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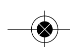

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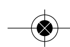

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IRS guidance to financial institutions for reporting required minimum distributions

Notice 2023-23, 2023-13 IRB xxx, provides guidance to financial institutions for reporting required minimum distributions (RMDs) for 2023 because of a change to the RMD rules made by the SECURE 2.0 Act (P.L. 117-328, 12/29/2022). (See also IRS GuideWire, 3/7/2023) The SECURE 2.0 Act (the Act) delayed the required beginning date for RMDs.

Under the Act, IRA owners who turn 72 in 2023 will not have a RMD for 2023 (because the age with reference to which the required beginning date is determined for those IRA owners is changed from 72 to 73). Under relief provided in Notice 2023-23, the IRS will not consider an RMD statement provided to an IRA owner who will turn 72 in 2023 to have been provided incorrectly if the IRA owner is notified by the financial institution no later than 4/28/2023 that no RMD is actually required for 2023.

Taxpayers can now upload more documents to IRS

The IRS has announced that taxpayers who receive certain notices requiring them to send information to the IRS now have the option of submitting their documentation online through IRS.gov. The IRS stated that this new secure step will allow taxpayers or their tax professional to electronically upload documents rather than mailing them in, helping to reduce time and effort resolving tax issues. (IR 2023-29, 2/16/2023)

Nine notices will be available for this feature. According to the IRS, this potentially can help more than 500,000 taxpayers each year who receive these notices, which include military personnel serving in combat zone areas and recipients of important credits like the Earned Income Tax Credit and Child Tax Credit.

Taxpayers who receive one of the following notices with a link and access code can choose to upload their documents:

- CP04, relating to combat zone status.
- CP05A, information request related to a refund.
- CP06 and CP06A, relating to the Premium Tax Credit.
- CP08, relating to the Child Tax Credit.
- CP09, relating to the Earned Income Tax Credit (EITC).
- CP75, relating to the EITC.
- CP75a, relating to the EITC.
- CP75d, relating to the EITC and other credits.

The IRS plans to expand this capability to dozens of other notices.

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April 2023
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ROBERT F. REILLY

This article examines a recent Tax Court case that involves a closely held C corporation's dispute regarding reasonableness of executive/shareholder compensation tax deductions. The court's discussion provides practical guidance to private company owners and to their legal, accounting, and other professional advisers.

Introduction

There are many reasons why valuation analysts, damages analysts, compensation consultants, and other professional advisers (collectively, "analysts") may be asked to analyze—and opine on—the reasonableness of the amount of compensation paid to the executives of a private company or a not-for-profit institution.

Assessing the reasonableness of executive/shareholder compensation is a generally accepted due diligence procedure in the development of private company business valuations prepared for many purposes. Analysts typically "normalize" the private company's historical results of operations for amounts paid to executive/shareholders that are in excess of what may be considered reasonable compensation for the actual services provided to the company.

Assessing the reasonableness of executive compensation (including non-shareholder executives) is important for (1) a private company owned by an employee stock ownership plan ("ESOP") or (2) a not-for-profit organization. Excessive executive compensation payments may be considered unfair to the ESOP participants and may decrease the fair market value of the ESOP-owned sponsor company stock. Therefore, the ESOP participants, the ESOP trustee, or the U.S. Department of Labor may challenge the reasonableness of compensation paid to ESOP sponsor company executives.

Not-for-profit organizations (whether in the health care, education, research, or other industries) may not pay more than a fair market value level of compensation to executives or professionals. Therefore, the IRS (the "Service"), various federal regulatory agencies, and the respective state attorneys general may challenge the reasonableness of compensation paid to executives or professionals employed by such not-for-profit entities.

Assessing the reasonableness of executive/shareholder compensation is an important due diligence procedure when a noncontrolling shareholder is claiming to have suffered damages as the result of the actions of the com-

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pany's board of directors or the company's controlling shareholder. Such a damages claim may relate to either (1) shareholder oppression and breach of fiduciary duty litigation or (2) dissenting shareholder appraisal rights litigation.

Also, assessing the reasonableness of executive/shareholder compensation may be particularly important in income tax disputes between the closely held company and the IRS. In fact, private company owners and their legal and other tax advisers often look to income-tax-related judicial decisions for practical guidance related to reasonableness of compensation issues. The Tax Court recently provided such judicial guidance in the matter of *Clary Hood, Inc.,* which is discussed below.

Clary Hood, Inc.

The Tax Court case *Clary Hood, Inc.*[1] ("the *Hood decision*") involved a dispute between the Service and a private C corporation taxpayer Clary Hood, Inc. ("CHI"). The dispute involved the reasonableness of executive compensation paid to the private company chief executive officer/shareholder Clary L. Hood ("Hood").

The *Hood decision* is generally favorable to the Service, concluding that the taxpayer CHI owed (1) back income taxes for both tax years in dispute and (2) an IRC Section 6662 substantial understatement penalty for one of the tax years in dispute.

Important to private company owners and to their professional advisers, the *Hood decision* provides a thorough analysis of the so-called "multifactor approach" to assessing the reasonableness of executive compensation. In addition, the *Hood decision* provides a comprehensive discussion of what the Tax Court found persuasive—and unpersuasive—about the quantitative analyses, the expert reports, and the trial testimony of the various testifying experts in this case.

Summary of the Hood decision. Upon audit, the Service determined deficiencies in, and Section 6662 accuracy-related penalties with respect to, the CHI federal income tax returns for the tax (fiscal) years ending 5/31/2015 and 5/31/2016 (collectively, the "tax years at issue"). Exhibit 1 summarizes the conclusion of the Service's audit of CHI for fiscal years 2015 and 2016.

Although it is only a memorandum decision, the *Hood decision* presents a detailed description of the decision-making process followed by Tax Court Judge Greaves. The Hood decision presents a thorough discussion of the factors that the Tax Court considered in assessing the reasonableness of executive/shareholder compensation for this closely held C corporation. The decision explains the legal rationale for the court's reliance on the multifactor approach. Also, the decision explains the court's analysis of each factor within that multifactor approach.

Therefore, the 3/2/2022 *Hood decision* provides recent and meaningful practical guidance regarding reasonableness of executive compensation tax deduction analyses. This judicial decision provides such practical guidance to private company business owners, to tax counsel, to tax accountants, to compensation consultants, and to forensic and other financial analysts who advise private companies regarding reasonableness of executive/shareholder compensation issues.

Following the trial, the issues to be decided by the Tax Court were (1) the amount that CHI may deduct under Section 162(a)(1) as reasonable compensation paid to its chief executive officer/shareholder Clary L. Hood during the tax years at issue and (2) whether CHI was liable for the substantial understatement accuracy-related penalties under Section 6662(a) and (b)(2) for the tax years at issue.

For the reasons summarized in the following discussion (and comprehensively described in the *Hood decision*), the Tax Court held that (1) CHI was entitled to deduct no more than $3,681,269 and $1,362,831 for the 2015 and 2016 tax years, respectively, and (2) CHI was liable for the Section 6662 substantial understatement penalty for the 2016 tax year (but not for the 2015 tax year).

The Hood decision findings of fact. The following discussion summarizes the CHI business operations, the responsibilities of Hood as a CHI employee, and the compensation amounts paid by CHI to Hood. Most of these facts were stipulated to at trial by both the taxpayer and the Service.

Clary Hood as the company founder and CEO. Judge Greaves made the following important observation in the Hood decision: "To understand Clary Hood, Inc., one must first know Mr. Hood."

Before the years at issue in this tax dispute, Hood had dedicated his entire career to the construction industry, specializing in the con-

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struction industry segments of land grading and excavation. Hood learned the industry as a boy from his father, J.E. Hood. J.E. Hood operated his own land grading business. Upon graduation from high school in 1967, Hood joined his father's company in the land grading industry segment.

In 1980, Hood founded CHI with his wife, Gail. Together they served as the CHI sole shareholders and sole members of the company's board of directors. Hood exercised ultimate decision-making control over all of the CHI operations, from the company's founding up through the tax years at issue.

CHI business history and operations. Generally acting as a subcontractor, CHI concentrated on land grading and excavation services for construction projects in the South Carolina region. CHI started with two employees and a collection of used earth-moving equipment valued at less than $60,000. CHI developed into a 150-person company with nearly $70 million in revenue by the end of its 2016 fiscal year.

For the period of 2000 to 2010, the CHI revenue growth was slow and the company profits were cyclical. During that period, CHI generated less than $1 million in net income after taxes in most years. Like many construction companies in the late 2000s, CHI experienced financial distress during the "Great Recession" and sustained three years of operating losses during its fiscal years ending 5/31/2009 to 5/31/2011.

During those years, CHI survived due to its reputation and due to the following strategic decisions over which Hood exercised primary, if not exclusive, control: (1) conserving cash by maintaining a low debt profile and not declaring dividends; (2) temporarily reducing employee pay; (3) withholding Hood's salary, when necessary, to ensure that sufficient funds were available to cover the company payroll needs; and (4) selling $800,000 of equipment to offset losses and to supplement cash reserves.

Based on Hood's executive decision, CHI changed strategic direction in 2012. CHI shifted away from one of the company's largest and most consistent sources of revenue: site grading work for Walmart shopping centers ("Walmart projects"). Between 1999 and 2011, Walmart project revenue generally accounted for more than 20% of the CHI annual revenue.

While CHI initially welcomed this steady stream of revenue, the Walmart projects created constraints on the CHI resources for timely job completion. These constraints reduced the CHI ability to pursue more lucrative grading jobs. It became apparent to Hood that the grading company needed to shift away from Walmart projects. In 2011, without seeking input from any other company executives, Hood notified the Walmart developer's representative that CHI would not engage in any future Walmart projects. Ultimately, this risky management decision would prove very beneficial for CHI.

In July 2011, CHI began diversifying its customer base by transitioning from retail-related grading work to industrial and commercial grading projects. As a result of Hood's personal efforts, CHI was placed on the bid list for a sizable potential project with a zinc recycling plant in North Carolina. CHI won that project bid. Over the next several years, that project evolved into the largest and most profitable job in the company's history, bringing in over $30 million of revenue and a gross profit margin above 40%.

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[1] TCM 2022-15.

[2] *Cozart Packing Co.*, TCM 1972-175, aff'd, 475 F.2d 1339 (4th Cir. 1973).

[3] INDOPCO, Inc., 503 U.S. 79, 84 (1992).

[4] *Martens*, 934 F.2d 319, 1991 WL 87160, at *8 (4th Cir. 1991), aff'g per curiam TCM 1990-42.

[5] *Am. Sav. Bank*, 56 T.C. 828, 843 (1971).

[6] *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 119 (1930), aff'g *Ox Fibre Brush Co. v. Blair*, 32 F.2d 42 (4th Cir. 1929, rev'g 8 B.T.A.. 422 (1927).

[7] *R.J. Nicoll Co.*, 59 T.C. 37, 50 (1972).

[8] *Estate of Wallace*, 95 T.C. 525, 553-554, aff'd 965 F.2d 1038 (11th Cir. 1992).

[9] *Richlands Med. Ass'n*, 953 F.2d 639, 1992 WL 14603, at *2 (4th Cir. 1992), aff'g per curiam TCM 1990-660.

[10] *Estate of Wallace*, 95 T.C. at 556.

[11] *Richlands Med. Ass'n*, 1992 WL 14603, at *2.

[12] *Mayson Mfg. Co.*, 178 F.2d 115, 119 (6th Cir. 1949), rev'g and remanding a Tax Court Memorandum Opinion dated 11/16/1948).

[13] *E.J. Harrison & Sons, Inc.*, TCM 2003-239, 2003 WL 21921049, at *14-*16, aff'd in part, rev'd in part, and remanded on another issue, 138 F. App'x 994 (9th Cir. 2005).

[14] *Martens*, 1991 WL 87160, at *9.

[15] *Medina*, TCM 1983-253.

[16] *Metro Leasing & Dev. Corp.*, 326 F.3d 1, 3-4 (1st Cir. 2003), aff'g TCM 2001-119, 2001 WL 530694 and 119 T.C. 8 (2002).

[17] *Haffner's Serv. Stations, Inc.*, 326 F.3d 1, 1-3 (1st Cir. 2003), aff'g TCM 2002-38.

[18] *Exacto Spring Corp.*, 196 F.3d 833, 838 (7th Cir. 1999).

[19] *Elliotts, Inc.*, 716 F.2d 1241, 1245 (9th Cir. 1983), rev'g TCM 1980-282.

[20] *Pepsi-Cola Bottling Co. of Salina*, 61 T.C. 564, 567 (1974), aff'd, 528 F.2d 176, 179 (10th Cir. 1975).

[21] *Beiner, Inc.*, TCM 2004-219, 2004 WL 2164888.

[22] *Metro Leasing & Dev. Corp.*, 2001 WL 530694.

[23] *Golsen*, 54 T.C. 742, 757 (1970), aff'd 445 F.2d 985 (10th Cir. 1971).

[24] *Menard, Inc.*, 560 F.3d 620 (7th Cir. 2009), rev'g TCM 2004-207.

[25] *Exacto Spring Corp.*, 196 F.3d 833 (7th Cir. 1999).

