UNITED STATES TAX COURT
WASHINGTON, DC 20217

PAZA STAFFING SERVICES, INC.,	)	
	)	**ALS**
Petitioner(s),	)	
	)	
v.	)	Docket No. 6881-12R.
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
Respondent	)	
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ORDER AND DECISION

This case was assigned to this division of the Court because it is related to one originally on the January 27, 2014 San Francisco, California trial calendar. It is a declaratory judgment case under I.R.C. § 7476 arising from the Commissioner's decision to revoke the qualification of petitioner's ESOP. The Commissioner moved for summary judgment on the ground that Paza Staffing Services, Inc.'s (Paza) ESOP is not a qualified plan under I.R.C. § 401(a). Petitioner cross-moved for summary judgment on the grounds that its ESOP is currently--and was in 1999--a qualified plan under I.R.C. § 401(a).

Background

Summary judgment is appropriate where "there is no genuine dispute as to any material fact and . . . a decision may be rendered as a matter of law." Tax Court Rule 121(b). "An adverse party may not rest upon the mere allegations or denials of such party's pleading, but such party's response . . . must set forth specific facts showing that there is a genuine dispute for trial." Tax Court Rule 121(d).

We review the Commissioner's decision for abuse of discretion. *See Buzzetta Constr. Corp. v. Commissioner*, 92 T.C. 641 (1989); *Hollen v.*

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Commissioner, 101 T.C.M. (CCH) 1004, 1005 (2011). Both parties agree that we can decide this case based solely on the administrative record. Tax Court Rule 217(a) plainly states that "disposition of an action for declaratory judgment involving a revocation . . . may be made on the basis of the administrative record alone [as long as] . . . the parties agree that such record contains all the relevant facts and that such facts are not in dispute." The administrative record in this case was certified by an official for the Commissioner and filed with the Court back in 2012. The parties agree that there is no genuine issue of fact about the administrative record.

The Facts

We begin by briefly describing the different entities and transactions at play here. On November 18, 1998, Dr. Zapolanski acquired all 10,000 shares in Paza from its initial incorporator. A little over a week later, Zapolanski signed a resolution, as the sole director of Paza, establishing the ESOP and appointing himself trustee. Zapolanski then transferred the Paza stock to the ESOP in exchange for a $10,000 note (the stock itself being the collateral). This made the ESOP Paza's sole shareholder. Zapolanski was the ESOP's sole participant for the year at issue.

On December 1, 1998, Zapolanski, in his capacity as Paza's president, signed a contract with another company named Golden Gate to lease employees. Zapolanski is also the president, secretary, and sole owner of Golden Gate. He received a $83,000 salary from Paza during the 1999 tax and plan year.

The ESOP's plan documents stated that employees employed on December 31, 1998 were immediately eligible participants in the ESOP, but employees hired in 1999 and after had to log one year -- a consecutive 12-month period where the employee accrued 1000 hours of service -- before they would be eligible. For the plan year ending in December 1999, Paza made a $12,450 cash contribution to the ESOP and it accrued to the benefit of the plan's sole shareholder -- Zapolanski. This released the Paza stock from encumbrance -- from there it was allocated to Zapolanski's ESOP account. ESOPs are classified as tax-exempt entities under I.R.C. § 501(a) -- meaning the stock released to Zapolanski's account was tax exempt. By 1999, the Paza stock was valued at $333,000. Also during 1999, five Golden Gate employees (if properly included) met the eligibility requirements for the ESOP, yet only Zapolanski was an active participant.

The Commissioner determined that Paza's ESOP failed to meet the coverage requirements of I.R.C. §§ 401(a)(3) and 410(b), and he sent Paza a final non-qualification letter, in which he disqualified the ESOP for the 1999 plan year and all subsequent years. We need to figure out a few things. First, we need to figure out which employees should be included in our analysis of the ESOP; just Paza's, or do we include Golden Gate's? Once we know that, we can figure out if the ESOP meets the coverage requirements under I.R.C. §§ 401(a)(3) and 410(b). Last, we will examine the adequacy of the Commissioner's final non-qualification letter.

Discussion

To be a qualified plan, a plan must meet all of the requirements of I.R.C. § 401(a). I.R.C. § 401(a); *see Fujinon Optical, Inc. v. Commissioner*, 76 T.C. 499 (1981). I.R.C. § 401(a)(3) points us to another section of the Code: A plan must meet the minimum-participation standards of I.R.C. § 410. *See Fujinon Optical*, 76 T.C. at 503. The primary issue in this case stems from I.R.C. § 410(b)(1)(B), which requires qualified plans to benefit "a percentage of employees who are not highly compensated employees which is at least 70 percent of the percentage of highly compensated employees benefitting under the plan."[1] But what group of people do we consider in our math? If we only need to include Paza employees in the group, then we need only confirm that Zapolanski is covered because *he* is Paza's only employee. But Paza loses its case if we must include Golden Gate's employees in the group. *See* I.R.C. § 410(b)(1)(B).

