Yarish v. Commissioner, 139 T. C. 290 (U. S. Tax Court 2012)

In Yarish v. Commissioner, the U. S. Tax Court ruled that under I. R. C. § 402(b)(4)(A), highly compensated employees must include in income the entire amount of their vested accrued benefit in a disqualified employee stock ownership plan (ESOP), not just the annual increase. This decision, pivotal for tax planning involving ESOPs, clarifies that the tax liability for such benefits is triggered upon the plan's disqualification, impacting how contributions to these plans are treated for tax purposes.

Parties

Robert S. Yarish and Marsha M. Yarish, Petitioners, v. Commissioner of Internal Revenue, Respondent. The petitioners filed in the U. S. Tax Court, seeking a determination on the taxation of benefits from a disqualified ESOP.

Facts

Robert S. Yarish, a plastic surgeon, organized Yarish Consulting, Inc. , an S corporation, in 2000 to manage his medical practice entities. Yarish Consulting sponsored an Employee Stock Ownership Plan (Yarish ESOP), in which Robert Yarish participated as a highly compensated employee and was fully vested from the start until the plan's termination. The ESOP received multiple contributions from 2000 to 2004. By the end of 2004, Robert Yarish's account balance in the ESOP, constituting his vested accrued benefit, was $2,439,503, none of which had been taxed to the Yarishes prior to the 2004 plan year. The ESOP was terminated at the end of 2004, with Robert Yarish's account balance transferred to an individual retirement account. The ESOP was retroactively disqualified by the Commissioner for the years 2000 through 2004, a decision upheld by the Tax Court in a prior case, Yarish Consulting, Inc. v. Commissioner, T. C. Memo 2010-174. The statute of limitations had lapsed for all years except 2004, leading to a dispute over the amount of the vested accrued benefit to be included in the Yarishes' income for 2004.

Procedural History

The Commissioner retroactively disqualified the Yarish ESOP for failing to meet the requirements of I. R. C. § 401(a), specifically the coverage requirements under § 410(b), and determined that the trust was not exempt under § 501(a). This determination was upheld in Yarish Consulting, Inc. v. Commissioner, T. C. Memo 2010-174. The Yarishes filed a petition in the U. S. Tax Court, challenging the amount of the vested accrued benefit that should be included in their income for 2004 under § 402(b)(4)(A). Both parties moved for partial summary judgment on the issue of how much of the vested accrued benefit should be taxable for 2004.

Issue(s)

Whether, under I. R. C. § 402(b)(4)(A), the entire amount of a highly compensated employee’s vested accrued benefit in a disqualified ESOP must be included in income for the year of disqualification, or only the annual increase in the vested accrued benefit for that year?

Rule(s) of Law

I. R. C. § 402(b)(4)(A) provides that a highly compensated employee must include in gross income for the taxable year an amount equal to the vested accrued benefit in a disqualified plan (other than the employee’s investment in the contract) as of the close of the taxable year. The legislative history of § 402(b)(4)(A) indicates that the provision aims to penalize highly compensated individuals by taxing their vested accrued benefits attributable to employer contributions and income on contributions not previously taxed to the employee.

Holding

The U. S. Tax Court held that under I. R. C. § 402(b)(4)(A), the entire amount of Robert Yarish’s vested accrued benefit in the Yarish ESOP, amounting to $2,439,503 as of the end of 2004, must be included in the Yarishes’ income for that year, given that none of it had been previously taxed.

Reasoning

The court found the phrase “other than the employee’s investment in the contract” in § 402(b)(4)(A) to be ambiguous and thus looked to legislative history to discern its meaning. The legislative history, particularly the 1986 conference report, indicated that the provision was designed to penalize highly compensated employees by taxing their vested accrued benefits that had not been previously taxed. The court rejected the petitioners’ argument that only the annual increase in the vested accrued benefit for 2004 should be taxable, finding that § 402(b)(4)(A) is an exception to the general rule that income is includible in the year of “accession to wealth. ” The court also dismissed the petitioners’ contention that “investment in the contract” should be interpreted according to its definition in § 72, finding that § 402(b)(4)(A) and § 72 serve different purposes and that the phrase is not a term of art universally applicable across the Internal Revenue Code. The court concluded that since none of Robert Yarish’s vested accrued benefit had been previously taxed, the entire amount must be included in income for 2004.

Disposition

The U. S. Tax Court granted the Commissioner’s motion for partial summary judgment and denied the petitioners’ motion for partial summary judgment, ruling that the entire amount of Robert Yarish’s vested accrued benefit in the Yarish ESOP must be included in the Yarishes’ income for 2004.

Significance/Impact

The decision in Yarish v. Commissioner establishes a clear precedent that under I. R. C. § 402(b)(4)(A), the entire vested accrued benefit of a highly compensated employee in a disqualified ESOP must be included in income for the year of disqualification, not just the annual increase. This ruling has significant implications for tax planning and compliance involving ESOPs, emphasizing the importance of ensuring plan qualification to avoid unexpected tax liabilities. Subsequent courts have followed this interpretation, further solidifying the rule's application in tax law. The case underscores the need for careful management of ESOPs to prevent disqualification and the resultant tax consequences for highly compensated participants.