EXHIBIT 1
Clary Hood, Inc. — Summary of Results of IRS Audit

Fiscal Year	Income Tax Deficiency Concluded	Section 6662 Substantial Understatement Penalty
2015	$1,581,202	$316,240
2016	$1,613,308	$322,662

EXHIBIT 2
Clary Hood, Inc. — Summary of Results of Operations — Fiscal Years Ending 5/31/2000 through 5/31/2016

Fiscal Year-End	Company Revenue ($)	Company Gross Income (Loss) ($)	Net Income (Loss) before Taxes ($)	Year-End Shareholders' Equity ($)	Year-End Cash on Hand ($)
2016	68,834,166	22,090,576	14,537,867	31,262,166	15,482,871
2015	44,111,646	13,879,822	7,088,529	21,742,422	10,059,619
2014	34,074,836	10,008,003	8,271,261	17,419,060	9,434,712
2013	42,830,999	11,755,042	7,427,560	11,965,811	5,024,051
2012	23,680,476	3,738,212	2,308,710	7,112,009	1,172,793
2011	15,575,546	1,072,062	(120,530)	5,478,422	1,234,290
2010	20,605,072	130,997	(589,730)	5,550,877	1,342,332
2009	27,757,113	1,023,856	(390,922)	5,910,615	923,853
2008	38,439,625	5,116,648	2,864,533	6,186,310	1,170,632
2007	25,898,118	3,099,005	1,294,923	4,366,759	647,649
2006	14,936,476	1,615,374	125,617	3,554,653	657,222
2005	22,150,933	2,157,518	981,456	3,476,981	140,955
2004	13,243,547	1,826,002	874,588	2,858,337	293,333
2003	9,332,724	(97,393)	(773,222)	2,330,395	137,797
2002	17,590,697	250,363	(896,490)	2,822,055	120,078
2001	25,347,752	1,531,231	(123,607)	3,378,880	342,416
2000	16,366,605	2,235,929	833,116	3,454,137	324,324

Also in 2011, one of Hood's industry contacts enabled CHI to bid on—and win—another large grading project with one of the Bridgestone plants in Aiken, South Carolina. That project accounted for nearly $9.5 million of CHI revenue over the next few years, with the company earning an overall gross profit margin of 41%. Around 2014, Hood's efforts secured another large grading job, a project for the Tryon Equestrian Center. By the end of the 2016 fiscal year, that project generated over $23 million in revenue and $5.4 million gross profit for the grading company.

The CHI revenue growth and financial performance improved materially after its transition away from the Walmart projects. This CHI financial performance improvement is summarized in the Exhibit 2 financial data for the CHI fiscal years ending 5/31/2000 to 5/31/2016 (the "review period").

It is noteworthy that the amounts in Exhibit 2 (with immaterial exceptions) are the amounts reported on the CHI federal income tax returns. That is, the net income amounts are calculated after the company's tax deduction for Hood's compensation amounts.

It is also noteworthy—particularly to the Service and to the Tax Court—that CHI never declared or paid a cash dividend to its shareholders (i.e., Clary and Gail Hood) at any time during the review period.

The CHI management structure. Hood used various management titles with CHI during the review period. However, during this time period, Hood's executive duties at CHI were generally the same: (1) oversight of the company's equipment fleet (procurement, use, maintenance, and disposition; (2) hiring, training, and supervision of mechanics; (3) supervision and inspection of jobsites; (4) preparation, review, and approval of job fee estimates and budgets; (5) submission and negotiation of job bids; (6) setting employee salaries and bonuses; and (7) acquisition of bonding for grading projects.

According to the trial record, Hood rarely took vacations, and he typically worked between 60 and 70 hours per week (including weekends). Hood's leadership and work ethic contributed to the CHI revenue growth and profitability. However, the *Hood trial record indicated that much of the company's success was also due to the hard work and dedication of the other CHI executives: Andy Painter, Tom Addley, Chris Phillips, Mrs. Gail Hood, and Wesley Hood (*"Wesley"), the son of Mr. and Mrs. Hood.

Like Hood, Wesley joined his father's construction company right after graduation from high school. After several years of operating heavy equipment for the grading company, Wesley became more involved in the CHI management. In the 2000s, Wesley became the CHI president and CEO. However, Wesley decided to leave CHI in 2011.

Painter replaced Wesley as the CHI president at the beginning of 2012. Painter typically worked hours similar to Hood, and Painter performed the following management functions: (1) preparation of estimates for, and bidding on, prospective jobs; (2) oversight of the performance of projects; (3) engagement in business development; and (4) management of CHI daily operations.

Addley served in a similar capacity to Painter. Addley worked primarily as an onsite project manager for CHI, overseeing the performance of projects. In this management function, Addley typically worked 60 hours per week and performed the following functions: (1) assessing equipment and personnel needs, (2) maintaining client relations at project sites, and (3) monitoring the need for job modifications when warranted.

Phillips, a certified public accountant, joined CHI in 2010 as controller before becoming the company's chief financial officer in 2011. Phillips' duties at the company included (1) oversight of CHI finances; (2) review, negotiation, and payment of CHI loans; (3) oversight of insurance policies; (4) communication with bonding agents, banks, lenders, attorneys, and government agencies; (5) preparation of financial statements; (6) oversight of the CHI accounting department; and (7) continual review and analysis of costs in order to improve the company's financial efficiency.

Gail Hood acted as a general adviser to CHI on equipment needs, project needs, personnel needs, and financial management. She was also responsible for personal guaranties to bonding companies during the review period. Gail Hood typically worked approximately 10 hours per week during the review period, but her responsibilities with the company decreased in the later end of the review period.

The executive/shareholder compensation amounts in dispute. There was no written employment agreement in place between Hood and the company during the review period.

EXHIBIT 3
Clary Hood, Inc. — Compensation Paid to Mr. Clary Hood — Fiscal Years Ending 5/31/2000 through 5/31/2016

For Fiscal Year	Hood Salary ($)	Hood Bonus ($)	Hood Total Compensation ($)
2016	196,500	5,000,000	5,196,500
2015	168,559	5,000,000	5,168,559
2014	181,538	1,500,000	1,681,538
2013	381,707	1,000,000	1,381,707
2012	21,100	200,000	221,100
2011	83,400	35,000	118,400
2010	132,500	-0-	132,500
2009	130,000	-0-	130,000
2008	130,000	320,981	450,981
2007	130,000	221,685	351,685
2006	131,000	242,000	373,000
2005	130,000	1,000	131,000
2004	130,000	-0-	130,000
2003	127,337	-0-	127,337
2002	130,813	-0-	130,813
2001	130,000	107,000	237,000
2000	130,000	122,000	252,000

The CHI board of directors, which was comprised solely of Clary and Gail Hood, set the amount of Hood's annual compensation, including bonuses. Although they generally solicited and accepted the advice of the CHI independent accountants, Clary and Gail Hood did not use any type of formula in setting Hood's compensation amounts during the review period—except during the tax years at issue.

During the review period, Hood received from CHI the amounts presented in Exhibit 3. CHI reported these amounts as employee compensation deductions on its federal income tax returns.

Based on the CHI agreement with its bonding companies, Clary and Gail Hood agreed to personally guarantee any claim the bonding companies may have had against CHI during the review period for amounts beyond the

EXHIBIT4
Clary Hood, Inc. — Compensation (Other than Bonuses) Paid to Senior Executives — Fiscal Years Ending 5/31/2010 through 5/31/2016

For Fiscal Year $	Andy Painter Compensation $	Tom Addley Compensation $	Gail Hood Compensation $	Chris Phillips Compensation $	Wesley Hood Compensation $
2016	233,654	233,654	104,800	114,900	52,000
2015	191,500	191,500	85,546	74,000	52,000
2014	178,646	178,646	56,480	52,083	52,000
2013	113,907	113,907	26,000	51,454	3,000
2012	-0-	-0-	24,220	50,824	20,520
2011	-0-	-0-	23,680	23,400	164,080
2010	-0-	-0-	26,500	19,600	157,000

EXHIBIT 5
Clary Hood, Inc. — Bonus Amounts Paid to Senior Executives — Fiscal Years Ending 5/31/2013 through 5/31/2016

For Fiscal Year $	Andy Painter Bonus $	Tom Addley Bonus $	Gail Hood Bonus $	Chris Phillips Bonus $
2016	100,000	80,000	-0-	60,000
2015	40,000	40,000	-0-	30,000
2014	30,000	30,000	-0-	25,000
2013	25,000	25,000	-0-	25,000

company's ability to pay ('surety bond guaranties'). Hood also agreed to personally guarantee payment of some of the CHI business loans, credit lines, and capital leases during the review period ("debt guaranties").

In addition, CHI lent money to—and extended credit to—Hood and to some of his other business ventures during the review period. Before the tax years at issue in the dispute, CHI never compensated Hood (or Mrs. Hood) for the debt guaranties or for the surety bond guaranties.

In fall 2014, Phillips first discussed the issue of Hood's compensation with the CHI independent accountants at the Elliott Davis, LLC ("Elliott Davis") accounting firm. Phillips believed that Hood had been undercompensated in prior years. Phillips sought professional advice on how to develop the compensation for Hood on a going-forward basis. Jeff Greenway, an audit partner at Elliott Davis, sent Phillips a summary of salary surveys. That summary included data from a PAS, Inc. ("PAS") survey and a 2010 Construction Financial Managers Association survey. Using this information, Phillips developed preliminary calculations to determine the amount that CHI had undercompensated Hood during the review period.

Phillips, Hood, Greenway, and Stacy Stokes, a tax partner at Elliott Davis, discussed Hood's compensation situation during a fiscal year-end business meeting in May 2015. They all agreed that (1) Hood was undercompensated during the review period and (2) Hood de-

served a bonus in the amount of $5 million pending a follow-up compensation analysis.

The $5 million catch-up bonus amount was supported by an Excel spreadsheet ("the compensation due spreadsheet") developed by Phillips. The compensation due spreadsheet presented a financial model with (1) the CHI income statements for each year of the review period through 5/31/2015, (2) Hood's annual compensation for each of those years according to the CHI federal income tax returns, and (3) a series of items for each year labeled "Clary Hood Calculated Compensation."

The "Clary Hood Calculated Compensation" items included the following: (1) a base salary beginning with $200,000 for the tax year ending 5/31/2000, then increasing 5% annually; (2) an annual bonus amount of 20% of profits before taxes; (3) an annual fee of $100,000 for bonding guaranties; and (4) an annual debt guaranty fee equal to approximately 1% of the debt and capital leases personally guaranteed by Hood.

The compensation due spreadsheet also incorporated data from the Greenway-provided salary surveys. Following the May 2015 meeting, Stokes provided Phillips with additional research on the topic of reasonable executive compensation. Stokes also modified the compensation due spreadsheet. Stokes added line items below the income statements, including a "Total Equity" figure and a "Return on Equity for the Year" calculation for each year during the review period.

Based on these inputs and calculations, the financial model concluded a proposed $5 million catch-up bonus amount for Hood.

The CHI board of directors met on 5/21/2015. The CHI board approved $5 million as a catch-up bonus payment to Hood for its 2015 tax year ("the 2015 amount") described as "backpay compensation."

In support of this catch-up bonus amount, the CHI board minutes described the following prior services rendered by Hood during the review period: (1) navigating CHI through "the loss of a president and long-time vice president in 2011"; (2) deciding "to change direction of the [c]ompany away from 'big box' grading work to more industrial grading opportunities"; (3) "[d]ealing [with] and reacting to the most severe recession faced by the [c]ompany in 2009-2011"; (4) "personally guaranteeing most or all of the [c]ompany debt, capital leases, and credit lines since inception"; (5) acting as the "[p]ersonal guarantor to the [c]ompany's bonding company since inception"; (6) "[p]roviding a steadying influence to both customers, vendors, and, most importantly, employees"; (7) "leading the [c]ompany by being prudent in seeking job opportunities and the purchasing of equipment necessary to handle the [c]ompany's emergent work opportunities"; (8) "personally overseeing that equipment used by Clary Hood, Inc. on job sites met or exceeded expectations in the performance of the job"; and (9) "managing and leading the [c]ompany over the most profitable four year run in its existence."

Listing exactly the same reasons, the CHI board approved another $5 million as a catch-up bonus payment to Hood on 5/20/2016 ("the 2016 amount").

It is noteworthy that Hood personally set the salaries and bonuses for all CHI officers and personnel on an individual basis. For the fiscal years ending 5/31/2010 through 5/31/2016, CHI paid its officers and other executive employees (other than Hood) the amounts presented in Exhibit 4—amounts that it characterized as compensation expense (excluding bonuses).

For the fiscal years ending 5/31/2013 through 5/31/2016, CHI also paid its officers and other executive employees (other than Hood) additional amounts—amounts that it characterized as bonuses. These annual bonus payment amounts are presented in Exhibit 5.

Notice of deficiency and filing of the Tax Court petition. Following an audit of the CHI federal income tax returns, the Service issued a notice of deficiency for the tax years at issue. The notice of deficiency concluded that portions of Hood's compensation paid for the tax years at issue exceeded reasonable compensation amounts under Section 162(a)(1). The Service disallowed the deduction for these alleged excess (greater than reasonable amount) compensation payments.

The Service allowed $517,964 of the $5,711,105 total amount CHI reported as compensation for Hood for the 2015 tax year and $700,792 of the $5,874,585 total amount CHI reported as compensation for Hood for the 2016 tax year. The Service's notice concluded total deficiencies of $1,581,202 and $1,613,308 for the 2015 and 2016 the tax years, respectively.

The Service's notice also included accuracy-related penalties under Section 6662 for underpayments due to the substantial understate-

ment of income tax of $316,240 and $322,662 for the 2015 and the 2016 tax years, respectively.

In response to the Service's notice of deficiency, CHI filed a petition with the Tax Court, disputing (1) the disallowed compensation amounts and (2) the Section 6662 substantial understatement penalties.

The Tax Court's opinion. The Tax Court memorandum opinion provides a fulsome discussion of the court's analysis of the factors affecting the reasonableness of Hood's executive compensation (and of CHI's income tax deduction). First, the decision addressed the issue of why the taxpayer CHI had the burden of proof in the Hood matter.

