The Independent Investor Test and the Imposition of the Accuracy-Related Penalty

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In income tax disputes, the federal courts often rely on the so-called independent investor test to assess the reasonableness of shareholder/employee compensation in the case of a C corporation taxpayer. In the case of Brinks Gilson & Lione v. Commissioner, *the Tax Court relied (in part) on the independent investor test—but not to determine if any claimed shareholder/employee compensation was a disguised dividend distribution. Before trial, the Internal Revenue Service and the taxpayer agreed that some of the corporation's year-end bonus payments were, in fact, nondeductible dividend distributions. In this case, the Tax Court had to decide on the application of the Section 6662 accuracy-related penalty related to the taxpayer's compensation tax deductions. This Tax Court decision provides judicial guidance to both taxpayers and practitioners as to the determination of (1) the accuracy-related penalty in a reasonableness of compensation tax dispute and (2) the application of the independent investor test to assess the reasonableness of close corporation shareholder/employee compensation.*

Introduction

This discussion involves the U.S. Tax Court decision in the matter of *Brinks Gilson & Lione v. Commissioner of Internal Revenue*.[1]

This case involves the imposition of the accuracy-related tax penalty. Brinks Gilson & Lione ("BGL"), an intellectual property law firm, was the C corporation taxpayer in this matter and the petitioner in the Tax Court case.

The imposition of the accuracy-related penalty related to the taxpayer's mischaracterization of nondeductible dividends paid to its shareholder/attorneys as tax deductible compensation expense. The shareholder/attorney distributions were made in the form of year-end bonus payments.

Internal Revenue Code Section 6662 imposes an accuracy-related penalty if any part of an underpayment of the tax required to be shown on a tax return is due to, among other things:

1. negligence or disregard of rules or regulations or
2. a substantial understatement of tax.

The term "understatement" is defined in Section 6662(d)(2)(A) as the excess of (1) the tax required to be shown on the tax return over (2) the amount actually shown on the tax return as filed.

In the case of a corporation, an understatement is "substantial" if, as was relevant in the *Brinks Gilson & Lione* case, it exceeds the lesser of:

1. 10 percent of the tax required to be shown on the tax return for the subject tax year or
2. $10 million.

In the *Brinks Gilson & Lione* case, the taxpayer argued that the Internal Revenue Service ("the Service") erred in the imposition of the Section 6662 accuracy-related penalty. The taxpayer argued that it had substantial authority for its treatment of the year-end bonus payments as deductible compensation expense.

In addition, the taxpayer argued that:

1. it had "reasonable cause" for the underpayment of the corporation's income tax and
2. it had acted "in good faith."

Therefore, the taxpayer claimed that it qualified for exceptions to the Section 6662 accuracy-related penalty.

In summary, the Tax Court disagreed with all of the taxpayer's arguments and imposed the Section 6662 penalty. In this case, the Tax Court did not have to determine the reasonableness of the amount of compensation paid to the BGL shareholder/attorneys.

The taxpayer and the Service agreed before the trial that certain amounts of the year-end bonuses were, in fact, excess compensation (and nondeductible dividend payments) for the tax years in dispute.

However, in deciding on the application of the Section 6662 penalty, the Tax Court did consider the application of the so-called independent investor test to assess the reasonableness of close corporation shareholder/employee compensation.

Based (in part) on its consideration of the independent investor test, the Tax Court concluded that taxpayer did not qualify for an exception to the Section 6662 accuracy-related penalty. Accordingly, this judicial decision illustrates yet another application of the independent investor test in the judicial determination of the reasonableness of a C corporation's shareholder/employee compensation.

The *Banks Gilson Lione* decision is only a Tax Court memorandum decision. Nonetheless, the published decision is 38 pages in length.

That is, the published decision does provide ample judicial guidance to both taxpayers and practitioners with regard to:

1. the application of the accuracy-related tax penalty,
2. the determination of the reasonableness of close corporation shareholder/employee compensation, and
3. the application of the independent investor test.

