CORPORATION PARTIALLY OWNED BY ESOP DENIED DEDUCTION FOR COMPENSATION PAYMENTS TO ESOP PARTICIPANTS

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A recent case in the Tenth Circuit Court of Appeals addresses the intersection of Employee Stock Ownership Plans ("ESOPs") and the rules under Section 267 of the Internal Revenue Code related to the timing of deductions for payments to a related party. The corporation at issue was an S corporation using the accrual method of accounting. For 2009 and the first nine months of 2010, two individuals collectively owned 79.6% of the corporation's stock, while an ESOP owned the remaining stock. In October 2010, the ESOP acquired all of the stock in the corporation which was held by the two shareholders.

In the case of a wage payment to an employee who is a related person to the corporation making the payment, Section 267 provides that the corporation may only deduct the wage payment for its taxable year that includes the date on which the wage payment is includible in the employee's income. Any person who owns (directly or indirectly) stock in an S corporation is considered to be a related person to the S corporation. In turn, the constructive ownership rules under Section 267 provide that stock owned by a trust is deemed proportionately owned by the trust's beneficiaries.

The impact of the Section 267 rules can be seen in this example. Suppose an S corporation, using the accrual method of accounting and whose taxable year is the calendar year, pays employees on a biweekly basis. The final pay period for a calendar year straddles the last week of Year 1 and the first week of Year 2. While the corporation could normally accrue a compensation deduction for Year 1 in relation to wages earned during the first week of the payroll period, the Section 267 related party rules require that any wage payments for the payroll period that are payable to an employee who is a related party may only be deducted in Year 2 because that is when the wage payment is includible in the employee's income.

At issue in the case was whether an ESOP is the type of trust to which the constructive ownership rules under Section 267 apply. Like the Tax Court below, the Tenth Circuit held that an ESOP is the type of trust covered by the constructive ownership rules under Section 267 and, therefore, any wage payments to the ESOP participants would only be deductible by the corporation at the time those wage payments were includible in the employees' income.

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The ruling impacts S corporations that are partially owned by an ESOP and that use the accrual method of accounting. In addition to regular wage payments, the ruling may affect the timing of any compensation deduction for bonuses that are earned during Year 1 but paid in early Year 2, which in our experience is a common practice.

If an ESOP owns 100% of an S corporation, the Section 267 rules generally become irrelevant, as the ESOP is exempt from tax and any flow-through income from the S corporation effectively goes untaxed. Similarly, if an S corporation uses the cash basis method of accounting, the Section 267 rules would become irrelevant, since any wage payment would only be deductible by the S corporation at the time the wages are actually paid to employees. [*Steven and Pauline Peterson v. Commissioner of Internal Revenue*, 2019]

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