Burden of proof. Not surprisingly, the Tax Court concluded that (1) the Service's determinations set forth in its notice of deficiency are generally presumed to be correct and (2) the taxpayer (in this case, CHI) bears the burden of proving that the determinations are in error. Specifically, the Hood decision mentions Cozart Packing Co.,[2] which applies this presumption to a reasonable compensation determination. Citing *INDOPCO, Inc.*,[3] the *Hood decision* states the rule that the taxpayer bears the burden of proving entitlement to any deduction claimed.

After addressing the initial burden of proof issue, the *Hood decision* systematically described the relevant issues related to a reasonableness of executive/shareholder compensation analysis.

Reasonableness of executive/shareholder compensation tax deductions

Tax deduction requirements under Section 162(a). CHI, a C corporation, is subject to federal income tax on its taxable income, which is its gross income less allowable deductions. Under Section 162, a corporation may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Such expenses include a reasonable allowance for salaries or other compensation; for example, bonuses or for personal services actually rendered. Whether the compensation payments are reasonable and purely for services is a question of fact to be determined based on all the facts and circumstances of each particular case. In its discussion of the facts and circumstances criteria, the memorandum decision cited Martens[4] and American Savings Bank.[5]

Since it was an issue in the *Hood matter*, it is noteworthy that an employer may deduct compensation paid to an employee in a year although the employee may have performed the services in a prior year. To support this proposition, the Hood decision cited Lucas v. Ox Fibre Brush Co.[6] and *R.J. Nicoll Co.*[7] However, the employer has to show that (1) the employee was not sufficiently compensated in the prior year and (2) the current year's compensation was in fact paid to compensate for that underpayment. To support this proposition, the *Hood* decision cited Estate of Wallace.[8]

The *Hood* decision specifically stated:

> Another consideration is whether the employee was also a shareholder of the corporation. Where officer-shareholders are in control of a closely held corporation and set their own compensation, careful scrutiny is required to determine whether the alleged deductible compensation is in fact a nondeductible dividend.

In this regard, the *Hood decision* cited Richlands Medical Association[9] and *Estate of Wallace*.[10]

The multifactor approach to assessing the reasonableness of compensation. The Tax Court recognized that the U.S. Court of Appeals for the Fourth Circuit, the appeals court to which an appeal of the Hood matter would be made, requires consideration of multiple factors in determining reasonable compensation (the so-called "multifactor approach"). These multiple factors include the following: the employee's qualifications; the nature, extent, and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; and the salary policy of the taxpayer as to all employees. In its discussion of this multifactor approach, the *Hood decision* cited Richlands Medical Association.[11]

In the context of a private corporation with a limited number of officers, additional reasonableness of compensation factors to consider may include (1) the amount of compensation paid to the particular employee in the previous years (as considered in *Mayson Manufacturing Company*[12]) and (2) any personal guaranties of debts or other obligations of the corporation (as considered in *E.J. Harrison & Sons, Inc.*[13]).

In the application of the multifactor approach, no single factor is considered to be de-

cisive. Instead, the trial court may consider and weigh the totality of the factors and circumstances when making its decision (as in *Martens*[14]). In doing so, the trial court may find certain factors less relevant or helpful than other factors when considering the factors necessary to reach a reasonableness of compensation conclusion (as in *Medina*[15]).

The independent investor test. Some federal courts have applied the so-called independent investor test to analyze the reasonableness of private company executive/shareholder compensation. Some of the judicial decisions that applied the independent investor test include (1) Metro Leasing & Development Corporation[16] (noting that the independent investor test is one of several factors that may be considered in analyzing the reasonableness of executive/shareholder compensation); (2) *Haffner's Service Stations, Inc.*[17] (rejecting the independent investor test as the only test and instead applying a multifactor approach with consideration of the taxpayer company's profit and return on equity); and (3) *Exacto Spring Corp.*[18] (relying primarily on the independent investors test).

Under this independent investor test of reasonable executive/shareholder compensation, the court typically considers, "whether an inactive, independent investor would be willing to compensate the employee as he was compensated" (see *Elliotts, Inc.*[19]).

In the *Hood* matter, CHI asked the Tax Court to follow the independent investor test in determining whether the compensation paid to Hood in the tax years at issue was reasonable. At least one Court of Appeals has accepted the independent investor test in a reasonableness of compensation dispute. However, the Hood decision noted that the U.S. Court of Appeals for the Fourth Circuit has not adopted any version of the independent investor test.

In addition, the *Hood* decision noted that the Tax Court generally applies the multifactor approach unless a case is appealable to a Court of Appeals which has expressly applied the independent investor test. See, for example, (1) Pepsi-Cola Bottling Co. of Salina[20] (noting that it is "well settled" that the Tax Court should consider the multifactor approach in reasonable compensation cases); (2) *Beiner, Inc.*[21] (refusing to apply the independent investor test exclusively by finding comparative industry salaries the most relevant factor in that case; and (3) *Metro Leasing & Development Corporation*[22] (concluding that it was not "appropriate to rely solely on the independent investor test to reach our findings and/or holding").

Therefore, in the *Hood* matter, the Tax Court concluded that it should apply the multifactor approach to determine the reasonableness of the compensation paid to Hood. That conclusion was based on the precedent of the Tax Court and, more importantly, based on the precedent of the U.S. Court of Appeals for the Fourth Circuit (see Golsen[23]).

The Tax Court analysis of Hood's compensation

In the judicial decision, Judge Greaves specifically mentioned "There is no doubt that Mr. Hood is the epitome of the American success story." In the *Hood matter,* the parties did not dispute that Hood was entitled to some degree of additional compensation for the prior services he rendered as a CHI employee during portions of the review period.

It is not the responsibility of either the Tax Court or the Service to substitute its business judgment for that of the CHI board as to the setting of the appropriate amount of an employee's compensation. However, it is the responsibility of the Tax Court to examine the extent to which that compensation may be deducted for federal income tax purposes. That is because, as even CHI management recognized, limits do exist as to what may be reasonably deducted as compensation expense.

From a federal income tax perspective, the Service challenged whether the increase in Hood's compensation in the 2015 and 2016 CHI fiscal years constituted (1) deductible employee compensation or (2) a means of draining corporate profits through a disguised dividend. For the reasons concluded from each of the factors described below, the Tax Court held that CHI could not deduct the full amount of compensation paid to Hood. Based on the court's assessment, CHI failed to adequately establish how the entire amount was both reasonable and paid solely as compensation for Hood's services to CHI during the review period.

Hood's background and qualifications. An employee's superior qualifications for his or her position may justify high compensation. With over 50 years of relevant work experience, Hood had substantial knowledge and experience in both managing and performance grading and excavation work. In addition,

Hood had developed an excellent reputation in his market. The court recognized that Hood's reputation allowed CHI to compete for, and win, subcontracting jobs.

The nature, extent, and scope of Hood's work. An employee's position, duties performed, hours worked, and general importance to the private corporation's success may justify high compensation. The court recognized that Hood was the key employee and driving force since the company's inception. Hood managed and built up the CHI business, solicited and obtained grading jobs, and supervised all work performed.

In addition, Hood made the executive decisions (1) to sever business dealings with Walmart and (2) to transition to the commercial and industrial market sectors, a decision which led to the CHI financial success.

The size and complexity of the CHI business operations. Courts may consider the size and complexity of a taxpayer's business when deciding the reasonableness of compensation paid to its executive/shareholders.

During the review period, CHI experienced exceptional growth in terms of both employees and revenue. The CHI workforce increased from approximately 80 to 150 employees. Also, the CHI annual revenue increased from as low as $9 million in 2003 to over $68 million by 2016. The *Hood decision noted,* "Even if we were to assume that land excavation and grading does not require substantial scientific or technical knowledge, petitioner's work is more complex than that of a general construction company."

CHI specialized in the land grading and excavation sectors of the construction industry. This industry sector requires performance of the following services at exacting specifications: earth excavation, site clearing and grading, storm drainage, installation of water systems, installation of curbs and gutters, landscaping, and irrigation services.

As a result of Hood's contributions, CHI created a niche in that specialty segment by (1) competing in a cost-effective manner and (2) developing an excellent reputation in its market.

Comparison of Hood's compensation to the CHI income. Although it is often helpful for analysts to measure executive/shareholder compensation as a percentage of both gross receipts and net income, the net income analysis is typically considered to be more important. This is because the net income analysis more accurately gauges whether a private company is disguising the distribution of dividends as compensation. A taxpayer's pattern of attempting to distribute a significant portion of its pretax net income as deductible executive/shareholder compensation may indicate that the private company is disguising dividends as compensation. That said, no particular ratio between executive/shareholder compensation expense and gross or net taxable income is a prerequisite for a determination of reasonableness.

In the instant case, CHI paid approximately 42% and 26% of its pretax income to Hood as compensation in its 2015 and 2016 fiscal years, respectively. In the *Hood matter*, the Tax Court did not find those percentages to indicate an egregious pattern of disguised dividends.

The prevailing economic conditions. The prevailing economic conditions may help to determine whether the success of a business is attributable to the efforts and business acumen of the executive/shareholder, as opposed to being attributable to the general trends in the economy. Adverse economic conditions, for example, tend to indicate that an executive/shareholder's skill was important to a private company that increased in size during bad economic years.

In the instant case, the CHI annual revenue increased from approximately $16 million to over $68 million during the review period. Greenway, a CPA with extensive experience in the construction industry, offered testimony at the *Hood* trial that the CHI success, at least in the post-Walmart era, was due to factors other than general economic conditions.

At trial, Greenway testified that CHI was his most profitable construction client between 2013 and 2016. Even the Service's testifying expert provided confirmation of this view. The Service's testifying expert placed the CHI performance in the upper quartile of its industry peers for the post-Walmart era. During that time period, CHI attained its most profitable jobs through Hood's direct involvement.

At trial, Hood testified that the CHI poorest performance years were predominantly attributable to years of national economic contractions. At trial, Hood testified that many of the CHI competitors went out of business during these economic downturns. Hood, on the other hand, took active measures as CEO to ensure the CHI survival during such economic

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downturn periods. Those measures included (1) selling equipment; (2) reducing employee compensation, including Hood's own compensation; and (3) conserving financial resources.

Comparison of Hood's compensation with distributions to stockholders. It is not a legal requirement for a private corporation to pay dividends. Also, private company shareholders are often content to enjoy the appreciation in the value of their stock that arises through the retention of company earnings. However, a complete absence of dividends to shareholders may result in an inference that some of the compensation paid to an executive/shareholder represents a distribution of profits.

CHI was profitable during the review period, especially in the tax years at issue. Nonetheless, CHI never declared or paid a cash dividend.

With regard to this dividend distribution factor, the *Hood decision states,* "Some of petitioner's claimed reasons for not doing so, e.g., to meet working capital needs during the Great Recession and maintain a competitive edge through strong balance sheets, are certainly persuasive when considering tax years such as 2010 in which business was slow and capital needs were high. These reasons, however, can be carried only so far before they start to lose their appeal after taking into account (1) Mr. Hood's decision, as controlling shareholder of petitioner, to defer monetary recognition through a dividend for his investment of the entire 16-year review period and (2) petitioner's decision to not recognize those deferrals through a dividend but instead reward Mr. Hood exclusively through a purported bonus after it had acquired sufficient capital and cash in the years at issue to do so."

Prevailing compensation rates for comparable positions at comparable concerns. In deciding whether compensation paid to an executive/shareholder is reasonable, analysts often compare it to compensation paid to persons holding comparable positions in comparable companies. Federal courts frequently place great emphasis on this comparative analysis factor.

In assessing this factor in the *Hood matter,* the Tax Court considered the testimony of the parties' testifying experts. In its decision, the Tax Court noted this principle: "As trier of fact, we are not bound by the opinion of any expert witness and will accept or reject expert testimony, in whole or in part, in the exercise of sound judgment."

The Samuel Kursh expert testimony. CHI offered the expert testimony of Samuel Kursh of BLDS, LLC ("BLDS"), an economic consulting firm. Kursh is an economist and BLDS principal whose experience includes corporate finance and market database analysis, as well as return on equity calculations.

The Kursh expert report ("the BLDS report") indicated that Kursh wrote the report in conjunction with his colleague Dr. Brett Margolin.

The *Hood decision* concluded that "Mr. Kursh's knowledge as to the report's content, supporting data, and calculations was materially lacking." At trial, Kursh admitted that Margolin would be better suited to answer basic questions regarding the BLDS report despite the fact that Margolin was not presented as a witness at the trial.

Regarding this expert's report, the Tax Court also concluded, "The BLDS report also lacked necessary supporting calculations and did not include all underlying data, leaving us unable to verify the veracity of its findings and conclusions."

In addition, the Tax Court commented that "The BLDS report additionally rested on numerous dubious assumptions. Perhaps most egregious, the BLDS report crudely compared the performance of petitioner, a private regional specialty construction firm, to that of dissimilar public companies such as the multinational conglomerate Caterpillar, Inc., with little attempt at adjusting for the obvious and stark differences between such companies."

Finally, with regard to the Kursh analysis, the Tax Court concluded that "the BLDS report focused on the independent investor test, which we do not find to be controlling."

The Theodore Sharp expert testimony. At trial, CHI also offered the expert testimony of Theodore Sharp, a senior partner at the management consulting firm Korn Ferry. Sharp is a member of the Korn Ferry Executive Pay and Governance group and specializes in compensation-related issues, including executive compensation benchmarking. At trial, Sharp testified that he reviewed and agreed with his written expert report ("the Korn Ferry report"), but Sharp acknowledged that he had not written it. The Korn Ferry report consisted of approximately one dozen PowerPoint slides in bullet-point format.

The Tax Court had the following observation regarding this expert's work: "As with the BLDS

report, supporting calculations used to reach key findings and conclusions were conspicuously absent from the report and underlying data sources were not adequately disclosed."