Description of the Subject Taxpayer

The taxpayer in this case is an intellectual property law firm organized as a regular C corporation. For the 2007 and 2008 tax years at issue in this case, BGL computed its federal taxable income on the basis of a calendar year, using the cash method of accounting. For the years in dispute, BGL also prepared its GAAP accounting financial statements using the cash method of accounting.

During the 2007 to 2008 period, BGL employed about 150 attorneys, of whom about 65 were shareholders. BGL also employed a nonattorney staff of about 270. The BGL business and affairs were managed by the firm's board of directors.

The BGL Shareholders

The BGL shareholders owned their shares in the corporation in connection with their employment with the firm as attorneys. Each shareholder/attorney acquired his or her shares at a price equal to the share's accounting book value. Upon a shareholder's employment termination, the shareholder was required to sell the shares back to BGL at a price determined under the same formula.

Subject to minor exceptions related to the firm "name partners," each shareholder's proportionate ownership of the BGL shares (i.e., the share-ownership percentage) equaled his/her proportionate share of the total compensation paid by the firm to its shareholder/attorneys.

For the 2007/2008 period, the BGL board set the annual compensation paid to the shareholder/attorneys. Then, the BGL board determined the necessary adjustments in each shareholder's share-ownership percentage necessary to reflect the proportionate compensation.

The BGL shareholder/attorneys were entitled to receive dividends as and when declared by the firm's board. However, it is noteworthy that BGL had not declared any dividends for at least a decade before the tax years in dispute.

Compensation Mechanics

For the tax years in dispute, the BGL board met to set compensation and shareholder-ownership percentages in late November or early December for the following year.

Based on the BGL annual budget, the board set each shareholder's expected compensation using a number of criteria including hours billed, collections,

business generated, and other contributions to the firm.

Because the board's compensation amounts were based on an annual budget, each shareholder only received a percentage of the expected total compensation (referred to as the "draw"). The remainder of the total compensation was received at year-end (referred to as the "year-end bonus").

It was the announced intention of the BGL board to distribute the amount of fiscal year-end bonus (referred to as the "bonus pool") that would result in the firm reporting a zero GAAP-basis net income for the year.

With very few exceptions for less active attorneys, the BGL shareholders shared in the bonus pool in proportion to their share ownership percentages. For each tax year in dispute, BGL calculated the year-end bonus pool—that is, $8,986,608 in 2007 and $13,736,331 in 2008—to be exactly equal to the firm's (pre-bonus) GAAP-basis net income.

Accordingly, the BGL reported (post-bonus) GAAP net income of zero for each year. That is, the BGL financial accounting reported that the firm revenue exactly equaled the firm expenses for 2007 and 2008.

For income tax purposes, BGL reported as employee compensation expense the total amount that it paid to its shareholder/attorneys, including the year-end bonus payments.

It is noteworthy that BGL withheld applicable income and employment axes, paid the employer's share of employment taxes, and filed the appropriate employer tax forms, including Forms W-2, Wage and Tax Statement, and Forms 941, Employer's Quarterly Federal Tax Return.

An independent payroll processing firm prepared the BGL Forms W-2 for 2007 and 2008 using records and information that BGL management reported to it. BGL management then provided the Forms W-2 to the firm's public accounting firm, McGladrey & Pullen ("McGladrey").

The BGL Invested Capital Balances

BGL reported shareholders' invested capital, measured by the accounting book value of its shareholders' equity, of approximately $8 million at the 2007 year-end and approximately $9.2 million at the 2008 year-end.

The BGL balance sheets for the years in dispute did not report any goodwill or other intangible asset values. This is only noteworthy because the Tax Court noted that the BGL balance sheets may have understated the economic value of the firm shareholders' equity.

The BGL Reported Taxable Income

McGladrey prepared the BGL corporation income tax returns for the tax years in dispute. BGL timely filed its tax returns for 2007 and 2008. In each tax return, BGL included the year-end bonuses it paid to its shareholders as a deduction for officer compensation.

