Hill, Farrer & Burrill, A General Partnership, Petitioner v. Commissioner of Internal Revenue, Respondent, 67 T. C. 411 (1976)

A partner's actual distribution of partnership profits determines 'owner-employee' status, not just the partnership agreement's terms.

Summary

In Hill, Farrer & Burrill v. Commissioner, the U. S. Tax Court ruled on whether a law firm's profit-sharing plan qualified under the Internal Revenue Code. The firm's partners distributed profits based on productivity, with some partners receiving over 10% of the total profits. The issue was whether these partners were 'owner-employees' under Section 401(c)(3)(B), which would subject the plan to additional qualification requirements. The court held that partners receiving more than 10% of profits were owner-employees because the term 'owns' includes a contractual right to profits measured by productivity, thus disqualifying the plan.

Facts

Hill, Farrer & Burrill, a 19-partner law firm, adopted a profit-sharing plan that met all qualification requirements except those for 'owner-employees'. The partnership agreement allocated one-third of profits based on capital contributions and two-thirds based on productivity. The firm's policy also awarded partners 20% of fees from clients they brought in. At all relevant times, at least one partner received more than 10% of the firm's total profits.

Procedural History

The firm sought a declaratory judgment from the U. S. Tax Court to determine if its profit-sharing plan was qualified under Section 401(a). The IRS had issued a final adverse determination letter, asserting that the plan did not meet the requirements for owner-employees as defined in Section 401(c)(3)(B).

Issue(s)

1. Whether a partner's actual receipt of more than 10% of partnership profits constitutes 'ownership' of more than a 10% profits interest under Section 401(c)(3)(B).

Holding

1. Yes, because the term 'owns' in the statute includes a partner's contractual right to a percentage of profits measured by productivity during the taxable year, even if the exact percentage is unknown at the year's start.

Court's Reasoning

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The court interpreted ‘owner-employee’ under Section 401(c)(3)(B) as including a partner who, at the end of the year, received more than 10% of the partnership’s profits. The court reasoned that the term ‘owns’ is broad enough to include contractual rights to profits, even if calculated based on productivity at year’s end. This interpretation aligns with the legislative intent to prevent potential abuses by partners with significant control over the partnership’s profits. The court emphasized that the partnership agreement provided a known formula for profit distribution, which constituted ownership of an interest in those profits. The court also noted the absence of evidence of abuse but stated that the statutory requirements still applied based on the partners’ profits interest. The concurring opinion supported looking at the end-of-year profits to determine owner-employee status, while the dissenting opinion argued that ownership should be determined solely by the partnership agreement’s terms, not actual distributions.

Practical Implications

This decision clarifies that for tax-qualified profit-sharing plans, a partner’s ‘owner-employee’ status is determined by the actual distribution of profits at the end of the year, not just the terms of the partnership agreement. Law firms and other partnerships must ensure their profit-sharing plans comply with additional requirements if any partner’s profits distribution exceeds 10% of the total. This ruling may lead partnerships to adjust their profit distribution methods or plan structures to avoid disqualification. Subsequent cases, such as *Larson v. Commissioner*, have applied this principle in determining owner-employee status based on actual profits received. The decision also underscores the need for partnerships to carefully consider the implications of their profit allocation formulas on their retirement plans’ tax qualification.

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