The Tax Court also expressed serious concerns about the soundness of the assumptions in the Korn Ferry report. For example, the Korn Ferry report relied on compensation survey data for companies with up to $500 million in annual revenue. The expert report attempted to offset the disparity with the CHI revenue size by applying a 20% "discount" to the data. The Korn Ferry report explained (and Sharp confirmed at trial) that this percentage was not supported by any empirical data but was selected "based on our experience working with similarly sized companies."

The Tax Court also commented that, "The external compensation survey data relied upon in the Korn Ferry report was materially lacking in completeness as well."

Finally, with regard to this taxpayer expert witness, the Tax Court concluded, "We therefore afford Mr. Sharp's testimony little to no weight."

The David Fuller expert testimony. At trial, the Service offered the expert testimony of David Fuller. Fuller is the founder of Value, Inc. In his role at Value, Inc, Fuller provides financial and valuation consulting services to corporate clients in various industries, including the construction industry. His practice areas include valuation opinions for financial and tax reporting purposes. Also, Fuller routinely provides advice to companies on the issue of executive compensation.

Fuller's expert report ("the Fuller report") accounted for all known amounts of compensation paid to Hood during the review period. Also, the Fuller report contained detailed disclosures of the data sources relied upon, the methodologies applied, and the supporting calculations. The data that Fuller analyzed included the entire 17-year review period. Fuller compared the CHI performance against data supplied by the Risk Management Association ("RMA") survey service for site preparation contractors, using the CHI annual asset size and revenue size.

The Fuller report placed CHI in annual quartiles in each year based on the company's performance against the RMA data. Then, the Fuller report examined officer compensation as a percentage of revenue within the respective annual performance quartile. As part of his analysis, Fuller observed compensation data for executive/shareholders in the construction industry from the survey service PAS. And, Fuller also applied the multifactor approach.

In terms of financial metrics, Fuller concluded that CHI was a lower quartile performing business from 2000 through 2011, a median performing business in 2012, and an upper quartile performing business from 2013 through 2016. Fuller assigned lower quartile wages for a board chairman to Hood for 2000 to 2011, average wages for a board chairman to Hood for 2012, and the highest level of compensation (i.e., the 99th percentile) for a board chairman to Hood for 2013 through 2016. Fuller also concluded that elective undercompensation by a company owner is not dissimilar to a loan to the company. Therefore, Fuller calculated interest each year on Hood's calculated undercompensation.

The Fuller report contained two opinions. In the first opinion ("the primary opinion"), Fuller concluded reasonable compensation for Hood to be $3,681,269 for the 2015 tax year and $1,362,831 for the 2016 tax year. As part of this determination, Fuller included compensation to Hood for the surety bond guaranties.

The second opinion ("the alternative opinion") excluded compensation for the surety bond guaranties. This is because Fuller noted that the PAS survey may have already included such guaranties in the construction industry data for a company board chairman. The alternative opinion ultimately concluded reasonable compensation for Hood to be $2,202,063 for the 2015 tax year and $1,314,500 for the 2016 tax year.

CHI disagreed with Fuller's opinion and asked the Tax Court to reject Fuller's report in its entirety. One of the principal reasons that CHI presented to justify its request is the allegation that the Fuller report was "statistically invalid." This allegation was because Fuller used data from the RMA and PAS survey services.

The Tax Court noted that the CHI expert witness Sharp admitted there is no such thing as "perfect data" when it comes to executive compensation. The Tax Court did not find these data services to be intrinsically defective or inappropriate for the purposes at hand. The court noted that the CHI other expert witness, Kursh, also relied on RMA data in the BLDS report. Also, the CHI independent accountant, Greenway, used PAS survey data, which the CHI CFO had found to be "helpful."

Accordingly, the Tax Court concluded, "Therefore, while such benchmark data may not be as statistically exacting as petitioner would like, petitioner did not provide satisfac-

tory countervailing evidence through its expert witness that would credibly support a greater allowable amount. In this absence, we are left looking to Mr. Fuller's report as the most credible and complete source of data, analyses, and conclusions in the record regarding what similar companies might be willing to pay Mr. Hood on petitioner's facts."

Did Hood provide extraordinary or unique services? At trial, CHI claimed that Hood's role in the company's growth and success should be seen as extraordinary or unique such that the Tax Court should place less reliance on industry comparisons.

In response to this taxpayer position, the Tax Court concluded, "We agree with petitioner that Mr. Hood is extraordinarily talented in his industry and that perhaps few other individuals could have achieved similar results for petitioner during the later years of the review period. However, petitioner fails to appreciate that these considerations were taken into account in the expert witnesses' reports. Mr. Fuller's report specifically placed petitioner's performance in the highest tier group of its comparable industry peers for years 2013 to 2016. Accordingly, we see no reason to discount reports that already sufficiently factor in Mr. Hood's extraordinary contributions to petitioner."

The CHI salary policy as to all other employees. Certain federal courts have considered salaries paid to other employees of a private company in deciding whether executive/shareholder compensation is reasonable. In the Hood matter, the Tax Court also looked to this factor to determine whether Hood was compensated differently from the other CHI employees solely because of his status as a shareholder.

CHI had no structured system in place for the setting of its nonshareholder employee compensation. Hood personally set the salary and the bonus amounts of other employees and officers. At trial, Hood testified that he based these decisions on his own subjective belief as to the individual's "work records," "ability to get along with people," and "pride in the company."

Hood's salary and bonus in the tax years at issue represented almost 90% of the total amount of compensation that CHI paid to its officers, despite the fact that nonshareholder officers such as Painter and Addley worked nearly the same number of hours as Hood and shared many of Hood's responsibilities.

CHI had no agreement in place with Hood regarding his compensation. Instead, Hood's compensation during the review period was set by him along with his wife in their roles as the CHI board of directors. Therefore, the court examined the specific circumstances surrounding the setting of Hood's compensation in the tax years at issue.

The 2015 compensation amount. The 2015 bonus amount was initially proposed at the May 2015 meeting by Phillips, Hood, and the CHI external advisers at Elliott Davis in which the meeting participants tentatively agreed on a bonus amount of $5 million for Hood. In arriving at this bonus amount, CHI and its advisers had the advantage of knowing its anticipated year-end profits for the 2015 tax year. The 2015 tax year was expected to be the most successful year in its corporate history. Despite the fact that CHI never paid Hood a dividend, the company continued with its plan to award Hood a lump sum bonus.

CHI also used its own performance as a proxy for Hood's performance with the board minutes citing only overarching contributions by Hood to the company during the review period. There was no attempt in the board minutes to value or quantify the specific services rendered by Hood during the review period (other than his debt guaranties).

In the *Hood decision*, the Tax Court concluded, "Such a comparison may make sense for a one-man enterprise; however, petitioner employed dozens of hardworking employees during the review period and conceded that the company's growth during this time could not be tied exclusively to Mr. Hood's efforts."

CHI did not provide evidence at trial to support what portion of the company's growth should reasonably be attached to each of the various services, including possible values thereof, rendered by Hood during the review period. In addition, CHI did not provide evidence at trial to distinguish between (1) the services provided by Hood during the review period and (2) the services provided by the company's other officers and employees.

In addition, the Tax Court provided the following observation in the *Hood* decision with respect to the 2015 bonus amount:

> Finally, and perhaps most telling, there was Mr. Hood's testimony during trial. When asked why he considered it acceptable to take a significant amount of money out of the company starting in the 2015 tax year despite his reluctance to do so in the past, Mr. Hood admitted that he was aware that he needed to start making necessary preparations from an "income

tax" perspective in "getting money out of" the company in anticipation of "a changing of the guard."

The 2016 compensation amount. In awarding Hood the 2016 bonus amount, CHI acted under the awareness that, on the basis of its preliminary financials, its 2016 fiscal year was to be even more profitable than its 2015 fiscal year. Nevertheless, the CHI board again chose not to declare a dividend. Instead, the CHI board rewarded Hood exclusively through another $5 million bonus, reciting the same underlying rationale it provided for the 2015 amount. In addition, CHI made no attempt to explain why the 2015 bonus amount had been insufficient catch-up compensation for Hood's prior services during the review period.

The Tax Court noted that the trial record did not indicate that (1) when it awarded Hood the 2015 bonus amount, the CHI board believed that Hood remained undercompensated or (2) additional catch-up compensation may be warranted in the future for these prior services.

In the *Hood decision,* the Tax Court noted that, "Petitioner nevertheless attempts to distinguish its legal effect by asking us to apply Reg. 1.162-7(b)(2) to a portion of the 2016 amount. This regulation provides that if contingent compensation is paid under a free bargain between an employer and employee before the services are rendered, then the purported compensation amount should be allowed as a deduction even though it may be greater than what may ordinarily be paid."

In the *Hood decision, the Tax Court also noted that,* "There is little to no evidence that a bargain as envisioned under this regulation existed between petitioner and Mr. Hood with respect to any portion of the 2016 amount." That is, no written management services agreement outlining an understanding between CHI and Hood existed regarding Hood's potential total compensation for the 2016 tax year. Also, CHI did not establish that its board of directors considered any part of the 2016 bonus amount at the May 2015 meeting, that is, before the commencement of Hood's 2016 performance.

Analysis of Hood's prior compensation amounts. Where a large salary increase is an issue (as in the Hood matter), it may be helpful for the analyst to compare past and present duties and salary payments. Such a comparison may help the analyst determine whether and to what extent the current payments represent compensation for services performed in prior years that can be currently deductible.

Hood's total compensation increased over 300% in the CHI 2015 fiscal year, its most profitable year to date. Nonetheless, there was no corresponding increase in Hood's duties or responsibilities in that year. According to the CHI corporate minutes, the stated justification for this increase is that Hood was undercompensated in prior years. In the *Hood decision,* the Tax Court addressed this issue as follows: "While we do not disagree that Mr. Hood was undercompensated in certain years of the review period, this does not entitle petitioner to carte blanche in deducting Mr. Hood's backpay bonus amount."

In addition, the Tax Court expressed concern that CHI did not sufficiently demonstrate through reliable means how the full amount of each of the 2015 and the 2016 bonus amounts was proportionate in value to each of the past services allegedly rendered by Hood.

Hood's personal guaranty of the CHI debts and bonding obligations. The CHI justification for Hood's higher compensation for the tax years at issue included Hood's debt guaranties and surety bond guaranties during the review period. Guaranty fees may qualify as a deductible business expense under Section 162(a).

In various judicial decisions, the Tax Court has considered some of the following factors when deciding the deductibility of such fees paid to a private company executive/shareholder: (1) whether the fees were reasonable in amount given the financial risks, (2) whether companies of the same type and size as the taxpayer customarily pay such fees to shareholders, (3) whether the executive/shareholder demanded compensation for the guaranty, (4) whether the taxpayer had sufficient profits to pay a dividend but failed to do so, and (5) whether the purported guaranty fees were proportional to the executive/shareholder's stock ownership.

The Tax Court noted that (1) it is customary for the owners of construction companies to guarantee debts and bonds and (2) compensation for these guaranties is appropriate. Further, the Service's expert witness, Fuller, testified the compensation that CHI paid to Hood for surety bond guaranties in the tax years at issue was reasonable.

Regardless of this issue, the Tax Court concluded, "We recognize that Mr. Hood historically did not seek compensation for the guaranties and petitioner had sufficient profits to pay a dividend during the years at issue; however, we place more weight on the customary nature and reasonableness of the fees."

The Hood decision reasonable compensation conclusion. Considering the totality of the factors discussed above, the Tax Court concluded that CHI did not adequately establish how the total compensation amounts paid to Hood during the tax years at issue were both (1) reasonable and (2) paid solely as compensation for his services to the company during the review period. While certain factors favored the taxpayer CHI, the court did not simply sum which party had the most factors in reaching its *conclusion*. In the court's analysis, all factors were not afforded equal weight.

In reaching its final conclusion, the Tax Court described that the factors addressing comparable pay by comparable companies, the CHI shareholder distribution history, the setting of Hood's compensation in the tax years at issue, and Hood's involvement in the CHI business were the most relevant and persuasive factors.

In concluding the appropriate reasonable compensation amount, the Tax Court found Fuller's expert testimony to be most helpful. The Service's expert Fuller considered the multifactor approach and included compensation for the surety bond guaranties. Also, Fuller offered a well-reasoned comparison of CHI and Hood's salary against industry standards. Accordingly, the Tax Court allowed a reasonable compensation tax deduction for amounts paid to Clary Hood of $3,681,269 for tax year 2015 and $1,362,831 for tax year 2016.

The Section 6662 penalties

According to Sections 6662(a) and (b)(2), a 20% penalty applies to any portion of an underpayment of tax required to be reported on a tax return that is attributable to a substantial understatement of income tax (i.e., "the reported substantial understatement penalty"). According to Section 6662(d)(1)(B), for a C corporation like CHI, a substantial understatement of income tax is an understatement that exceeds the lesser of (1) 10% of the tax required to be reported on the tax return for the taxable year (or, if greater, $10,000) or (2) $10,000,000.

With regard to the *Hood matter*, the understatements for the years at issue qualified as "substantial" within the meaning of Section 6662(d)(1)(B). That is because each understatement exceeded 10% of the tax required to be reported on the CHI tax return for that tax year.

Reasonable cause and good faith exception. According to Section 6664(c)(1), the substantial understatement penalty does not apply with respect to any portion of an underpayment to which a taxpayer acted "with reasonable cause and in good faith." According to Reg. 1.6664-4(b)(1), whether a taxpayer acted with reasonable cause and in good faith is decided on a case-by-case basis, taking into account all pertinent facts and circumstances.