Before filing its federal income tax returns, BGL management did not ask McGladrey whether the full amount of the year-end bonuses paid to the firm shareholders was deductible as compensation expense. And, McGladrey did not opine to BGL management on the tax deductibility of the year-end bonuses.

The BGL 2007 tax return reported total income of $91,742,819, taxable income of $539,902, and a tax liability amount of $188,966. The BGL 2008 tax return reported total income of $107,019,812, taxable income of $561,075, and a tax liability amount of $196,376.

The GAAP basis net income that BGL reported for each year was zero. Accordingly, the taxable income that BGL reported on is federal income tax return was entirely due to book income versus tax income differences.

The Internal Revenue Service Audit

During the audit of the 2007 and 2008 tax years, the Service disallowed various deductions, including

the year-end bonuses that BGL had paid to its shareholder/attorneys.

After a negotiation, the Service and the taxpayer entered into a closing agreement that provided, among other things, that portions of the BGL officer compensation deductions for the years in dispute—$1,627,000 in 2007 and $1,859,000 in 2008—"should be disallowed and re-characterized as non-deductible dividends."

As a result of certain concessions that BGL made in settlement, the taxpayer's agreed upon income tax liability was $1,298,618 for 2007 and $1,212,152 for 2008. These tax liability amounts resulted in underpayments of $1,109,652 and $1,015,776 for the tax years 2007 and 2008, respectively.

The Issues before the Tax Court

Because the audit closing agreement provided that a portion of the BGL officer compensation deductions for the disputed years "should be disallowed and re-characterized as non-deductible dividends," the deductibility of the shareholder year-end bonuses was not an issue at the trial.

The sole issue before the Tax Court was whether the taxpayer was liable for accuracy-related penalties under Section 6662. The Service's proposed Section 6662 penalty related to the underpayment of tax regarding the BGL deduction of those portions of the year-end bonuses that the taxpayer agreed were nondeductible dividends.

Section 6662(a) and (b)(1) provides for an accuracy-related penalty of 20 percent of the portion of an underpayment of tax attributable to:

1. negligence or
2. the disregard of rules and regulations.

Section 6662(a) and (b)(2) provides for the same penalty on the portion of an underpayment of tax attributable to "[a]ny substantial understatement of income tax."

Section 6662(d)(2)(A) defines the term "understatement" as the excess of the tax required to be shown on the tax return over the amount actually shown on the tax return as filed. In the case of a corporation, according to Section 6662(d)(1)(B), an understatement is considered to be "substantial" if it exceeds the lesser of:

1. 10 percent of the tax required to be shown on the tax return for the tax year or
2. $10 million.

According to Section 6662(d)(2)(B)(i), an "understatement" is reduced by the amount attributable to the treatment of an item for which the taxpayer has "substantial authority."

In addition, Section 6664(c)(1) provides an exception to the imposition of the Section 6662(a) accuracy-related penalty if the taxpayer can demonstrate that:

1. there was reasonable cause for the underpayment and
2. the taxpayer acted in good faith.

In the *Brinks Gilson & Lione* matter, the taxpayer did not dispute that the deficiency to which BGL had agreed for each of the years in dispute exceeded 10 percent of the income tax it was required to show on its tax return for that year. Rather, the taxpayer claimed that it had substantial authority for deducting the full amount of the year-end bonuses it had paid to its shareholder/attorneys.

In particular, the BGL argued that, because it had relied on the services of a prominent accounting firm to prepare its tax returns, the taxpayer (1) had reasonable cause to deduct those amounts and (2) acted in good faith in doing so.

If the Tax Court found that BGL in fact had "substantial authority" for its position, then the disallowance of apportion of its claimed compensation deduction would not increase the "understatement" within the meaning of Section 6662(d)(2)(A).

If the Tax Court reached that conclusion, then the substantial understatement penalty would not apply to the portion of the underpayment attributable to the disallowance of those deductions, regardless of whether or not BGL had reasonable cause or acted in good faith.

