Packard Dental Group v. Commissioner, 64 T. C. 647 (1975)

A profit-sharing plan covering only partners does not need to include employees transferred to a separate corporation for the plan to qualify under IRC § 401(d)(3).

Summary

In Packard Dental Group v. Commissioner, the court ruled that the transfer of employees from a partnership to a related corporation did not make them common law employees of the partnership for purposes of IRC § 401(d)(3). The partnership, consisting of three dentists, established a profit-sharing plan covering only the partners after transferring its employees to a corporation it controlled. The IRS challenged the plan's qualification, arguing the transferred employees should still be considered partnership employees. The Tax Court, however, found that the employees were no longer under the partnership's control post-transfer, thus the plan did not need to cover them to qualify under the tax code.

Facts

The Packard Dental Group, a partnership of three dentists, operated in Carlsbad, California. In 1962, they formed Packard Development Corp. to own their dental clinic building and equipment. On August 1, 1968, the partnership terminated its lease with the corporation and entered into a new lease-management agreement. Under this agreement, the corporation assumed responsibility for all personnel and services necessary for the dental practice, including billing, reception, and dental assistance. The partnership's employees, except the partners, were transferred to the corporation, which took over payroll and employment obligations. On August 21, 1968, the partnership established a profit-sharing plan covering only the partners. The IRS disallowed deductions for contributions to this plan, arguing that the plan did not meet the coverage requirements of IRC § 401(d)(3) because it excluded the transferred employees.

Procedural History

The IRS issued statutory notices of deficiency for the tax years 1968 and 1969, disallowing deductions for contributions to the partnership's profit-sharing plan. The partnership petitioned the Tax Court, which consolidated the cases. The court heard arguments and issued an opinion holding in favor of the petitioners, finding that the transferred employees were not common law employees of the partnership after August 1, 1968.

Issue(s)

1. Whether the employees transferred from the partnership to the corporation remained common law employees of the partnership for purposes of IRC § 401(d)(3).

Holding

1. No, because after the transfer, the partnership did not have the right to control the details of the services performed by the employees, who were now under the corporation's supervision and payroll.

Court's Reasoning

The court applied common law principles to determine employee status, focusing on the right to control the means and methods of work. It found that post-transfer, the corporation, not the partnership, controlled the employees' activities and assumed all employer obligations. The court rejected the IRS's argument that the partners' control over the corporation should be imputed to the partnership, emphasizing the separate legal status of the corporation. The court also considered the legislative intent behind IRC § 401, noting that Congress deliberately excluded corporate employees from the definition of owner-employees, thus not requiring their inclusion in the partnership's plan. The court distinguished this case from IRS revenue rulings, highlighting the factual differences, particularly the comprehensive service package provided by the corporation to multiple dentists.

Practical Implications

This decision allows partnerships to establish profit-sharing plans for partners without including employees transferred to a related corporation, provided the corporation assumes full control and responsibility for those employees. Legal practitioners should carefully structure employee transfers to ensure clear separation of control and responsibilities. This ruling may encourage similar arrangements to minimize the scope of employee coverage in retirement plans, potentially affecting the design of such plans in closely held businesses. Subsequent cases, such as those interpreting the Employee Retirement Income Security Act of 1974, may further refine these principles, but for the years in question, this case established a significant precedent on employee status and plan qualification.

