Weaver v. Comm'r, 121 T. C. 273 (2003)

In Weaver v. Comm'r, the U. S. Tax Court ruled that Clarkston Window & Door, Inc. , an accrual method S corporation, could not deduct fees for services rendered by J. D. Weaver & Associates, Inc. , a cash method C corporation, in the years claimed. The court determined that the economic performance requirement of section 461(h) and the deferred compensation rules of section 404(d) precluded the deductions. This decision underscores the importance of timing rules in the tax treatment of deferred compensation between related parties.

Parties

Jimmy D. Weaver and Marlene M. Morloc Weaver, Petitioners, versus Commissioner of Internal Revenue, Respondent.

Facts

Jimmy D. Weaver owned 80-percent interests in Clarkston Window & Door, Inc. (Clarkston), an S corporation operating on an accrual method and a calendar year, and J. D. Weaver & Associates, Inc. (J. D.), a C corporation operating on a cash method and a fiscal year ending July 31. Clarkston deducted professional fees for services rendered by J. D. in its 1996 and 1997 tax returns, amounting to $30,000 and $63,350 respectively. J. D. included these fees in its taxable income for its 1997 and 1998 taxable years. However, Clarkston had not paid J. D. these fees as of March 15, 1997, and 1998. Subsequently, J. D. merged into Clarkston, and the outstanding fees were eliminated by book entry during the final return year of J. D.

Procedural History

The Weavers petitioned the U. S. Tax Court to redetermine deficiencies determined by the Commissioner in their 1996 and 1997 federal income tax. The case was submitted on stipulated facts under Rule 122 of the Tax Court Rules of Practice and Procedure. The Commissioner determined that Clarkston could not deduct the fees in the years claimed, and the Tax Court held in favor of the Commissioner, applying the economic performance requirement of section 461(h) and the deferred compensation rules of section 404(d).

Issue(s)

Whether sections 404(d) and 461(h) of the Internal Revenue Code require Clarkston to defer its deductions of fees owed to J. D. for services provided by J. D. to Clarkston, given that Clarkston deducted the fees in its taxable year that closed 7 months before the end of the taxable year in which J. D. included the fees in its income?

Rule(s) of Law

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Section 461(h) of the Internal Revenue Code establishes the all events test, which is met when all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Economic performance generally occurs as the services are performed. Section 404(d) applies when there is a method or arrangement that has the effect of a plan deferring the receipt of compensation by a nonemployee, requiring that the deduction be taken in the year in which the compensation is includible in the gross income of the recipient.

Holding

The U. S. Tax Court held that sections 404(d) and 461(h) preclude Clarkston from deducting the fees for the years claimed because the arrangement between Clarkston and J. D. deferred the receipt of compensation by more than 2-1/2 months after the end of Clarkston's taxable year, failing the economic performance requirement.

Reasoning

The court reasoned that the all events test under section 461(h) was not met because Clarkston did not satisfy the economic performance requirement due to the timing rule of section 404(d). The court found that the arrangement between Clarkston and J. D. deferred the receipt of compensation beyond the permissible 2-1/2 months after the close of Clarkston's taxable year, thus triggering the application of section 404(d). The court rejected the petitioners' argument that the all events test was met based solely on the first two prongs, emphasizing that the economic performance requirement and section 404(d) must also be satisfied. The court also noted the presumption of deferral when compensation is received more than 2-1/2 months after the end of the payor's taxable year, which the petitioners failed to rebut. The court's analysis included a detailed examination of the legislative history and temporary regulations under sections 404 and 461, concluding that the arrangement between Clarkston and J. D. was subject to the deferred compensation rules.

Disposition

The Tax Court sustained the Commissioner's determination that the fees were not deductible in the years claimed by the petitioners, and the decision was entered under Rule 155.

Significance/Impact

The decision in Weaver v. Comm'r clarifies the application of the economic performance requirement under section 461(h) and the deferred compensation rules under section 404(d) to arrangements between related parties. It underscores the importance of adhering to the timing rules for deductions of compensation,

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particularly in the context of related entities using different accounting methods. The case has significant implications for tax planning involving deferred compensation arrangements, emphasizing the need to carefully consider the timing of income recognition and deduction to comply with these statutory requirements. Subsequent cases and practitioners have referenced Weaver in addressing similar issues of deferred compensation and economic performance between related parties.

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