In addition, the judicial determination that BGL had substantial authority for its position would also prevent imposition of the negligence penalty.

Accordingly, the Tax Court's first judicial consideration was whether BGL had substantial authority for its deduction of the year-end shareholder/attorney bonuses.

Consideration of Substantial Authority

According to the Tax Court's decision: "The determination of substantial authority requires a weighing of the authorities that support the taxpayer's treatment of an item against the contrary authorities. A taxpayer can have substantial authority for a position that is unlikely to prevail, as long as the

weight of the authorities in support of the taxpayer's position is substantial in relation to the weight of any contrary authorities."

The Taxpayer's Position

At trial, the taxpayer relied on the decision *Law Offices—Richard Ashare, P.C. v. Commissioner*[2] as its principal authority to support the deduction of year-end bonuses paid to the BGL shareholder/attorneys in 2007 and 2008.

In the *Ashare* decision, the Tax Court allowed a corporate law firm to deduct the amount that it paid to its sole shareholder as compensation—even though that compensation amount exceeded the firm's revenue for the year.

Also at trial, BGL claimed that Section 83 and the accompanying regulations (which deal with the transfer of property in connection with services) support the proposition that all of the amounts the taxpayer paid to its shareholder/attorneys should be treated as deductible compensation expense.

In addition, BGL cited authorities in other areas of the law to support the position that capital is not a material income-producing factor in a professional services business.[3]

As a final position, BGL argued that, under the so-called substance-over-form principle, the stock held by the BGL shareholders should be treated as debt. Based on this argument, the portion of the year-end shareholder/attorney bonuses determined to be nondeductible as compensation should nonetheless be deductible as interest expense.

In *Brinks Gilson & Lione*, the taxpayer devoted considerable effort to distinguishing the statutory and judicial authorities relied on by the Service.

The Service claimed that the amounts paid to the shareholder/employees of a corporation do not qualify as deductible compensation to the extent that the payments are funded by earnings attributable:

1. to the services of nonshareholder/employees or
2. to the use of the corporation's intangible assets or other capital.

The Service argued that the amounts paid to shareholder/employees attributable to those sources should be treated as nondeductible dividends.

In support of its position, at trial the Service relied primarily on the Tax Court opinion in *Pediatric Surgical Assocs., P.C. v. Commissioner*[4] and the U.S. Court of Appeals (Seventh Circuit) opinion in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*.[5]

In the *Pediatric Surgical* decision, the Service determined that compensation payments to shareholder/employees attributable to the services of nonshareholders should be nondeductible dividends.

In the *Mulcahy* decision, the Seventh Circuit denied a corporation's deduction for consulting fees paid to entities owned by the taxpayer's founding shareholders That taxpayer sought to justify its deduction for the consulting fees based on the grounds that the payments were, in effect, additional compensation to its shareholders.

The Service emphasized the *Mulcahy* decision because any appeal of the *Brinks Gilson & Lione* decision would be filed with the Seventh Circuit.

At trial, the taxpayer argued that the subject fact set was distinguishable from the *Pediatric Surgical* decision fact set. This is because any "profit" that BGL made from the services of its nonshareholder/attorneys could justifiably be paid to its shareholder/attorneys in consideration for business generation and other nonbillable services.

Also at trial, the taxpayer distinguished the *Mulcahy* decision fact set based on the allegedly unique nature of the BGL shareholder/attorneys' interests. In particular, the taxpayer argued that, because (1) the BGL shareholder/attorneys received their stock in connection with their employment and (2) the BGL shareholders had to sell their shares back to the corporation at a price equal to the GAAP basis book value, the BGL shares did not represent "real" equity interests.

Therefore, the BGL shares did not entitle the corporation shareholders to a return on their invested capital.

Finally, at trial the taxpayer argued that, because the *Mulcahy* decision was published after BGL filed its tax returns for the tax years in dispute, the *Mulcahy* decision should not be taken into account in assessing the relative weight of authorities for and against the taxpayer's substantial authority positions.