To determine what employees we need to include, we look to I.R.C. § 414(b).[2] "[a]ll employees of all corporations which are members of a controlled group of corporations" are treated like they are employed by one single employer. I.R.C. § 414(b); *Fujinon Optical*, 76 T.C. at 511; *Yarish Consulting, Inc. v. Commissioner*, 100 T.C.M. (CCH) 105, 106 n.7 (2010). I.R.C. § 414(b) directs us

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[1] This ratio test is the most common of three possible options. There is also a more general 70 percent test, and an average benefit test. I.R.C. § 410(b)(1). The Commissioner states that neither are applicable to this case and Paza doesn't disagree.

[2] Paza first argued that we should use section 414(m) -- which says that employees of an "affiliated service group" are considered employed by a single employer -- but then abandoned the argument and instead argued that Zapolanski didn't own anything because his interest in the ESOP had not yet vested.

to I.R.C. § 1563(a) for a definition of a "controlled group of corporations."[3] There are many types of controlled groups under I.R.C. § 1563, but only one matters here. Paza and Golden Gate are a controlled group if five or fewer individuals own:

- ". . . at least 80 percent of the total value of shares of all classes of stock, of each corporation," and
- "more than 50 percent of the total combined voting power . . ."

I.R.C. §§ 1563(a)(2) and (f)(5).

Now, Zapolanski does not directly own any stock in Paza -- the ESOP owns 100 percent of the stock and therefore holds 100 percent of the voting power. But Zapolanski is the ESOP's sole beneficiary, and he therefore has constructive ownership of the stock.[4] I.R.C. § 1563(e)(3)(A).[5] That means, that for our purposes, Zapolanski owns *100 percent* of the value of the shares, and *100 percent* of the voting power of Paza and Golden Gate. *See* I.R.C. §§ 1563(a)(2) and (f)(5). Therefore, Paza is a controlled group -- consisting of Paza and Golden Gate. *Id.*

So we include Golden Gate's employees in considering whether Paza's ESOP meets minimum participation standards. It does not. Zapolanski is the only "highly compensated employee"[6] at either company. That means that 100 percent of highly-compensated employees at Paza were benefitting under the ESOP. *See* I.R.C. § 410(b). So, the plan must also benefit 70 percent of the non-highly compensated employees. *Id.* The five qualified employees were non-highly compensated employees qualified for the plan, but they were not participants of the

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[3] We define a "controlled group of corporations" under I.R.C. § 1563(a) without regard to I.R.C. §§ 1563(a)(4) and (e)(3)(C). I.R.C. § 414(b).

[4] Zapolanski argues that he didn't own any stock because his interest in the ESOP had not yet vested. There is no legal authority for requiring vesting as a prerequisite for ownership; a plain reading of the statute does not show it to be a requirement.

[5] I.R.C. § 1563(e)(3)(A) says that "[s]tock owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary who has an actuarial interest of 5 percent or more in such stock, to the extent of such actuarial interest."

[6] A "highly compensated employee" means any employee who was a 5-percent owner at any time during the year or the preceding year. I.R.C. § 414(q)(1)(A).

plan. The plan therefore does not meet the minimum coverage requirements under I.R.C. § 410(b) and cannot be a qualified plan under I.R.C. § 401(a). *Fujinon Optical*, 76 T.C. at 511-12. We therefore find that the Commissioner did not abuse his discretion when he disqualified Paza's ESOP for the 1999 plan year and all subsequent years.[7]

It is

ORDERED that petitioner's October 3, 2015 motion for summary judgment is denied. It is also

ORDERED that respondent's May 17, 2013 motion for summary judgment is granted. It is also

DECIDED that petitioner's Employee Stock Ownership Plan #001 does not meet the requirements of I.R.C. § 401(a) for the plan year ending December 31, 1999, and all subsequent plan years.

(Signed) Mark V. Holmes
Judge

ENTERED: **AUG 17 2017**

[7] Plan failures under I.R.C. § 401(a) are continuing failures because allowing a plan to re-qualify later would be like allowing a plan "to rise phoenix-like from the ashes of such disqualification." *Pulver Roofing Co. v. Commissioner*, 70 T.C. 1001, 1015 (1978); *see also Family Chiropractic Sports Injury & Rehab Clinic, Inc. v. Commissioner*, 111 T.C.M. (CCH) 1046, 1049 (2016).