Shelby U. S. Distributors, Inc. v. Commissioner, 71 T. C. 874 (1979)

A profit-sharing trust's investment of nearly all its assets in employer securities does not disqualify it under IRC § 401(a) if the transactions are at arm's length and for the exclusive benefit of employees.

Summary

Shelby U. S. Distributors' profit-sharing trust invested 96% of its assets in notes and preferred stock of the employer. The Commissioner revoked the trust's tax-exempt status, arguing that the investments lacked liquidity, diversity, and prudence. The Tax Court held that the trust remained qualified under IRC § 401(a) as the investments were at arm's length, secured, and provided reasonable returns. However, the court disallowed deductions for an alleged covenant not to compete due to lack of evidence of its existence.

Facts

The Shelby Supply Co. , Profit-Sharing Trust was established in 1959 for employees of Shelby Supply Co. In 1965, Stratford Retreat House acquired the businesses and continued the plan. The trust lent money to Stratford, secured by business assets, and later invested in notes and preferred stock of Shelby U. S. Distributors, Inc. (Distributors) and its subsidiary, Shelby Supply Co. , Inc. (Supply), which assumed Stratford's debts. By the years at issue (1971-1973), 96% of the trust's assets were invested in employer securities. The Commissioner revoked the trust's exemption in 1974, claiming the investments violated IRC § 401(a). Distributors claimed deductions for an alleged covenant not to compete with Stratford, but no such covenant was documented.

Procedural History

The Commissioner determined deficiencies in the trust's and Distributors' taxes for 1971-1973, revoking the trust's exemption effective January 1, 1971. The Tax Court heard the case, focusing on whether the trust's investments disqualified it under IRC § 401(a) and whether Distributors could deduct the alleged covenant not to compete.

Issue(s)

1. Whether the trust's investment of 96% of its assets in employer securities disqualified it under IRC § 401(a)?
2. Whether Distributors could deduct the amortization of an alleged covenant not to compete with Stratford?

Holding

1. No, because the trust's investments were at arm's length, secured, and provided reasonable returns, consistent with the exclusive benefit of employees requirement.

2. No, because Distributors failed to prove the existence of a covenant not to compete with Stratford.

Court's Reasoning

The court analyzed the trust's investments under IRC § 401(a) and § 503(b), which allow investments in employer securities if at arm's length. The court rejected the Commissioner's arguments about liquidity, diversity, and prudence, noting that these standards were not codified until ERISA in 1974, after the years at issue. The court found no evidence of misuse of trust funds or prohibited transactions under § 503(b). The trust's investments were secured, interest was paid, and the Commissioner did not challenge the adequacy of security or reasonableness of interest. The court distinguished prior cases where trusts lost exemptions due to clear misuse of funds. On the covenant not to compete, the court applied the rule requiring "strong proof" of an unwritten covenant, which Distributors failed to provide.

Practical Implications

This decision clarifies that profit-sharing trusts can invest heavily in employer securities without losing tax-exempt status under IRC § 401(a), provided the transactions are at arm's length and for the exclusive benefit of employees. Practitioners should ensure that such investments are properly secured and provide reasonable returns. The case also reinforces the need for clear documentation of covenants not to compete to support deductions. Subsequent cases like Feroleto Steel Co. v. Commissioner (1977) and ERISA's enactment in 1974 have further shaped the rules for trust investments, but this case remains relevant for pre-ERISA plans.

