Lozano, Inc. v. Commissioner, 68 T. C. 366 (1977); 1977 U. S. Tax Ct. LEXIS 96

A closely held corporation can accrue a profit-sharing contribution for tax deduction purposes without formal board action if the decision is made by the controlling shareholders and informally communicated to employees.

Summary

In Lozano, Inc. v. Commissioner, the Tax Court held that a closely held corporation could deduct a profit-sharing contribution for the taxable year even though the board's authorization was informal and not recorded. The court found that the controlling shareholders' decision, made before the year's end and acquiesced to by the third director, constituted a valid board action under California law. This ruling highlights the flexibility in corporate governance for closely held corporations and the importance of the timing of accrual for tax purposes, despite non-compliance with the Commissioner's strict requirements outlined in Rev. Rul. 71-38.

Facts

Lozano, Inc. , a closely held California corporation, established a profit-sharing plan in 1965. For the taxable year ending November 30, 1971, Lozano's controlling shareholders, Manuel Lozano, Sr. , and Manuel Lozano, Jr. , met with their accountant before the fiscal year's end and decided to contribute the maximum deductible amount to the plan, as they had done in previous years. This decision was communicated to the third board member, Frank Lee Crist, Jr. , who acquiesced, though no formal board meeting occurred. The employees were informally informed of the decision before the year's end, and the contribution was paid within the statutory grace period allowed by IRC § 404(a)(6).

Procedural History

The Commissioner of Internal Revenue disallowed the deduction for the profit-sharing contribution, asserting that Lozano did not accrue the liability within the taxable year. Lozano appealed to the U. S. Tax Court, which held in favor of the taxpayer, allowing the deduction for the 1971 taxable year.

Issue(s)

1. Whether Lozano, Inc. properly accrued a liability for its profit-sharing contribution within its 1971 taxable year, despite the absence of a formal board resolution and written notice to employees.

Holding

1. Yes, because the court found that the decision by the controlling shareholders, acquiesced to by the third director, constituted a valid board action under California

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law for closely held corporations, and the employees were sufficiently notified of the decision before the year's end.

Court's Reasoning

The Tax Court focused on the substance of corporate actions over formalities, particularly in closely held corporations. It recognized that California law allows directors to act informally if all participate or acquiesce. The court rejected the Commissioner's strict requirement for a written board resolution and formal employee notification, as set forth in Rev. Rul. 71-38, citing previous cases where oral authorizations were deemed sufficient for tax deductions. The court emphasized that the key events fixing the liability occurred within the taxable year, satisfying IRC § 404(a)(6) requirements for accrual method taxpayers. The court also noted that the employees were informally but adequately informed of the decision, further supporting the accrual of the liability.

Practical Implications

This decision underscores the flexibility of corporate governance in closely held companies and has significant implications for tax planning. It allows such corporations to accrue deductions for contributions to employee benefit plans based on informal shareholder decisions, provided they are made before the end of the tax year and communicated to employees. This ruling may affect how closely held corporations structure their decision-making processes and document their actions for tax purposes. It also highlights the importance of understanding state corporate law when assessing the validity of corporate actions for federal tax purposes. Subsequent cases, such as Coker Pontiac, Inc. v. Commissioner, have reinforced this ruling by upholding the validity of informal corporate actions in similar contexts.

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