401(a)(5).
2. No, because the payment was for the acquisition of intangible capital assets, specifically customer lists and the exclusive sales agency, making it a non-deductible capital expenditure under IRC Section 263.

Court's Reasoning

The court examined the operation of the profit-sharing plan to determine if it discriminated in favor of shareholder-employees. The plan was not facially discriminatory, but in operation, it allocated benefits to shareholder-employees based on their salary and their share of the corporation's undistributed net profits, while non-shareholder employees received allocations based solely on their salary. The court found that the shareholders' share of net profits did not constitute compensation for purposes of IRC Section 401(a)(5), as there was no evidence that these payments were based on the shareholders' work performance or other factors indicative of compensation. The court also held that the payment to Penzner Associates was for customer lists and the exclusive sales agency, which are capital assets under IRC Section 263, and thus not deductible as a business expense under IRC Section 162.

Practical Implications

This decision emphasizes the importance of ensuring that profit-sharing plans do not discriminate in favor of shareholders or highly compensated employees by including non-compensation elements such as corporate profits in the allocation formula. It clarifies that for a plan to qualify under IRC Section 401(a), allocations must be based uniformly on compensation. Additionally, it reinforces that payments for acquiring intangible assets, such as customer lists and exclusive sales rights, are capital expenditures and not deductible as business expenses. This ruling guides tax practitioners in designing and advising on profit-sharing plans and in distinguishing between deductible business expenses and non-deductible capital expenditures.

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