Harwood Associates, Inc. v. Commissioner, 66 T. C. 281 (1976)

The IRS may retroactively revoke a determination letter if it was issued under a misapprehension of material facts, and a retirement plan that discriminates in favor of highly compensated employees cannot be qualified under Section 401(a).

Summary

Harwood Associates, Inc. adopted a profit-sharing retirement plan and received a favorable IRS determination letter in 1968. However, the IRS later discovered that the plan discriminated in favor of a highly compensated employee, leading to a retroactive revocation of the letter. The Tax Court upheld the revocation, finding that the IRS acted properly under Section 7805(b) due to a factual misapprehension. The court also addressed the deductibility of contributions to the non-qualified plan, concluding that deductions were limited by the vesting schedule outlined in the plan.

Facts

Harwood Associates, Inc. , a New York corporation, adopted a profit-sharing retirement plan effective August 31, 1967, and established a trust. The plan allowed for discretionary contributions by the employer, up to 15% of the compensation paid to participating employees. Wayne Lausin, a highly compensated salesman, was the only participant, while other eligible employees opted for cash bonuses instead. The company requested and received an IRS determination letter on January 31, 1968, stating the plan was qualified under Section 401(a). However, the IRS later learned that the plan did not meet the non-discrimination requirements of Section 401(a)(3)(A) and (B), as it favored Lausin, and revoked the determination letter retroactively on January 20, 1971.

Procedural History

Harwood Associates, Inc. filed its tax returns for fiscal years ending August 31, 1968, 1969, and 1970, claiming deductions for contributions to the retirement plan trust. Following an audit, the IRS disallowed these deductions and revoked the determination letter retroactively. Harwood Associates, Inc. petitioned the Tax Court, challenging the retroactive revocation and seeking to uphold the deductions.

Issue(s)

1. Whether the IRS properly revoked the determination letter retroactively.
2. To what extent Harwood Associates, Inc. was entitled to claim deductions for contributions to the trust established under the non-qualified plan.

Holding

1. Yes, because the IRS was not in possession of all material facts when issuing the

© 2025 SCOTUSreports.com. All rights reserved.

determination letter, justifying the retroactive revocation under Section 7805(b).
2. The deductions were limited to the extent of the participant's vested interest as per the plan's vesting schedule in Article 9, as the special vesting provisions in Article 12. 5 were not triggered.

Court's Reasoning

The court found that the IRS's retroactive revocation was justified under Section 7805(b) due to a factual misapprehension regarding the plan's participants. The court cited Section 401(a)(3)(A) and (B), which require that a qualified plan not discriminate in favor of highly compensated employees. The plan's operation discriminated in favor of Lausin, violating these requirements. The court applied Section 1. 401-3(c) of the Income Tax Regulations, which states that employees choosing immediate cash over deferred benefits are not considered covered for determining plan qualification. The court also interpreted the plan's contribution and vesting provisions, determining that the special vesting rule in Article 12. 5 was not applicable as contributions were timely made. Thus, deductions were limited to the extent of vesting under Article 9.

Practical Implications

This decision highlights the importance of full disclosure when seeking IRS determination letters for retirement plans. Employers must ensure that plans do not discriminate in favor of highly compensated employees to maintain qualified status. The case also clarifies that the IRS can retroactively revoke a determination letter if issued under a factual misapprehension. For non-qualified plans, employers should carefully review vesting schedules to determine the deductibility of contributions. This ruling influences how similar cases involving plan qualification and deduction claims should be analyzed, emphasizing the need for compliance with non-discrimination rules and accurate representations to the IRS.

© 2025 SCOTUSreports.com. All rights reserved.