Petersen v. Commissioner, 148 T. C. No. 22 (2017)

In Petersen v. Commissioner, the U. S. Tax Court ruled that accrued payroll expenses of an S corporation must be deferred until paid to employees who are ESOP participants, deemed related under I. R. C. § 267. This decision clarifies that ESOP participants are considered beneficiaries of a trust, impacting how deductions for accrued expenses are claimed by S corporations.

Parties

Steven M. Petersen and Pauline Petersen, along with John E. Johnstun and Larue A. Johnstun, were the petitioners. The Commissioner of Internal Revenue was the respondent. The case was heard at the trial level in the United States Tax Court.

Facts

Petersen, Inc. , an S corporation, established an Employee Stock Ownership Plan (ESOP) in 2001, transferring cash and stock to the related ESOP trust. During the years 2009 and 2010, Petersen accrued but did not pay certain payroll expenses, including wages and vacation pay, to its employees, many of whom were ESOP participants. The ESOP trust owned 20. 4% of Petersen's stock until October 1, 2010, when it acquired the remaining shares from the Petersens, becoming the sole shareholder. Petersen claimed deductions for these accrued expenses on its tax returns for 2009 and 2010, and the Petersens and Johnstuns, as shareholders, claimed flowthrough deductions on their individual returns.

Procedural History

The IRS audited Petersen's tax returns for 2009 and 2010 and disallowed the deductions for accrued but unpaid payroll expenses attributed to ESOP participants, invoking I. R. C. § 267. Subsequently, the IRS adjusted the individual returns of the Petersens and Johnstuns, resulting in deficiencies for 2009 and overpayments for 2010. The taxpayers petitioned the U. S. Tax Court, which consolidated the cases. The parties submitted the cases for decision without trial under Rule 122 of the Tax Court Rules of Practice and Procedure.

Issue(s)

Whether, under I. R. C. § 267, an S corporation's deductions for accrued but unpaid payroll expenses to ESOP participants must be deferred until the year the payments are includible in the participants' gross income?

Rule(s) of Law

I. R. C. § 267(a)(2) defers deductions for expenses paid by a taxpayer to a related person until the payments are includible in the related person's gross income. I. R. C. § 267(b) defines the relationships that trigger the application of this section. I. R.

C. § 267(e) provides that an S corporation and any person who owns (directly or indirectly) any of its stock are treated as related persons for the purposes of § 267(b). I. R. C. § 267(c) attributes stock ownership to beneficiaries of a trust.

Holding

The Tax Court held that the ESOP trust constituted a "trust" under I. R. C. § 267(c), and thus the ESOP participants, as beneficiaries, were deemed to constructively own Petersen's stock. Consequently, Petersen and the ESOP participants were "related persons" under I. R. C. § 267(b) as modified by § 267(e), requiring the deferral of deductions for accrued but unpaid payroll expenses until the year such payments were received by the ESOP participants and includible in their gross income.

Reasoning

The Court reasoned that the ESOP trust satisfied the statutory definition of a "trust" under I. R. C. § 267(c)(1), as it was established to hold and conserve property for the benefit of the ESOP participants. The trust was distinct from the plan, and its creation was consistent with the requirements for tax-exempt status under ERISA and the Internal Revenue Code. The Court rejected the taxpayers' arguments that the ESOP trust did not qualify as a trust for the purposes of § 267(c), noting that Congress did not limit the term "trust" in this section as it had in other sections of the Code. The Court further reasoned that I. R. C. § 267(e) clearly deems S corporations and their shareholders to be related persons, regardless of the percentage of stock owned, and this relationship extended to the ESOP participants who constructively owned Petersen's stock through the ESOP trust.

Disposition

The Tax Court entered decisions for the Commissioner regarding the deficiencies for 2009 and for the petitioners regarding the penalties.

Significance/Impact

This decision clarifies the application of I. R. C. § 267 to S corporations with ESOPs, establishing that ESOP participants are deemed related to the corporation for the purposes of this section. It impacts the timing of deductions for accrued expenses and may influence the tax planning strategies of S corporations with ESOPs. The ruling underscores the broad application of the constructive ownership rules in § 267(c) and the related person provisions in § 267(e), potentially affecting how deductions are claimed by similar entities.