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ESOP Participants and Accrued Compensation

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Are you an S Corporation with an ESOP shareholder? If so, it's important to understand what can and cannot be deducted when an Employee Stock Ownership Plan (ESOP) owns a percentage of S Corporation stock. The disallowance of certain related party expenses may increase the taxable income of the S Corporation. In this blog, we will be discussing the Matching Rule and how it relates to accrued expenses, specifically accrued compensation, for S Corporations that have an ESOP stockholder.

On May 15, 2019, the court case Petersen v. Commissioner reaffirmed the applicability of the Matching Rule for S Corporations partially owned by an ESOP. In general, The Matching Rule under Code Section 267 does not allow the S Corporation to deduct its accrued expenses for any ESOP participant until the payment is actually made. With this being said, if an accrual basis taxpayer has accrued but unpaid wages and/or vacation pay at year end payable to a cash basis related taxpayer (i.e., individual) the deduction will be denied until paid. As indicated by the Court, an ESOP is considered a trust with the ESOP participants as the beneficiaries. As such, the company and the ESOP participants (i.e., trust beneficiaries) are deemed related persons and the rules under Code Section 267 apply.

IRC 267(a)(2) explains that S Corporations, as well as other entities, can only deduct an expense in the tax year that the payment is reported as income by a related party (in this case, the ESOP participants). IRC 267(e)(1)(B)(ii) describes a related party as any person or entity who directly or indirectly has ownership in S Corporation's stock. Because of this, if an ESOP owns any percentage of S Corporation stock, the participants of the ESOP are deemed to have indirect ownership in the S Corporation. Due to the Matching Rule, the S Corporation cannot deduct accrued compensation until the year it is actually paid and included as income by the ESOP participants. Accrued compensation not only includes accrued payroll, but also amounts for accrued vacation, accrued bonuses, and any plan contributions for participants based on accrued compensation.

Knowing this information ahead of time can allow taxpayers to prepare for tax years where they may have an increase in taxable income due to the disallowance of accrued compensation expenses.

For more information on this or any previous topic, please contact Brian Dansa at **bdansa@dopkins.com**.

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