

TaxNewsFlash

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Tax Court: S corporation and employees/beneficiaries of ESOP shareholder are “related persons” under section 267

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

The case is: *Petersen v. Commissioner*, 148 T.C. No. 22 (June 13, 2017). Read the Tax Court [opinion](#) [PDF 115 KB]

Overview

Section 267 disallows or defers deductions for certain losses and expenses incurred in transactions between related persons. Specifically, section 267(a)(2) provides that if a taxpayer makes a deductible payment to a “related person,” that payment is not allowable as a deduction to the payor until it is includable in the gross income of the payee.

Section 267(e) provides that in the case of an S corporation, “any person who owns (directly or indirectly) any stock of such corporation” is treated as a related person. In addition, section 267(c) provides that stock owned by a trust is constructively owned by the beneficiaries of the trust.

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 includable in the income of the ESOP-participating employees.

Concerning the penalty assessment, the Tax Court found that the taxpayers made a good-faith effort to assess their tax liabilities properly and were not liable for any accuracy-related penalty.

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