A defense of reasonable cause requires that the taxpayer exercise ordinary business care and prudence as to the disputed item. Several judicial decisions have concluded that a taxpayer's reliance on professional advice may sometimes meet this standard.

For a taxpayer to reasonably rely upon professional advice to negate a substantial understatement penalty, the taxpayer has to prove by a preponderance of the evidence that (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment.

With regard to this issue, the *Hood decision stated*, "In cases involving corporations, we look at the efforts of a corporate taxpayer's relevant decision makers, officers, and employees to ascertain the corporation's proper tax liability in determining whether the taxpayer meets this standard."

The 2015 penalty amount and a competent professional with sufficient expertise. CHI sought advice on the amount of Hood's compensation and on the applicable tax consequences from Greenway and Stokes at the Elliott Davis accounting firm. Greenway was an Elliott Davis audit partner for nearly 18 years with more than 30 years of public accounting experience. As head of the Elliott Davis construction practice group, Greenway had a history of working with CHI before the years at issue, and Greenway was familiar with the comparative performance and profitability of CHI against its industry peers through his "hundreds of [other] construction clients." Greenway testified at trial that he considered at least two construction industry executive compensation surveys in connection with the advice he provided to CHI regarding Hood's compensation.

As an Elliott Davis tax partner with almost 20 years of public accounting experience, Stokes was similarly qualified. His relevant experience included (1) guiding at least 20 other clients on executive compensation matters and (2) acting as a personal tax adviser to both CHI and Hood.

Accordingly, the Tax Court concluded that the CHI advisers were adequately qualified to

counsel the company on the issue of Hood's compensation and its tax implications.

Did the taxpayer provide necessary and accurate information? Phillips initially raised the issue of Hood's compensation with Greenway in the fall of 2014. Over the course of the next several months, Phillips performed preliminary calculations in an Excel spreadsheet. Phillips provided draft calculations to Greenway and Stokes during the May 2015 meeting. All parties agreed at that meeting that Hood deserved catch-up compensation in the form of a $5 million bonus, pending follow-up research and analysis.

As part of the follow-up due diligence, Phillips finalized his calculations on the compensation due spreadsheet. The spreadsheet included (1) certain financial information concerning CHI for each year of the review period through 5/31/2015, (2) Hood's reported compensation for each of those years, and (3) a series of items for each year labeled "Carly Hood Calculation Compensation."

Although the Service disagreed with the assumptions underlying the "Clary Hood Calculated Compensation" spreadsheet items, the Service did not claim that the data and the analyses provided by Phillips were incorrect or inadequate. Also, the Service did not claim that any other CHI information should have been provided to Stokes or Greenway.

Did the taxpayer actually rely on the adviser's judgment? Clary and Gail Hood, as the sole members of the CHI board of directors, had limited financial and accounting knowledge. They trusted Phillips to guide them as to the issue of Hood's compensation for the years at issue. Phillips, as the company's CFO and signer of its federal income tax returns, knew the CHI financial performance and federal tax profile better than anyone at the company. However, Phillips was also inexperienced in matters of executive compensation.

Recognizing these shortcomings and wanting to ensure that CHI arrived at a reasonable amount of compensation for Hood, Phillips went to Elliott Davis for advice beginning in 2014. Also, Phillips continued to discuss the issue of Hood's compensation with Elliott Davis throughout May 2015.

Following the May 2015 meeting, Stokes provided Phillips with research material summarizing the tax law on executive compensation. Stokes also reviewed the compensation due spreadsheet that Phillips created for the purpose of analyzing a potential bonus amount for Hood for the 2015 tax year. The spreadsheet was based on CHI data and incorporated input that Phillips previously received from Greenway.

At trial, Stokes testified that he did not scrutinize each of the components underlying the comprehensive spreadsheet. However, his existing knowledge of the CHI business did not lead him to believe that any of these assumptions were unreasonable. Greenway confirmed the same conclusion at trial.

Stokes made a few modifications to the compensation due spreadsheet before sending it back to Phillips (with a copy to Hood). In his email, Stokes noted his approval of the analysis in the spreadsheet and its helpfulness in documenting the support necessary for the proposed 2015 bonus amount.

With regard to this issue, the *Hood decision concluded,* "We are satisfied that petitioner relied in good faith on the above advice when awarding Mr. Hood the 2015 amount and deducting the same for its 2015 tax year. The record does not show evidence of a rubber-stamp approval or a wink-and-a-smile by its advisers with respect to the 2015 amount."

Therefore, the Tax Court concluded the following with regard to the Section 6662 penalty as to 2015: "Accordingly, we decline to sustain respondent's determination as to the accuracy-related penalty for the 2015 amount."

The 2016 penalty amount and reliance on professional advice. CHI claimed that it also relied on professional advice in awarding Hood the 2016 bonus amount. In contrast to the detailed record surrounding the advice given to determine the 2015 bonus amount, CHI provided almost no evidence at trial with respect to the advice it may have received to determine the 2016 bonus amount.

Phillips prepared an updated compensation due spreadsheet for the 2016 bonus amount. However, there was no evidence that the CHI board of directors considered or relied on his worksheet when deciding to award Hood the 2016 bonus amount. Phillips and Stokes each testified at trial that an analysis similar to the one performed for the 2015 bonus amount was undertaken in 2016. However, the court noted that there was no evidence presented in the record of any communication between CHI and its advisers that would credibly support a finding that advice was actually rendered with respect to the 2016 bonus amount.

The Tax Court particularly noted this lack of evidence when considering that (1) in awarding

Hood the 2015 bonus amount, the record did not reflect that the CHI board still believed that Hood remained entitled to additional catch-up compensation for the review period and (2) in awarding Hood the 2016 bonus amount, the CHI board minutes did not attempt to address why the 2015 bonus amount was not sufficient in this regard. Specifically, on this issue, the *Hood decision states,* "If this changing view was based on advice petitioner received during its 2016 tax year, we would need to know what that specific advice was and who provided it."

The substantial authority defense. CHI also argued at trial that it has substantial authority to negate the imposition of the Section 6662 substantial understatement penalty with respect to the 2016 bonus amount. Section 6662(d)(2)(B)(k) negates an understatement that is attributable to the tax treatment of any item for which there is (or was) substantial authority for such treatment.

According to Reg. 1.6662-4(d)(3), the substantial authority standard is objective, and therefore it is not relevant whether the taxpayer believed that the substantial authority existed.

CHI claimed that its tax return position for each tax year at issue, including the 2016 bonus amount, was based on the independent investor test. CHI claimed that two judicial decisions by the U.S. Court of Appeals for the Seventh Circuit, *Menard, Inc.*[24] and *Exacto Spring Corp.,*[25] "provide clear cut substantial authority" for the company's use of this reasonableness of compensation test for the tax years at issue.

Reg. 1.6662-4(d)-(3)(iv)(B) does permit a taxpayer to consider court cases outside of the taxpayer's home jurisdiction to establish substantial authority. However, a single Court of Appeals acceptance of a test does not necessarily equate to substantial authority.

The *Hood decision noted that* "the Court of Appeals for the Fourth Circuit, the court to which an appeal of this case would lie, see Section 7482(b), applies the multifactor approach without consideration of a hypothetical investor and without indication that a different formulation of this test might be more appropriate."

Accordingly, the Tax Court concluded, "We therefore cannot accept the petitioner's position with respect to the 2016 amount was based on substantial authority."

Therefore, based on the above analysis, the Tax Court allowed the imposition of the Section 6662 substantial understatement penalty for the CHI 2016 tax year.

Summary and conclusion

The Tax Court case *Clary Hood, Inc.* involves a closely held C corporation's dispute regarding reasonableness of executive/shareholder compensation tax deductions. There was no dispute in this litigation that CHI was an extremely successful specialty construction company during the tax years at issue. Also, there was no dispute in this litigation that *Clary Hood*, the company CEO and (with his wife) shareholder, was largely responsible for the construction company's success during the tax years at issue. The disputed issue in the litigation was whether bonuses paid to Hood in 2015 and 2016 exceeded a reasonable amount of executive compensation for the services Hood actually performed for the company.

In its memorandum decision, the Tax Court provided a fulsome discussion of the methodology and the analysis it applied in addressing this reasonableness of executive/shareholder compensation issue. This judicial discussion provides practical guidance to private company owners and to their legal, accounting, and other professional advisers.

While this judicial guidance regarding reasonableness of compensation analysis is directly applicable to federal income tax matters, it may also be helpful with regard to family law litigation, shareholder litigation, ERISA compliance, not-for-profit entity regulatory compliance, and other matters involving the question of reasonableness of an executive's or a professional's compensation.

In particular, the *Hood decision* describes what the Tax Court liked—and disliked—about the testimony provided by the experts for both the taxpayer and the Service. That judicial description provides practical guidance to forensic accountants and other financial advisers who provide testifying expert services. That judicial assessment of expert testimony and of expert reports is directly applicable to federal income tax disputes. It may also be helpful to testifying experts—and to legal counsel and litigants—involved in other types of commercial disputes.

Finally, the *Hood decision* provides a comprehensive discussion of the court's analysis regarding the application of the Section 6662 substantial understatement penalty. That discussion should be instructive to both individual and corporate taxpayers and to their tax counsel and other tax advisers.

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ANTHONY DIOSDI

This article examines legal issues concerning the IRS's legal authority to assess and collect international penalties.

Introduction: reporting requirements and penalties

Chapter 61 of the Internal Revenue Code contains countless reporting requirements regarding foreign information filing obligations. Many of the sections under Chapter 61 impose significant penalties for the failure to comply with the reporting requirements. The more well-known reporting requirements and penalties are found in Chapter 61 and are as follows:

The Internal Revenue Code requires certain persons to provide the IRS with information regarding foreign corporations. This information is typically provided on Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. The Form 5471 and schedules are used to satisfy the reporting requirements of Section 6038 and Section 6046 along with the applicable regulations.

Substantively, Form 5471 backstops various international provisions of the Internal Revenue Code such as Sections 901/904 (Foreign Tax Credit), Section 951(a) (Subpart F and Section 956), Section 951A (GILTI), Section 965 (transition tax), Section 163(j) (interest deduction limitation), and Section 482 (transfer pricing). International information returns that often are associated with Form 5471s include Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation), Form 5713 (International Boycott Report), Form 8621 (PFIC), Form 8990 (Limitation on Business Interest Expense), and Forms 1116/1118 (Foreign Tax Credit).

In the Form 5471, at a minimum, the reporting agent must provide the following information regarding a foreign corporation:[1]

- Stock ownership, including current year acquisition and dispositions.
- The names of U.S. shareholders.
- GAAP income statement and balance sheet.
- An accounting of foreign taxes accrued and paid.
- Current and accumulated earnings and profits, including any actual dividend distributions during the corporation's taxable year.
- An accounting of each U.S. shareholder's pro rata share of GILTI and Subpart F income.

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- Disclosure of any transactions between the foreign corporation and its shareholders or related persons.

The Form 5471 is ordinarily attached to a U.S. person's federal income tax return.[2]

The penalty for failure to file, or for delinquent, incomplete, or materially incorrect filing is a reduction of foreign tax credits by 10% and a penalty of $10,000, as well as a reduction in the taxpayer's foreign tax credit.[3] An additional $10,000 continuation penalty may be assessed for each 30-day period that noncompliance continues up to $60,000 per return, per year.

Similarly, Section 6038A requires 25% foreign-owned domestic corporations and limited liability companies to report specified information as an attachment to a corporate tax return. This is done on Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business.

In filing a Form 5472, the filer must provide information regarding its foreign shareholders, certain other related parties, and the dollar amounts of transactions that it entered into during the taxable year with foreign related parties. A separate Form 5472 is filed for each foreign or domestic related party with which the reporting entity engaged in reportable transactions during the year.[4] The practical importance of the Form 5472 is that the IRS often uses this form as a starting point for beginning transfer pricing audits.[5]

Any reporting corporation or limited liability company that fails to file Form 5472 may be subject to a penalty of $25,000.[6] If the failure continues for more than 90 days after notification by the IRS, there is an additional penalty of $25,000 for each 30-day period or fraction. There is no upper limit on this penalty.

Another well-known provision in Chapter 61 is Section 6039F. Section 1905 of the 1996 Tax Act created new reporting requirements under Section 6039F for U.S. persons (other than certain exempt organizations) that receive large gifts (including bequests) from foreign persons. The information reporting provisions require U.S. donees to provide information concerning the receipt of large amounts that the donees treat as foreign gifts, giving the IRS an opportunity to review the characterization of these payments and determine whether they are properly treated as gifts. Donees are currently required to report certain information about such foreign gifts on Part IV of Form 3520.

Section 6039F(b) generally defines the term "foreign gift" as any amount received from a person other than a U.S. person that the recipient treats as a gift or bequest. However, a foreign gift does not include a qualified transfer (within the meaning of Section 2503(e)(2)) or any distribution from a foreign trust. A distribution from a foreign trust must be reported as a distribution under Section 6048(c) (discussed below) and not as a gift under Section 6039F.

Section 6039F(c) provides that if a U.S. person fails, without reasonable cause, to report a foreign gift as required by Section 6039F, then (1) the tax consequences of the receipt of the gift will be determined by the Secretary and (2) the U.S. person will be subject to a penalty equal to 5% of the amount for the gift for each month the failure to report the foreign gift continues, with the total penalty not to exceed 25% of such amount.

Under Sections 6039F(a) and (b), reporting is required for aggregate foreign gifts in excess of $100,000 during a taxable year.[7] Once the $100,000 threshold has been met, the U.S. donee is required to file a Form 3520 with the IRS.

Originally, penalties associated with Form 5471, Form 5472, and Form 3520 (hereinafter "international penalties") were assessed manually on individuals and entities whose missing filings were discovered during an audit. The IRS is still assessing international penalties during audits.

