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Tenth Circuit: S corporation, employees/ESOP beneficiaries held section 267 “related persons”

The U.S. Court of Appeals for the Tenth Circuit today affirmed a decision of the U.S. Tax Court concerning the timing of deductions by a subchapter S corporation for expenses paid to employees who participate in the corporation’s employee stock ownership plan (ESOP). The Tax Court held the taxpayers were liable for past-due taxes arising out of errors in their income tax returns caused by premature deductions for expenses paid to their corporation’s ESOP.

The case is: *Petersen v. Commissioner*, No. 17-9003 (10th Cir. May 15, 2019). Read the Tenth Circuit’s [decision](#) [PDF 205 KB]

The Tenth Circuit remanded the case for a re-determination of the amount of the deficiencies.

Summary

In June 2017, the Tax Court held—in a case of “first impression” concerning application of section 267(a) to S corporation employers and ESOP participants—that an ESOP formed by an S corporation and the ESOP-participating employees are “related persons” for purposes of section 267. As such, the Tax Court held that deductions for accrued but unpaid payroll expense must be deferred until the pay was received by the employees and includible in their gross income.

The taxpayers were founders and owners of an S corporation. During 2009 and 2010, the S corporation maintained an employee stock ownership plan (ESOP) for its employees that owned some of all of the stock of the S corporation. Also in 2009 and 2010, the S corporation accrued expenses for wages, vacation pay, and other payroll items on behalf of its employees. Some of these accrued payroll expenses were not paid until the next year.

The IRS asserted that the ESOP trust was a “trust” within the meaning of section 267(c)(1), such that the trust beneficiaries—the S corporation employees who were ESOP participants—were deemed to be “related persons” for purposes of section 267(b).

The Tax Court determined that the entity holding the S stock for the benefit of the ESOP-participating employees was a trust within the meaning of section 267(c) and that the stock held by the trust was

deemed owned by its beneficiaries. As a result, the S corporation and the ESOP-participating employees were “related persons,” and the S corporation’s deduction for accrued but unpaid payroll expenses was to be deferred until such payments were includible in the income of the ESOP-participating employees. Read [TaxNewsFlash](#)

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