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Court Denies S Corp SEP Deduction; Contributions Weren't Made for Wife

 See Tax Acts, on p. 8)

Simplified employee pension (SEP) plans are designed to allow employers who cannot afford the expense and effort of complying with the rules governing qualified employee pension benefit plans to provide pension benefits comparable to those of qualified plans.¹

One advantage of a SEP is its simplicity. In many cases, an employer can establish a SEP by completing a one-page IRS form.² On the other hand, the price of such simplicity is the SEP's inflexibility in that it must comply with participation, non-discrimination, and vesting requirements. That fact was impressed on an S corporation's shareholder in *Brown v. Commissioner*,³ where the Tax Court denied him a deduction for the corporation's contributions to his SEP account because it didn't also make contributions for the only other employee of the corporation, his wife.

Facts

Aaron Brown is the president and a shareholder of Aaron Brown Mortgage, Inc., which elected to be taxed as an S corporation. Aaron and his wife, Leslie, are the only employees of the corporation. Leslie reported wages from the corporation of \$18,000 for 2003 and 2004, while Aaron reported wages of \$36,000 for those years.

Aaron Brown Mortgage, Inc. established a simplified employee pension account with the Vanguard Group. Aaron signed
(See SEP Deduction, on p. 2)

SEP Deduction, from p. 1

a Form 5305-SEP, Simplified Employee Pension - Individual Retirement Accounts Contribution Agreement, as president of the corporation. One of the agreement's requirements provides that the employer agrees to make yearly discretionary contributions to the individual retirement account (IRA) of all employees who are 18 years or older and have worked for the employer at least one-half year out of the last five years. The instructions on the form caution the employer that all eligible employees must be allowed to participate in the SEP.

The corporation made \$7,200 SEP contributions to an IRA for 2003 and 2004 for Aaron. On their Forms 1040 for 2003 and 2004, the Browns deducted from their gross income the contributions made by the corporation to the Vanguard SEP plan for Aaron. They also deducted \$3,000 from gross income for IRA contributions made by Leslie in each year. The IRS examined the returns and disallowed the SEP deductions in both years, saying that the Browns had not established that they were entitled to the deduction.

Background

A SEP is an individual retirement account or annuity to which an employer makes a contribution.⁴ The employer may deduct SEP contributions for the tax year if they are made no later than the due date of the return for the tax year. The arrangement will qualify as a SEP for a tax year only if certain requirements are met. The employer must contribute to the SEP of each employee who: (1) has attained the age of 21; (2) has performed service for the employer for at least three of the immediately preceding five years; and (3) has received at least \$450 in compensation from the employer for the year.⁵

An employer can establish less restrictive eligibility requirements than those described above, but not more restrictive requirements. In this case, Aaron Brown Mortgage, Inc. chose terms less restrictive than the statutory requirements with respect to the age and period of service requirements.

✓ **OBSERVATION:** SEP requirements are both more restrictive and more permissive than those applying to qualified plans in general. Other qualified plans can require an employee to wait no more than two years before becoming eligible to participate, while a SEP plan allows as much as a three year waiting period. On the other hand, part-time employees cannot be excluded under SEPs as they can under the 1,000 hour of service requirement available under other qualified plans. Furthermore, an

employer cannot cover only certain classes of employees under a SEP, as it can under other qualified plans.

The Issues

The IRS argued that that the deduction was improper because no SEP contribution was made for the only other employee of the corporation, Leslie. It said, therefore, that the contribution did not meet the requirement that the employer must contribute to the SEP of each employee.

The Browns argued that they had been caught by a mere "technicality." They claimed that the attribution rules⁶ treat the SEP contribution to Aaron's IRA as a contribution to Leslie's IRA.

Tax Court Decision

The Tax Court held that the Browns were not entitled to a deduction for the corporation's contributions to Aaron's SEP. The court rejected the contention that the corporation's failure to contribute to an IRA in favor of an employee, Leslie, was a mere technicality. That requirement, according to the court, is aimed at fairness and equitable treatment for employees and is one of the few basic provisions of the SEP regime. Even if the provision could fairly be characterized as a technicality, it is one that was brought to the attention of Aaron, as the president of the corporation, more than once in the agreement. Aaron, as president, signed and agreed to the provisions contained in the agreement, including the requirement that each employee receive from the corporation a contribution to his or her IRA.

The court said the problem with the Brown's attribution argument is that Code Section 318, Constructive Ownership of Stock, addresses stock ownership, as the title implies, not IRA or SEP contributions. For example, an individual is considered as owning the stock owned, directly or indirectly, by or for his spouse.⁷ In addition, Code Section 318 applies to those provisions to which the rules contained in the Code section are expressly made applicable. Code Section 318(b) lists the provisions to which the attribution rules apply and the IRA provision is not one of those provisions.

Notes

- 1/ S. Rep. 1263, 95th Cong., 2d Sess. 6 (1978).
- 2/ Form 5305-SEP, Simplified Employee Pension - Individual Retirement Accounts Contribution Agreement.
- 3/ T.C. Summary 2008-56 (5/20/08).
- 4/ Code Section 401(k).
- 5/ Code Section 408(k)(2).
- 6/ See Code Section 318.
- 7/ Code Section 318(a)(1)(A)(i).

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