Several years ago the IRS began a systemic assessment of international penalties associated with the late filing of these returns. The systemic assessment of international penalties is controversial. Many taxpayers are unaware of their international reporting obligations and learn of their filing obligations after the due date of the filing obligation has already passed.

Many of these same taxpayers often try to comply with their international filing obligations by filing an international informational return (i.e. Form 5471, Form 5472, and Form 3520) late. The IRS typically rewards these same taxpayers "trying to do the right thing" by automatically assessing international penalties against them. These penalties can range from a minimum of $10,000 to several million dollars.

The policy of automatically assessing international penalties discourages compliance. Not only does the summary assessment proce-

dure for international penalties discourage compliance, for reasons discussed below, the summary assessment and collection of international penalties probably exceeds the IRS's statutory authority.

Does the IRS have the legal authority to assess and collect international penalties?

The IRS treats international penalties as summarily assessable, as they are not subject to deficiency procedures, wherein taxpayers receive a notice of deficiency alerting them of the potential assessment and explaining the taxpayer's options for contesting or complying with the penalty assessment. The notice of deficiency also informs taxpayers of the last day to petition the Tax Court for pre-assessment and prepayment judicial review.

Many penalties related to income tax filings are not summarily assessable (that is, they are generally subject to deficiency procedures). For example, deficiency procedures typically apply when the IRS determines noncompliance of a taxpayer resulted in an underpayment of some type of tax. Common penalties associated with the issuance of a notice of deficiency include an accuracy or negligence penalty under Section 6662. In other words, typically the IRS is required to issue a taxpayer a notice of deficiency and permit the taxpayer the ability to challenge an assessment before initiating collection actions.

Summarily assessable penalties are primarily found in Section 6671 through 6720C. Chapter 68, Subchapter B, titled "Assessable Penalties," authorizes the IRS to assess and collect penalties "in the same manner as taxes" without first sending a notice of deficiency.[8] Summary assessments are made without the issuance of a notice of deficiency and "shall be paid upon notice and demand and collected in the same manner as taxes." Most of these "penalties" are included in Chapter 68 of the Internal Revenue Code. Chapter 68, Subchapter A, titled "Additions to the Tax and Additional Amounts," allows the IRS to impose penalties for failure to file or pay tax, understatements or underpayments of tax, and penalties for fraud. However, Chapter 61 penalties are not located in Chapter 68 of the Internal Revenue Code and are not therefore assessable penalties.

The IRS believes it has a grant of authority to assess international penalties under Section 6201(a). This provision of the Internal Revenue Code permits the IRS to assess tax as well as interest and penalties. In *NFIB v. Sebelius*,[9] the U.S. Supreme Court agreed that the plain language of Section 6201 places assessable penalties within the definition of a tax for purposes of granting the IRS the authority to assess those penalties. As a result, the IRS has taken the position that *NFIB v. Sebelius* authorized it to summarily assess and collect international penalties found in Chapter 61 of the Internal Revenue Code without the issuance of a notice of deficiency.

This interpretation is overbroad and misplaced. The IRS's ability to assess a penalty and collect an assessment are two distinct matters.[10] Section 6201 authorizes the collection of assessable penalties found in Chapter 68, Subchapter B. Section 6201 does not provide the IRS with the authority to assess and collect international penalties authorized in Chapter 61 of the Internal Revenue Code. The IRS also does not have the authority to assess or collect international penalties found in Chapter 61 of the Internal Revenue Code because these penalties cannot be classified as a tax. Since international penalties cannot be characterized as a tax, these penalties cannot be assessed or collected in the same way as a tax.[11]

This not only means that the IRS does not have the authority to collect international penal-

[1] *See* Reg. 1.6038-2(f) and (g).

[2] Reg. 1.6038-2(i).

[3] Sections 6038(b) and (c).

[4] Reg. 1.6038A-2(a).

[5] *See* Internal Revenue Manual, International Audit Guidelines Handbook, 4/1/2002, 4.61.3.

[6] Section 6038A(d); Reg. 1.6038A-4(a).

[7] *See* VI.B.1 of Notice 97-34.

[8] Chapter 68, Subchapter B authorizes penalties under Sections 6677 through 6725. An example of a penalty found under Chapter 68, Subchapter B is Section 6677. Section 6677 authorizes the IRS to impose an initial penalty of $10,000 on persons who fail to report information with respect to certain foreign trusts.

[9] *NFIB v. Sebelius,* 567 U.S. 519, 546 (2012),

[10] *See* Erin Collins and Garrett Hahn, *Foreign Information Reporting Penalties: Assessable or Not?* Tax Notes Today (7/9/2018) 211-213.

[11] *See* Robert Horwitz, *Can the IRS Assess or Collect Foreign Information Reporting Penalties?* Tax Notes Today (1/31/2019) 301-305.

[12] Id.

[13] *See* Frank Agostino and Phillip Colasanto, *The IRS's Illegal Assessment of International Penalties,* Tax Notes Today (4/8/2019) 261-269.

[14] Tax Court *Docket No. 10647-21L.*

ties found in Chapter 61; the IRS does not have the authority to file corresponding liens or levies in connection with an international penalty assessment. This also means that the collection due process procedures in connection with an international penalty assessment are not valid.[12]

It appears that the IRS's only recourse to collect an international penalty residing with Chapter 61 would be to ask the Department of Justice to sue the individual or entity assessed an internal penalty. This would involve bringing suit in a United States district court with proper venue and asking the court to liquidate the penalty assessment into a judgment.

Should taxpayers assessed international penalties be subject to the deficiency procedures that would allow a prepayment judicial review?

As indicated above, the IRS has no direct legal means of assessing and collecting an international penalty assessment originating with Chapter 61. Even if somehow the IRS has the legal authority to assess and collect an international penalty listed in Chapter 61, at least some of these international penalties are not the type the Internal Revenue Code permits to be systemically imposed.

A number of legal commentators, such as Frank Agostino and Phillip Colasanto, suggest that international penalties assessed under Sections 6038 and 6038A (penalties for failing to timely file Forms 5471 and 5472) should be subject to the safeguards of the deficiency procedures.[13] It should be noted that Forms 5471 and 5472 are attached to a federal tax return. Since Forms 5471 and 5472 are attached to a federal income tax return, the safeguards of the deficiency protections that cover a tax return should also apply to any attached international information return such as a Form 5471 or Form 5472.

Conclusion

The summary assessment of international penalties is a huge burden on taxpayers and discourages compliance. The IRS's policy of systematically assessing and collecting international penalties also invites costly litigation which needlessly diverts precious IRS resources. Such litigation has already commenced in *Farhy*[14] before the Tax Court. The sole legal issue in *Farhy* is whether the IRS has the legal authority to assess and collect a penalty under Section 6038 for failing to timely file Form 5471s. The Tax Court has yet to issue an opinion on this matter.

Before the IRS spends more valuable resources litigating these types of cases, it should cease its policy of treating international penalties as assessable and instead establish a more effective system to promote international filing compliance.

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THOMAS M DALTON, BARBARA LOUGEE, AND LOREN MARGHEIM

Real estate partnership losses face a maze of limitations before earning a place on the partners' individual tax returns. Planning is required to overcome these hurdles.

Over the years, Congress has created a formidable gauntlet for taxpayers who seek to deduct tax losses through real estate partnerships. Independently enacted barriers prevent investors from utilizing sought after tax benefits through a web of Code and regulatory provisions. For the unwary, this web is laden with traps, dead ends, and obscure limitations. The purpose of this article is to present a logical path through this maze by identifying the major hurdles, the order in which these hurdles must be navigated, and planning tips for a successful journey to the deduction of real estate partnership losses.

Partnerships and limited liability companies (LLCs) are uniquely adapted to real estate tax shelters and in most (but not all) situations are treated the same. Allocation of profits and losses are flexible, and the tax consequences of formation and liquidation are less severe than for corporations. For these reasons, limited partnerships and LLCs have been an attractive investment vehicle. We will use the following straightforward example to illustrate the major tax issues of owning real estate within a partnership or LLC.

Example

Able and Baker form a limited partnership for the purposes of purchasing and operating a commercial real estate building. Able, a general partner, contributes $10,000 cash and Baker, a limited partner, contributes $90,000 cash to the partnership. They agree that Able has a 10% profit and loss interest and Baker has a 90% profit and loss interest. The partnership purchases a rental building for $1 million using $100,000 cash and a $900,000 nonrecourse, interest only mortgage. For simplicity, assume the building depreciates straight-line over 10 years for both tax and book purposes. Also, for simplicity, assume that cash revenues and cash expenses are exactly equal during the first six years, creating a loss of $100,000 each year from the depreciation expense.

IRC Section 704(a) is the starting point for this discussion. It authorizes partners to allocate these losses as they wish through the partnership agreement. This freedom is illusory, however, because the hurdles can be very substantial. These hurdles confront the taxpayer in the following order.

Hurdle 1 – substantial economic effect. IRC Section 704(b) requires the partnership alloca-

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tions to have "substantial economic effect." Without substantial economic effect, allocations must be made according to the partners' "interests in the partnership" as determined by the IRS. In our example the IRS may conclude that Able and Baker's interests in the partnership are indeed 10/90 as the partners wish — but maybe not. If substantial economic effect is not present, the IRS will reallocate losses according to the IRS's opinion of the partners' true interests in the partnership. Partnerships typically create special allocations of losses for investors, which may not be respected if the partnership agreement does not have substantial economic effect.

To have economic effect, Section 704(b) requires that the partnership agreement must: (1) require economic capital accounts for each partner, (2) provide that liquidating distributions are made according to the economic capital accounts, and (3) require each negative economic capital account be restored by the partner upon liquidation. The third requirement destroys all limited partners' and LLC owners' incentives to participate in the partnership because the requirement removes the limited liability feature.

In other words, if the partnership defaults on debts (other than nonrecourse debt), the lender will come after the partnership assets. Since the partners are required to restore their negative economic capital accounts, the lender can collect from the limited partners (or LLC owners) to the extent of the limited partners' negative capital accounts.

In our example, assume five years have passed and that the partnership borrowed $100,000 cash (recourse). Depreciation expense of $500,000 has been allocated to the two partners according to the partnership agreement. After five years the balance sheet is as set forth in Exhibit 1.

Able is a general partner and understands the risk of a failed investment. But imagine Baker's shock as a limited partner when he realizes that he is legally required to pay back the $360,000 negative economic capital account. The mortgage may be nonrecourse, but the partnership has other liabilities and might even incur more. Baker is now required to cover debts up to the amount of his negative capital account. This was never the general intent of limited liability within LLCs or limited partnerships.

The answer to Baker's situation is found in the Section 704(b) regulations. The regulations indicate that Baker is excused from the negative capital account restoration requirement as long as the partnership agreement allocates enough minimum gain created by the nonrecourse debt to him. The potential gain (nonrecourse debt in excess of the property basis) is essentially a substitute for a negative capital account payback requirement. Baker might eventually be obliged to pay tax on the negative capital account if the real estate market collapses and the partnership liquidates, but he will not be required to restore it with cash.

The point is, if the partnership agreement does not have magic language that creates substantial economic effect (or the minimum gain alternative to negative capital account restoration), the loss allocations might be invalid and Baker might not receive the benefit of his 90% loss allocation. In our example, let us assume that the partnership agreement does, in fact, meet the Section 704(b) requirements and the partners can move on to the next hurdle.

Planning. The partnership should hire a competent attorney with partnership experience to draft the partnership agreement and include language that satisfies the Section 704(b) substantial economic effect requirements. The partnership should also hire a competent tax advisor familiar with the Section 704(b) requirements to ensure that the partnership remains in compliance with the substantial economic effect requirements.

Hurdle 2 – various expense and loss limitations. There are a variety of specific expense and loss limitations in the IRC. For example, the deduction after netting capital losses with capital gains is capped at $3,000 each year. IRC Section 179 expense and future bonus depreciation are also limited. Charitable contributions are limited by adjusted gross income. Some of these limitations apply at the partnership level and some apply at the partner level. But partners do not escape the standard limitations by virtue of being partners. Any of these limitations can inhibit the deductibility of losses by a partner.

Planning: The tax advisor must be familiar with current tax provisions that limit deductibility of specific expenses.

Hurdle 3 – basis limitation. IRC Section 704(d) limits partner loss deductibility to the amount of the partner's tax basis in the partnership. A partner's tax basis in the partnership is the sum of a partner's previously taxed capital invested in the partnership plus the partner's share of partnership liabilities.

In many cases, a partner's previously taxed capital invested in the partnership is represented by the partner's tax basis capital account. This account represents the contributed tax basis of property, plus the partner's share of profits, less the partner's share of losses, less distributions to the partner. But this is not always the case. For example, a partner may have acquired the partnership interest by purchase from another partner. Without a Section 754 election, the new partner's outside (or true) investment in the partnership may not equal the inside investment (tax basis capital account).

In Year 6 of our example, assume that the tax basis capital account represents each partner's previously taxed capital invested in the partnership. Able is allocated a $10,000 loss and Baker is allocated a $90,000 loss.

Able's tax basis before considering the Year 6 loss is:

Previously taxed capital (tax basis capital account)	(40,000)
Share of partnership nonrecourse liabilities	90,000
Share of partnership recourse liabilities	100,000
Able's tax basis in the partnership before the Year 6 loss	150,000

Baker's tax basis before considering the Year 6 loss is:

Previously tax capital (tax basis capital account)	(360,000)
Share of partnership nonrecourse liabilities	810,000
Share of partnership recourse liabilities	0
Baker's tax basis in the partnership before the Year 6 loss	450,000

Neither Able nor Baker is limited by tax basis when deducting the partnership loss in Year 6, and the losses continue on to the next hurdle. Limited losses, if any, are carried forward indefinitely until sufficient tax basis exists to allow deductibility.

