Friedman & Jobusch Architects & Engineers, Inc. v. Commissioner, 73 T. C. 956 (1979)

An employee benefit plan that discriminates in favor of owner-employees, both in form and operation, does not qualify for tax deductions under section 404(a).

Summary

In Friedman & Jobusch Architects & Engineers, Inc. v. Commissioner, the Tax Court ruled that contributions to the company's stock bonus trust were not deductible under section 404(a) because the plan discriminated in favor of the company's owner-employees, Friedman and Jobusch. The plan's design allowed the owners to benefit from higher stock valuations upon their death, while other employees received lower book value. Additionally, the trust engaged in prohibited transactions by lending money to the owners. However, the court found that the owners did not receive constructive dividends from partnership interests mistakenly issued to them personally.

Facts

Friedman & Jobusch Architects & Engineers, Inc. established a stock bonus plan and trust in 1967 to transfer ownership to employees and provide deferred compensation. The plan required distributions in company stock upon certain events. However, undisclosed restrictions limited the stock's value for most employees to book value, while a separate agreement allowed the trust to buy the owners' shares at a higher adjusted book value upon their death. The trust also engaged in prohibited transactions by lending money to the owners and the company. Partnership interests in Howard Investment, Ltd. and Hotels, Ltd. were initially issued to Friedman and Jobusch personally, but they transferred these interests to the corporation without consideration.

Procedural History

The IRS determined deficiencies in the taxpayers' income tax for the years 1968-1970, leading to a petition in the Tax Court. The court considered whether the contributions to the stock bonus trust were deductible under section 404(a) and whether Friedman and Jobusch received constructive dividends from the corporation.

Issue(s)

1. Whether contributions made by Friedman & Jobusch Architects & Engineers, Inc. to its stock bonus trust are deductible under section 404(a).
2. Whether Friedman and Jobusch received constructive dividends from the corporation.

Holding

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1. No, because the plan and trust discriminated in favor of Friedman and Jobusch, both in form and operation, failing to meet the requirements of sections 401(a) and 501(a).
2. No, because Friedman and Jobusch did not receive beneficial ownership of the partnership interests and promptly transferred them to the corporation.

Court’s Reasoning

The court found that the plan discriminated against non-owner employees in two ways. First, the plan’s design allowed Friedman and Jobusch to receive significantly higher value for their stock upon death compared to other employees due to undisclosed restrictions and a separate stock purchase agreement. This violated the nondiscrimination requirement of section 401(a)(4). Second, the trust engaged in prohibited transactions under section 503(b) by lending money to the owners, a benefit not extended to other employees. The court rejected the IRS’s argument that the owners received constructive dividends from partnership interests, as these were mistakenly issued to them personally and promptly transferred to the corporation without consideration. The court emphasized that the plan must be nondiscriminatory both in form and operation to qualify for tax deductions.

Practical Implications

This decision underscores the importance of ensuring that employee benefit plans, particularly those involving stock ownership, do not discriminate in favor of owner-employees. Companies must carefully review their plan documents and operational practices to avoid similar issues. The ruling highlights the need for full disclosure to the IRS during plan approval processes. It also serves as a reminder that prohibited transactions, such as loans to owners, can jeopardize a plan’s tax-qualified status. Practitioners should advise clients to maintain strict separation between company and trust assets. This case has influenced subsequent decisions on employee benefit plan discrimination and has been cited in cases involving prohibited transactions and constructive dividends.

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