Fazi v. Commissioner, 102 T. C. 695 (1994)

A pension plan must have a formally adopted written instrument to be qualified under IRC Section 401; operational compliance alone is insufficient.

Summary

John Fazi, a dentist and sole shareholder of his dental corporation, established a pension plan that operated in compliance with changes mandated by recent tax legislation. However, the plan was not formally adopted as required. The Tax Court held that without a formally adopted written plan, the pension plan was not qualified under IRC Section 401 for the years in question. Additionally, the court overruled its prior decision in Baetens, holding that the tax treatment of distributions from an unqualified plan hinges on the plan's status at the time of distribution, not when contributions were made.

Facts

John U. Fazi, a dentist, incorporated his practice and established three employee pension plans, with him being the sole shareholder and officer. Plan 1, a money purchase pension plan, was based on a prototype from General American Life Insurance Co. and was amended several times to comply with tax law changes. After the enactment of TEFRA, DEFRA, and REA, which required further amendments, Fazi's plan became top-heavy. Although the plan operated in compliance with the new laws, it was not formally adopted via a joinder agreement with the insurance company. In 1986, Fazi dissolved his corporation and distributed the plan's assets, attempting to roll over his distribution into an IRA.

Procedural History

The IRS determined the plan was not qualified for 1985-1987 due to the lack of formal adoption and thus deemed the entire distribution taxable. Fazi contested this in the U. S. Tax Court, which consolidated this deficiency case with related declaratory judgment cases. The Tax Court ruled that without formal adoption, the plan was not qualified, and also reconsidered its previous stance on the tax treatment of distributions from unqualified plans.

Issue(s)

1. Whether the failure to formally adopt a written plan compliant with TEFRA, DEFRA, and REA disqualified Fazi's pension plan for 1985, 1986, and 1987.
2. If the plan was unqualified, whether the tax treatment of the distributions should be based on the plan's status at the time of contribution or distribution.

Holding

1. Yes, because a qualified plan requires a formally adopted written instrument, and

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operational compliance alone is insufficient.
2. No, because the tax treatment of distributions from an unqualified plan should be based on the plan's status at the time of distribution, not when contributions were made.

Court's Reasoning

The court emphasized the necessity of a "definite written program" under IRC Section 401 and its regulations, which could not be met without formal adoption. The court found that Fazi's plan, though operationally compliant, was not formally adopted, as evidenced by the lack of a signed joinder agreement and payment of the required fee to the insurance company. The court rejected the argument that state law could override federal tax requirements for plan adoption. Regarding the tax treatment of distributions, the court overruled its prior decision in Baetens, aligning with Courts of Appeals that held the qualification status at the time of distribution determines taxability. This decision was influenced by the statutory language and the need for uniformity across circuits, despite recognizing potential inequities.

Practical Implications

This ruling underscores the importance of formal plan documentation and adoption for maintaining qualified status under IRC Section 401. Employers must ensure that their pension plans are formally amended and adopted to comply with legislative changes, not merely operated in compliance. The decision also impacts how distributions from unqualified plans are taxed, requiring practitioners to focus on the plan's status at the time of distribution. This may influence future cases to consider the plan's qualification at the time of distribution, potentially affecting planning strategies for rollovers and distributions. Additionally, this case highlights the tension between operational compliance and formal documentation, emphasizing the need for clear communication and documentation in pension plan administration.

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