Planning: There are a number of ways to increase tax basis in a partnership. Property with tax basis can be contributed to the partnership by a partner. The partnership can increase liabilities, which can be allocated to partners. Special allocations of income items can be made to specific partners who lack sufficient tax basis to deduct losses. Partners can personally guarantee debt, effectively turning nonrecourse debt into recourse debt.

Hurdle 4 –"at risk" limitation. IRC Section 465 limits partner loss deductibility to the amount a partner has "at-risk" in a business activity. The calculation of a partner's at-risk amount is similar to the tax basis calculation, except that nonrecourse liabilities are generally not included.

In our example, the partner losses have successfully survived the first three hurdles. However, nonrecourse liabilities now create a problem. Without some foresight regarding liabilities, the partners' at-risk amounts before considering the Year 6 loss are as follows:

Able's at-risk amount before considering the Year 6 loss is:

Previously taxed capital	(40,000)
Share of partnership recourse liabilities	100,000
Able's at-risk amount in the partnership before the Year 6 loss	60,000

Baker's at-risk before considering the loss is:

Previously taxed capital	(360,000)
Share of partnership recourse liabilities	0
Baker's at-risk amount in the partnership before the Year 6 loss	(360,000)

Able has sufficient at-risk to allow his $10,000 loss to move on to the next hurdle. However, Baker does not. Further, Baker's outside tax basis in the partnership is still reduced by the loss, which is why the basis limitation is calculated before the at-risk limitation. Limited losses, if any, are carried forward indefinitely until at-risk is sufficient to allow deductibility.

Planning: Fortunately, the at-risk provisions contain an exception for "qualified nonrecourse financing." Qualified nonrecourse financing is debt from a qualified lender, secured to the property for which no person is personally liable. A qualified lender is generally a commercial lender. The debt cannot be seller or promoter financed. The debt cannot be from a related party (unless the related party is a regular money lender and the loan is on the same terms and interest rate as for other nonrelated parties).

If the partnership's nonrecourse debt is qualified nonrecourse financing, the nonrecourse mortgage is counted toward at-risk the same as in the tax basis calculations. Assuming that Able and Baker's mortgage qualifies as

EXHIBIT 1
Balance Sheet

Account	Tax basis balance sheet	Section 704(b) economic balance sheet
Cash	100,000	100,000
Building	1,000,000	1,000,000
Accumulated depreciation	(500,000)	(500,000)
Total assets	600,000	600,000
Recourse liability	100,000	100,000
Nonrecourse mortgage	900,000	900,000
Capital Able	(40,000)	(40,000)
Capital Baker	(360,000)	(360,000)
Total liability and equity	600,000	600,00

qualified nonrecourse financing, their partnership losses move on to the next hurdle.

Hurdle 5 – passive loss limitations. IRC Section 469 generally defines rental profits and losses as passive for purposes of the passive loss limitations. Passive losses can only be deducted against passive income. There is a $25,000 exception for actively managed rental property that is at least 10% owned, but the exception phases out as the taxpayer's modified adjusted gross income exceeds $100,000 (fully phased out at $150,000).

Assuming that there are no suspicious motives (tax avoidance or substance over form issues), this is the IRC's last line of defense against partnership real estate loss deductibility. To survive this hurdle, the partner must balance passive income from other sources against the partnership rental losses.

For example, if Able has only $4,000 of income from passive sources, he can only deduct $4,000 of his $10,000 partnership loss. The same applies to Baker as a limited partner.

Planning: Taxpayers must carefully plan to balance passive losses against passive income. Unused passive losses do not disappear, but instead are carried forward until enough passive income is available for loss deductions. Taxpayers who can qualify as a real estate professional avoid the passive loss limitations as long as they materially participate.

Under Temp. Reg. 1.469-5T(e)(2) either partner in our example might qualify as materially participating in the partnership rental activity if they pass test 1, 5, or 6 of the seven material participation tests outlined in Temp. Reg. 1.469-5T(a). Further, if Able and Baker qualify as real estate professionals, the passive losses are fully deductible regardless of their passive income from other sources.

Conclusion

Real estate partnership losses face a maze of limitations before earning a place on the partners' individual tax returns. Tax practitioners must plan well in advance to overcome these hurdles. These hurdles begin with the partnership agreement itself, and end with the passive loss limitations applied on the taxpayer's individual return. Tax practitioners can provide a valuable service to their clients by clearly explaining real estate partnership loss limitations and the steps necessary to avoid them.

ACCOUNTING

The IRS has provided guidance under the Inflation Reduction Act to establish a program to allocate credits for qualified investments in eligible qualifying advanced energy projects under Code Section 48C(e). (Notice 2023-18, 2023-10 IRB 508; IR 2023-27 (2/13/2023))

Notice 2023-18 establishes a Section 48C(e) program to allocate $10 billion in credits ($4 billion of which may only be allocated to projects located in certain energy communities census tracts). The notice also provides initial program guidance.

The IRS anticipates allocating $4 billion of Section 48C credits in the first allocation round, with approximately $1.6 billion of these credits to be allocated to projects located in certain energy communities. The IRS will allocate the remaining credits in future allocation rounds.

The notice also provides the general rules for determining the Section 48C credit, definitions of qualifying advanced energy projects, and the procedures for allocating the credits.

The IRS plans to issue additional guidance to provide more details regarding information applicants will be required to submit to request a credit allocation.

The IRS has provided guidance to establish a program to provide solar and wind power to certain low-income areas under Section 48(e), which was added by the Inflation Reduction Act. (Notice 2023-17, 2023-10 IRB 505; IR 2023-26 (2/13/2023))

Notice 2023-17 establishes the Low-Income Communities Bonus Credit Program and provides initial guidance for potential applicants for allocations of calendar year 2023 capacity limitation.

The initial guidance provides the general eligibility requirements, a description of the four statutory facility categories for which an eligible facility may request an allocation, amounts of capacity limitation reserved for each facility category, a general description of the program design and goals, the application review process, and the proposed timeline for opening two 60-day application periods in 2023 based on project categories.

The guidance applies to owners of certain solar and wind facilities placed in service in connection with low-income communities that are eligible for the Section 48 energy investment credit.

The IRS plans to issue additional program guidance outlining specific application procedures, applicable definitions, and other information necessary to submit an application.

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PROCEDURE

The IRS has modified the lookback period for refund claims on returns with due dates that were postponed due to Covid-19 in Notice 2021-21 or Notice 2020-23. (Notice 2023-21, 2023-11 IRB 563)

In response to the Covid-19 pandemic, the IRS used its disaster relief authority to postpone certain return filing due dates for tax years 2019 and 2020. However, when postponing these due dates, the IRS failed to extend the lookback period for refunds claimed on returns filed after April 15. Generally, a taxpayer's claim for refund must be filed by the later of three years from the date the taxpayer filed the return to which the claim relates or two years from the date the tax to which the claim relates was paid. This is referred to as the "lookback rule." A taxpayer can only get a refund of amounts paid within the lookback period.

Since the IRS did not extend the lookback period some taxpayer payments, including estimated and withheld taxes deemed paid on April 15, fell outside the lookback period for taxpayers who did not file by April 15. This meant that taxpayers who filed a timely refund claim could not be refunded those payments.

This problem was identified by the National Taxpayer Advocate (NTA). The NTA noted that both Notice 2020-23 and Notice 2021-21 only postpone the deadline for filing returns; they did not extend the time for filing for purposes of the lookback rule. Therefore, taxpayers would normally only have until 4/18/2023 to receive a refund of taxes withheld on wages for 2019, which is less than three years from the date they filed their return if they took advantage of the postponement for filing their return.

Similarly, if a taxpayer filed a 2020 return on 5/17/2021, pursuant to Notice 2021-21, the taxpayer could file a timely claim for refund by 5/17/2024; but if the taxpayer did so, the taxpayer would not get a refund of the withholding deemed paid on 4/15/2021, as the withholding would be outside the lookback period.

The IRS has now fixed this problem by issuing new guidance. This new guidance, found in Notice 2023-21, disregards the periods from 4/15/2020 to 7/15/2020 (for 2019 returns), and from 4/15/2021 to 5/17/2021 (for 2020 returns), when determining the beginning of the lookback period. Now both lookback periods align with the postponed return filing due dates for those years.

The IRS has issued final regulations amending the rules for filing returns and other documents electronically (e-file). These regulations will require certain filers to e-file beginning in 2024. (TD 9972; IR 2023-31, 2/21/2023)

TD 9972 affects filers of partnership returns, corporate income tax returns, unrelated business income tax returns, withholding tax returns, certain information returns, registration statements, disclosure statements, notifications, actuarial reports, and certain excise tax returns. The final regulations reflect changes made by the Taxpayer First Act to increase e-filing without undue hardship on taxpayers.

Specifically, the final regulations:

- Reduce the 250-return threshold enacted in prior regulations to generally require electronic filing by filers of 10 or more returns in a calendar year. The final regulations also create several new reg-

ulations to require e-filing of certain returns and other documents not previously required to be e-filed.

- Require filers to aggregate almost all information return types covered by the regulations to determine whether a filer meets the 10-return threshold and is required to e-file their information returns. Earlier regulations applied the 250-return threshold separately to each type of information return covered by the regulations.
- Eliminate the e-filing exception for income tax returns of corporations that report total assets under $10 million at the end of their taxable year.
- Require partnerships with more than 100 partners to e-file information returns. Partnerships that are required to file at least 10 returns of any type during the calendar year must e-file their partnership return.

To help with this process, the IRS has created a new, free online portal to help businesses file Form 1099 series information returns electronically. Known as the Information Returns Intake System (IRIS), this free electronic filing service, according to the IRS, is secure, accurate, and requires no special software.

The final regulations generally provide hardship waivers for filers that would experience hardship in complying with the e-filing requirements, and administrative exemptions from the e-filing requirements to promote effective and efficient tax administration.

In *Thomas, 160 TC No. 4 (2023),* the Tax Court allowed the IRS to introduce a taxpayer's personal blogs into evidence in the middle of a dispute, holding that the blogs were newly discovered evidence under Section 6015(e)(7)(B).

A taxpayer and her spouse filed joint federal income tax returns for 2012, 2013, and 2014, but did not pay the full amounts of tax shown on those returns. After the husband's death, the taxpayer sought relief from joint and several liability pursuant to Section 6015(f). The IRS denied her request, and she petitioned the Tax Court seeking a determination under Section 6015(e).

At trial, the IRS proposed to introduce into evidence certain posts from the taxpayer's personal blog that were relevant to the ultimate disposition of the case. The posts were not part of the administrative record; the IRS learned of them only after the taxpayer filed her petition. The taxpayer objected to the admission of the posts on the ground that they were not "newly discovered or previously unavailable evidence" as contemplated by Section 6015(e)(7)(B).

The Tax Court, denying the taxpayer's motion, held that the posts were "newly discovered" evidence within the meaning of Section 6015(e)(7)(B) and as such were properly admitted.

CORPORATIONS

Notice 2023-20, 2023-10 IRB 523, provides additional interim guidance (described in section 1 of Notice 2023-7, 2023-3 I.R.B. 390) that is intended to help avoid substantial unintended adverse consequences to the insurance industry from the application of the new corporate alternative minimum tax (CAMT), as added to the Internal Revenue Code by the Inflation Reduction Act of 2022.

In addition to announcing that Treasury and the IRS intend to issue proposed regulations addressing the application of the CAMT, sections 3 through 7 of Notice 2023-7 provided interim guidance regarding certain time-sensitive CAMT issues that taxpayers may rely on until the issuance of the forthcoming proposed regulations. Notice 2023-7 also stated that Treasury and the IRS intended to issue additional interim guidance expected to address, among other issues, certain issues related to the treatment under the CAMT of life insurance company separate account assets that are marked to market for financial statement purposes, the treatment of certain items reported in other comprehensive income (OCI), and the treatment of embedded derivatives arising from certain reinsurance contracts.

Sections 3 through 5 of Notice 2023-20 provide additional interim guidance regarding these and other issues intended to be addressed by the proposed regulations. Taxpayers may rely on the guidance provided in sections 3 through 5 of Notice 2023-20 until the issuance of the proposed regulations.

Section 2 of Notice 2023-20 provides a summary of relevant law and other information underlying the rules described in sections 3 through 5 of Notice 2023-20. Section 3 of Notice 2023-20 describes rules that address certain CAMT issues regarding variable contracts and similar contracts. Section 4 of Notice 2023-20 describes rules that address certain CAMT issues regarding funds withheld reinsurance and modified coinsurance agreements.

Section 5 of Notice 2023-20 describes rules that address certain issues that arise under the CAMT for certain formerly tax-exempt entities whose exemption from federal income taxation was repealed by statute and as to which Congress provided special rules for determining the federal income tax basis in their assets held when the repeal of their exemption became effective. Section 6 of Notice 2023-20 describes the anticipated applicability dates of the forthcoming proposed regulations. Section 7 of Notice 2023-20 requests comments on the issues addressed in the notice.

INTERNATIONAL

In *Bittner*, 131 AFTR2d 2023-799 (S Ct 2023), the U.S. Supreme Court held that the $10,000 maximum penalty for the non-willful failure to file an FBAR accrues on a per-FBAR basis, not a per-account basis.

A U.S. person must report all foreign bank accounts if the aggregate value of those accounts exceeds $10,000 anytime during a calendar year. The accounts are reported on FinCEN Form 114, Report of Foreign Bank and Financial Accounts, also known as an FBAR.

A person who fails to report a reportable account on an FBAR may be subject to a penalty. The amount of the penalty depends on whether the violation was willful or non-willful. The maximum penalty for a non-willful violation of the reporting requirements is $10,000 (adjusted for inflation for violations after 2015).

