Federal Land Bank Association of Asheville, North Carolina, Petitioner v. Commissioner of Internal Revenue, Respondent; Mountain Production Credit Association, Petitioner v. Commissioner of Internal Revenue, Respondent, 74 T. C. 1106 (1980)

A retirement plan with low participation rates does not necessarily fail to qualify under IRC § 401(a)(3)(B) if it does not discriminate in favor of highly compensated employees.

Summary

The Federal Land Bank Association and Mountain Production Credit Association challenged the IRS's determination that their retirement plans did not qualify under IRC § 401(a)(3)(B) due to low participation rates during the initial plan year. The Tax Court held that despite only two out of 23 eligible employees participating, and one being a highly compensated employee, the plan did not discriminate in favor of officers or highly compensated employees. The court emphasized that the plan was open to all full-time employees meeting minimal service requirements, and the low participation rate did not tilt the scales in favor of the prohibited group. The decision underscores that a plan's qualification under § 401(a)(3)(B) hinges on nondiscrimination, not necessarily on achieving a fair cross-section of participants.

Facts

The Federal Land Bank Association of Asheville and Mountain Production Credit Association, both federally chartered, adopted identical prototype retirement plans effective July 1, 1973. The plan was open to all full-time employees working more than 20 hours per week for over 5 months per year, with participation beginning on the September 1 following employment as of July 1. Employees opting into the plan agreed to a 6% salary reduction, with the employer contributing an additional 3% of the employee's basic compensation. During the initial plan year from September 1, 1973, to August 31, 1974, only two out of 23 eligible employees participated, one of whom was a highly compensated employee. The IRS determined that the plan did not meet the coverage requirements under IRC § 401(a)(3)(B).

Procedural History

The petitioners initially filed for declaratory relief under IRC § 7476, which the Tax Court dismissed for lack of jurisdiction. The Fourth Circuit Court of Appeals reversed this decision and remanded the case for a decision on the merits. Upon remand, the Tax Court reviewed the case based on the stipulated administrative record, focusing on whether the plan complied with IRC § 401(a)(3)(B) for the initial plan year.

Issue(s)

1. Whether the petitioners' retirement plan complied with IRC § 401(a)(3)(B) during

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its initial year, given the low participation rate and the participation of one highly compensated employee.

Holding

1. Yes, because the plan was open to all full-time employees meeting nominal service requirements, and the low participation rate did not result in discrimination in favor of highly compensated employees.

Court's Reasoning

The court rejected the IRS's argument that the plan discriminated in favor of the prohibited group due to the lack of a fair cross-section of participants. The court noted that the plan's eligibility was open to all full-time employees without discriminatory classifications, and the participation rate did not favor highly compensated employees. The court emphasized that the plan's low participation rate in both the prohibited and non-prohibited groups did not indicate discrimination. The court also considered the plan's features, such as no age restrictions and generous vesting provisions, as encouraging participation. The court cited legislative history indicating that the primary purpose of the nondiscrimination rules is to prevent tax manipulation by management employees, which was not evident in this case.

Practical Implications

This decision clarifies that a retirement plan's qualification under IRC § 401(a)(3)(B) does not hinge solely on achieving a fair cross-section of participants. Instead, the focus is on ensuring that the plan does not discriminate in favor of highly compensated employees. This ruling may encourage employers to design plans that are accessible to all employees, even if participation rates are initially low. Practitioners should advise clients that a plan's structure and eligibility criteria are critical, and low initial participation does not necessarily disqualify a plan if it remains nondiscriminatory. This case may influence future IRS determinations and court decisions regarding plan qualification, emphasizing the importance of the plan's design and intent over actual participation levels.

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