Babst Services, Inc. v. Commissioner, 67 T. C. 131 (1976)

A profit-sharing plan must include all employees to avoid discrimination in favor of officers, shareholders, and highly compensated employees under IRC § 401(a)(3)(B).

Summary

Babst Services, Inc. established a profit-sharing plan that only covered four salaried employees, excluding 47 others, including all hourly workers. The Tax Court ruled that the plan discriminated in favor of officers, shareholders, and highly compensated employees, violating IRC § 401(a)(3)(B). The court emphasized that the plan's eligibility criteria, which excluded nearly 92% of the workforce, were discriminatory despite not being automatically disqualifying. This decision underscores the importance of inclusive coverage in profit-sharing plans to ensure compliance with tax laws.

Facts

Babst Services, Inc. , a mechanical and plumbing contractor, adopted a profit-sharing plan effective June 1, 1970. The plan covered only salaried employees aged 25 or older with at least one year of service. At the time of adoption, Babst had 51 employees, but only four were eligible for the plan: Emile M. Babst III, Z. Harry Kovner, Lola R. Babst, and Robert Thompson. Emile Babst and Harry Kovner were officers and shareholders, while Lola Babst, Emile's wife, was an officer with a nominal role. Robert Thompson was neither an officer nor a shareholder. The plan excluded all 44 hourly employees, who were union members with separate pension plans, and three salaried employees who did not meet the age and service requirements.

Procedural History

Babst Services, Inc. sought a deduction for contributions to its profit-sharing plan. The Commissioner of Internal Revenue disallowed the deduction, asserting that the plan did not meet the requirements of IRC § 401(a). Babst Services appealed to the U. S. Tax Court, which heard the case and issued its decision on November 4, 1976.

Issue(s)

1. Whether the profit-sharing plan of Babst Services, Inc. discriminated in favor of officers, shareholders, and highly compensated employees under IRC § 401(a)(3)(B).

Holding

1. No, because the plan's eligibility requirements operated to exclude nearly 92% of the company's employees, favoring officers, shareholders, and highly compensated employees.

Court’s Reasoning

The court applied IRC § 401(a)(3)(B), which requires a finding by the Secretary or delegate that the plan’s classification of employees is not discriminatory in favor of officers, shareholders, supervisors, or highly compensated employees. The court found that the plan’s coverage of only four out of 51 employees, all of whom were either officers, shareholders, or among the highest paid, was discriminatory. The court rejected Babst’s argument that the plan was non-discriminatory because it included Lola Babst, who was less compensated than some excluded hourly employees, noting her status as an officer and community property interest in her husband’s shares. The court also noted that the plan’s failure to include the union pension plans as part of its coverage prevented it from meeting the alternative coverage test under IRC § 401(a)(3)(A). The court emphasized the broad discretion given to the Commissioner in determining discrimination and found no abuse of discretion in the Commissioner’s decision. The dissent argued that the plan’s minimal eligibility requirements were not inherently discriminatory and that the majority erred in focusing on the plan’s operation rather than its coverage.

Practical Implications

This decision highlights the importance of inclusive eligibility criteria in profit-sharing plans to comply with IRC § 401(a)(3)(B). Employers must carefully consider how their plans cover all employees, including hourly workers, to avoid discrimination claims. The case also underscores the deference courts give to the Commissioner’s discretion in determining plan discrimination. For legal practitioners, this ruling emphasizes the need to thoroughly review client plans for potential discriminatory effects, especially in companies with a mix of salaried and hourly employees. Subsequent cases and legislative changes, such as the Employee Retirement Income Security Act of 1974 (ERISA), have further refined the rules governing plan eligibility, but Babst Services remains a key precedent for understanding the application of IRC § 401(a)(3)(B).