The Ninth Circuit has held that the $10,000 non-willful failure to file an FBAR penalty applies per FBAR, not per financial account (e.g., bank accounts) required to be reported on the form. The Fifth Circuit has held that the penalty applies per account not reported.

The Supreme Court, reversing a Fifth Circuit opinion, held that the non-willful penalty rules of the Bank Secrecy Act treat the failure to file a legally compliant report as one violation carrying a maximum penalty of $10,000, not a cascade of such penalties calculated on a per-account basis.

PERSONAL

The IRS has provided details clarifying the federal tax status of special payments made by 21 states in 2022. (IR 2023-23, 2/13/2023) The IRS determined that in the interest of sound tax administration and other factors, taxpayers in many states will not need to report these payments on their 2022 tax returns.

The IRS announced that it will not challenge the taxability of payments related to general welfare and disaster relief. This means that people in the following states do not need to report these state payments on their 2022 tax return: California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Maine, New Jersey, New Mexico, New York, Oregon, Pennsylvania, and Rhode Island. Alaska is in this group as well, subject to special rules.

In addition, many people in Georgia, Massachusetts, South Carolina, and Virginia also will not include state payments in income for federal tax purposes if they meet certain requirements. For these individuals, state payments will not be included for federal tax purposes if the payment is a refund of state taxes paid and either the recipient claimed the standard deduction or itemized their deductions but did not receive a tax benefit.

The IRS stated that it is aware of questions involving special tax refunds or payments made by certain states related to the pandemic and its associated consequences in 2022. A variety of state programs distributed these payments in 2022, and the rules surrounding their treatment for federal income tax purposes are complex. While in general payments made by states are includable in income for federal tax purposes, there are exceptions that would apply to many of the payments made by states in 2022.

Refund of state taxes paid. If the payment is a refund of state taxes paid and either the recipient claimed the standard deduction or itemized deductions but did not receive a tax benefit (for example, because the $10,000 tax deduction limit applied), the payment is not included in income for federal tax purposes.

Payments from the following states in 2022 fall in this category and will be excluded from income for federal tax purposes unless the recipient received a tax benefit in the year the taxes were deducted: Georgia; Massachusetts; South Carolina; and Virginia.

General welfare and disaster relief payments. If a payment is made for the promotion of the general welfare or as a disaster relief payment — for example, related to the pandemic — it may be excludable from income for federal tax purposes under the General Welfare Doctrine or as a Qualified Disaster Relief Payment. The IRS emphasized that determining whether payments qualify for these exceptions is a complex fact-intensive inquiry that depends on a number of considerations.

The IRS has reviewed the types of payments made by various states in 2022 that may fall in these categories. The IRS stated that if a taxpayer does not include the amount of one of these payments in its 2022 income for federal income tax purposes, the IRS will not challenge the treatment of the 2022 payment as excludable from income on an original or amended return.

Payments from the following states fall in this category, and the IRS will not challenge the treatment of these payments as excludable for federal income tax purposes in 2022: Alaska (only for the supplemental Energy Relief Payment received in addition to the annual Permanent Fund Dividend); California; Colorado; Connecticut;

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Delaware; Florida; Hawaii; Idaho; Illinois; Indiana; Maine; New Jersey; New Mexico; New York; Oregon; Pennsylvania; and Rhode Island.

Other payments. Other payments that may have been made by states are generally includable in income for federal income tax purposes. This includes the annual payment of Alaska's Permanent Fund Dividend and any payments from states provided as compensation to workers.

COMPENSATION AND BENEFITS

The IRS has issued proposed regulations that would provide rules relating to the use of forfeitures in qualified retirement plans, including a deadline for the use of forfeitures in defined contribution plans. (REG-122286-18, 2/27/2023)

The proposed regulations would clarify that forfeitures arising in any defined contribution plan (including in a money purchase pension plan) may be used for one or more of the following purposes, as specified in the plan: (1) to pay plan administrative expenses; (2) to reduce employer contributions under the plan; or (3) to increase benefits in other participants' accounts in accordance with plan terms.

The use of forfeitures to reduce employer contributions includes the restoration of inadvertent benefit overpayments and the restoration of conditionally forfeited participant accounts that might otherwise require additional employer contributions — for example, the restoration of accounts conditionally forfeited under Reg 1.411(a)-7(d) (relating to certain distributions and cash-outs of accrued benefits).

The proposed regulations would generally require that plan administrators use forfeitures no later than 12 months after the close of the plan year in which the forfeitures are incurred. The proposed regulations would not affect generally applicable deadlines related to the timing of contributions and allocations under a plan, such as the deadline for correcting excess contributions to avoid excise taxes under Section 4979 as set forth in Reg. 1.401(k)-2(b)(5)(i).

The proposed regulations provide a transition rule related to the 12-month deadline. Under this rule, forfeitures incurred during any plan year that begins before 1/1/2024 are treated as having been incurred in the first plan year that begins on or after 1/1/2024; accordingly, those forfeitures must be used no later than 12 months after the end of that first plan year.

Although nothing in the proposed regulations would preclude a plan document from specifying only one use for forfeitures, the plan may fail operationally if forfeitures in a given year exceed the amount that may be used for that one purpose. For example, if (1) a plan provides that forfeitures may be used solely to offset plan administrative expenses, (2) plan participants incur $25,000 of forfeitures in a plan year, and (3) the plan incurs only $10,000 in plan administrative expenses before the end of the 12-month period following the end of that plan year, there will be $15,000 of forfeitures that remain unused after the deadline established in these proposed regulations. Thus, the plan would incur an operational qualification failure because forfeitures remain unused at the end of the 12-month period following the end of that plan year. The plan could avoid this failure if it were amended to permit forfeitures to be used for more than one purpose.

Use of forfeitures in defined benefit plans. The proposed regulations would update rules relating to the use of forfeitures in defined benefit plans to reflect the enactment, after the issuance of Reg. 1.401-7, of new minimum funding requirements applicable to defined benefit plans. In addition, the requirement in existing Reg. 1.401-7(a) that forfeitures under pension plans be used as soon as possible to reduce employer contributions would be eliminated because it is inconsistent with those minimum funding requirements.

The minimum funding requirements of Sections 412, 430, 431, and 433 do not allow the use of forfeitures to reduce required employer contributions to a defined benefit plan in the manner contemplated by existing Reg. 1.401-7. Instead, reasonable actuarial assumptions are used to determine the effect of expected forfeitures on

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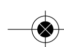
the present value of plan liabilities under the plan's funding method. Differences between actual forfeitures and expected forfeitures will increase or decrease the plan's minimum funding requirement for future years pursuant to the plan's funding method.

Proposed applicability date. The proposed regulations are proposed to apply for plan years beginning on or after 1/1/2024. Thus, for example, the deadline for the use of defined contribution plan forfeitures incurred in a plan year beginning during 2024 will be 12 months after the end of that plan year. Taxpayers, however, may rely on these proposed regulations for periods preceding the applicability date.



IRS EXAMINATION QUESTIONS

ISRAEL BLUMENFRUCHT

Rental property: basis for depreciation

Several years ago, you paid $150,000 to build your home on a lot that cost you $50,000. Before converting the property to rental use last year, you paid $30,000 for permanent improvements to the house. You received a $5,000 easement payment from the State of California for use of the land for a power line. The county indicates the fair market value (FMV) of the house is $250,000 and the land is $100,000. What is your basis for depreciation?

1. $150,000
2. $175,000
3. $180,000
4. $250,000

Solution: The correct choice is "c."

When property is converted from personal use to business or investment use, the Regulations provide a limitation on the depreciation deduction (Reg. 1.167(g)-1). If the property has declined in value since it was acquired, the Regulations prevent the taxpayer from claiming higher depreciation deductions based upon the original purchase price; on the other hand, in the case of appreciated property, taxpayers are prevented from using the higher fair market value as the depreciable basis. Specifically, the Regulations require that the taxpayer determine the basis for depreciation for such property as the lower of: (1) the adjusted basis of the property on the date of the conversion, or (2) the fair market value of the property on the date of the conversion.

With respect to determining the adjusted basis of the property, the taxpayer may increase the original cost basis of the property by any permanent capital improvements, local property assessments for water, sidewalks, and roads, legal fees for defending and perfecting the title, and zoning costs. The original cost basis of the property must be decreased by any depreciation deductions allowed, such as for using the property as a home office and insurance proceeds received for casualty losses.

The basis of the land is also decreased by any amounts received for granting an easement, as was the case in this problem, because it is treated as a sale of an interest in the property. If the amount received for the easement is more than the basis of the land, the basis is reduced to zero and the excess is recognized as a gain (IRS Publication 551).

Accordingly, the adjusted basis of the home that the taxpayer converted to rental property in this problem is equal to the $150,000 paid to build the home, increased by the $30,000 of permanent capital improvements for a total adjusted basis of $180,000. The $5,000 easement payment received from the State of California for use of the land for a power line reduces the basis of the land to $45,000 ($50,000 – 5,000) and does not affect the depreciable basis of the home. Since the county indicates that the fair market value of the house on the date of conversion is $250,000, the depreciable basis of the converted property is the lower $180,000 adjusted basis of the property. Obviously, the amount allocated to the land is not considered in determining the basis for depreciation since land is not depreciable.

Taxation of Social Security benefits

Gordon, age 70, is retired and works part-time as a security guard earning $8,000. He received $5,000 interest from a saving account and $2,500 interest from tax-exempt municipal bonds. His Social Security benefits were $12,000 and his taxable pension was $6,000. To determine if any of his Social Security is taxable, Gordon should compare how much of his income to the $25,000 base amount?

1. $27,500
2. $21,500
3. $19,000
4. $25,000

Solution: The correct choice is "a."

In general, Social Security benefits received by a taxpayer are not included in gross income. However, if the taxpayer's income exceeds a specified base amount, the recipient may be required to include in gross income up to 85% of the Social Security benefits received during the year (Section 86).

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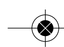

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In determining the amount of Social Security benefits which must be included in gross income, the taxpayer must first compute his or her "modified adjusted gross income" (MAGI). (This term is used in the Code only with respect to Social Security benefits.) MAGI is defined as adjusted gross income before including any Social Security benefits plus, among other items, tax-exempt interest and the foreign earned income inclusion. Tax-exempt interest includes not only interest earned from state and municipal bond obligations, but it also includes tax-exempt interest from Series EE savings bonds that is used to pay for qualified educational expenses. Note that by requiring taxpayers to include such items in the calculation of MAGI, Congress has in essence opened a back door for taxing tax-exempt interest income by disguising it in the form of taxing Social Security benefits!

The next step is to determine the taxpayer's "base amount." Currently, there are two sets of base amounts. Note that these base amounts are statutory and not indexed for inflation. The first set of base amounts are used by lower income taxpayers to determine whether they must include up to 50% of their Social Security benefits in gross income. The second set of base amounts are used by all other taxpayers to determine whether they must include up to 85% of their Social Security benefits in gross income.

The base amount is a function of the taxpayer's filing status. The following is the first set of base amounts: (1) $25,000 for a taxpayer who files as single, head of household, or as married filing separately and did not live with his or her spouse for the entire year; (2) $32,000 for taxpayers filing a joint return; and (3) $0 for married taxpayers filing separately who lived with their spouse any time during the year.

The first set of base amounts are used by taxpayers whose MAGI plus 50% of their Social Security benefits exceeds these base amounts (but not the second set of base amounts). Note that if a taxpayer's base amount ($25,000, $32,000 or $0) exceeds the sum of his or her MAGI plus 50% of Social Security benefits received, all of the Social Security benefits are excluded from gross income.

Taxpayers subject to the first set of base amounts include in gross income the lesser of (1) 50% of the Social Security benefits received or (2) 50% of the sum of MAGI plus 50% of the Social Security benefits. Thus, the maximum amount that need be included in gross income for these taxpayers is 50% of their Social Security benefits.

The following is the second set of base amounts:(1) $34,000 for a taxpayer who files as single, head of household, or as married filing separately and did not live with his or her spouse for the entire year; (2) $44,000 for taxpayers filing a joint return; and (3) $0 for married taxpayers filing separately who lived with their spouse any time during the year.

The second set of base amounts are used by taxpayers whose MAGI plus 50% of their Social Security benefits exceeds the second set of base amounts. The exact amount of Social Security benefits that must be included in gross income for these taxpayers is determined by calculating a specific formula which is relatively complicated. However, in no event can more than 85% of the Social Security benefits be included in gross income. The rationale for excluding 15% of the Social Security benefits from gross income is that for the average Social Security recipient, 15% of the amount received is a recovery of amounts the individual paid into the program, and the remainder of the benefits is financed by the employer's contribution and interest earned by the Social Security trust fund.

Accordingly, in determining if any of his Social Security benefits is taxable, Gordon must first compute his MAGI. His MAGI includes his $8,000 of earnings as a part-time security guard, $5,000 of interest from a savings account, $2,500 interest from tax-exempt securities, and $6,000 of taxable pension benefits, for a total MAGI of $21,500. He must then compare his $25,000 base amount to the sum of his $21,500 MAGI plus 50% of the $12,000 of Social Security benefits he received or $6,000. Thus, $27,500 ($21,500 + 6,000) is compared with the $25,000 base. The actual amount of Social Security benefits that Gordon must include in gross income is $1,250 [.5($27,500 - 25,000)] since this is less than 50% of his Social Security benefits.

The problems presented in this column are adapted from the official, verbatim texts of IRS Special Enrollment Examination questions. The answers were prepared by Prof. Blumenfrucht. The examination covers tax topics about which the IRS expects tax practitioners to be extremely knowledgeable.

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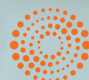

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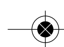

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