Burnetta v. Commissioner, 68 T. C. 387 (1977)

The common law concept of employment determines who is an employee for the purpose of pension and profit-sharing plan coverage under Section 401 of the Internal Revenue Code.

Summary

In Burnetta v. Commissioner, the U. S. Tax Court ruled on whether certain office workers, who were paid through a third-party payroll service, were employees of the professional corporations for the purpose of pension and profit-sharing plan coverage. The court determined that the workers were indeed employees of the corporations, as the corporations controlled their hiring, pay, and work duties. Consequently, the Burnetta corporation's plans failed to meet the required coverage under Section 401(a)(3)(A) of the Internal Revenue Code. Additionally, the court held that the forfeiture clause in the plans did not constitute a substantial risk of forfeiture, thus affecting the tax treatment of contributions.

Facts

Edward L. Burnetta, O. D. , P. A. , and Charles A. Crockett, M. D. , P. A. , established pension and profit-sharing plans but excluded certain office workers from these plans. These workers were paid by a third-party payroll service, Staff Employees, Inc. , but their hiring, pay, and duties were controlled by the corporations. The plans had a forfeiture clause for employees convicted of theft or embezzlement. The Commissioner of Internal Revenue challenged the corporations' tax treatment of these plans, asserting that the excluded workers were employees for coverage purposes.

Procedural History

The case originated with the Commissioner's determination of deficiencies in the corporations' federal income tax. The petitioners contested these deficiencies, leading to a consolidated hearing before the U. S. Tax Court. The court heard arguments and reviewed evidence regarding the employment status of the office workers and the implications for the pension and profit-sharing plans.

Issue(s)

1. Whether the medical office personnel were employees of the Burnetta corporation and/or the Crockett corporation for purposes of determining whether the corporations' pension and profit-sharing plans met the coverage requirements of Section 401(a)(3) during the years at issue.
2. If the plans are determined to be nonqualified, whether such plans present a substantial risk of forfeiture for purposes of determining whether the contributions made thereto are includable in the gross income of the petitioner individuals and deductible by the petitioner corporations in the years such contributions were made.

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Holding

1. Yes, because the corporations controlled the hiring, pay, and duties of the office personnel, making them common law employees for the purpose of Section 401 coverage requirements.
2. No, because the possibility of forfeiture upon conviction for theft or embezzlement does not constitute a substantial risk of forfeiture under Section 83 of the Internal Revenue Code.

Court’s Reasoning

The court applied common law principles to determine employee status, focusing on the right to control and direct the workers. The corporations, through Burnetta and Crockett, had complete control over the hiring, pay rates, and work duties of the office personnel, while Staff Employees, Inc. , merely handled payroll. The court rejected the petitioners’ reliance on Packard v. Commissioner and Revenue Ruling 75-41, as those cases involved different factual scenarios regarding control over employees. Regarding the forfeiture clause, the court found it did not present a substantial risk of forfeiture, aligning with proposed regulations under Section 83 that a remote contingency does not meet this standard.

Practical Implications

This decision clarifies that for pension and profit-sharing plan coverage, the focus is on common law employment, not merely who issues paychecks. Legal practitioners must ensure that all common law employees are considered for plan coverage to comply with Section 401. Businesses using third-party payroll services must still account for these workers in their plans. The ruling also impacts how forfeiture clauses are viewed for tax purposes, affecting the timing of income inclusion and deductions. Subsequent cases like Packard have been distinguished on their facts, reinforcing the importance of control in determining employee status.

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