The Application of the "Independent Investor Test"

According to the Tax Court decision in *Brinks Gilson & Lione*, "The principle applied in *Mulcahy* is well established in the law and grounded in basic economics: The owners of an enterprise with significant capital are entitled to a return on their investments."

That statement means that when a taxpayer pays salaries to shareholder/employees in amounts that

leave insufficient remaining profits to provide an adequate return on equity ("ROE") to shareholders, that inadequate ROE indicates that a portion of the amount paid as salaries is actually a distributions of earnings.

The Tax Court noted that an increasing number of Federal Courts of Appeal, including the Seventh Circuit, have been moving away from the so-called multifactor analysis in assessing the reasonableness of close corporation shareholder/employee compensation. Instead, the Appeals Courts were focusing on the independent investor test.

The independent investor test considers the reasonableness of close corporation shareholder /employee compensation from the perspective of whether the residual net income provides an ROE that would be acceptable to an independent (nonemployee) investor. The Tax Court specifically noted the following judicial authority: *Exacto Spring Corp. v. Commissioner*.[6]

Based on the relevance of the independent investor test as applied in the above-cited judicial decisions, the Tax Court noted that the fact that the *Mulcahy* decision itself was not "authority" was of little consequence for purposes of its decision in this matter.

The Tax Court noted that: "The Court of Appeals for the Seventh Circuit and the other courts that have assessed compensation paid to shareholder employees by its effect on the returns available to shareholders' capital refer to the governing inquiry as the "independent investor test."[7]

The independent investor test recognizes that shareholder/employees are economically indifferent to whether the total payments they receive from the taxpayer corporation are called compensation or dividends. From an income tax perspective, however, only compensation payments are deductible to the taxpayer corporation.

In contrast, dividend payments are not deductible to the taxpayer corporation. Therefore, the taxpayer corporation has a bias toward labeling any payments to shareholder employees as compensation rather than as dividends, without the arm's-length consideration of what a nonemployee investor would accept as a fair rate of ROE.[8]

The Tax Court noted that "the courts consider whether ostensible salary payments to shareholder/employees meet the standards for deductibility by taking the perspective of a hypothetical "independent investor" who is not also an employee."

Application of the Independent Investor Test to BGL

In the *Brinks Gilson & Lione* decision, it was easy for the Tax Court to decide: "Ostensible compensation payments made to shareholder/employees by a corporation with significant capital that zero out the corporation's income and leave no return on the shareholders' investments fail the independent investor test."

The trial record established that BGL had substantial capital even without considering the valuation of any off-balance-sheet intangible assets. At trial, the BGL expert witness admitted that a law firm's reputation and customer lists could be valuable intangible assets.

However, the Tax Court did not have to measure the value of any of the BGL intangible assets in its application of the independent investor test ROE. Regardless of such off-balance-sheet intangible assets, BGL reported a book value of shareholders' equity of about $8 million at the end of 2007 and about $9.3 million at the end of 2008.

The Tax Court concluded: "Invested capital of this magnitude cannot be disregarded in determining whether ostensible compensation paid to shareholder/employees is really a distribution of earnings."

The Tax Court did not believe that an independent investor would accept a zero percent ROE on an $8 or $9 million book value of equity. Such an independent investor would not allow the BGL board to pay out 100 percent of the firm's book-basis net income as shareholder/employee compensation—and leave no residual income as a return to the nonemployee/shareholder.

Accordingly, the Tax Court concluded: "petitioner's practice of paying out year-end bonuses to its shareholder/attorneys that eliminated its book income fails the independent investor test."

BGL Claimed an Exemption from the Independent Investor Test

At trial, BGL argued that its shareholder/attorneys held their stock in the corporation solely in connection with their employment. That is, the BGL shareholders acquired their stock at a price equal to its cash-basis book value. And, upon terminating their employment, the BGL shareholders had to sell their stock back to the corporation at a price determined under the same formula.

The taxpayer argued that, as a result of this arrangement, the BGL shareholder/attorneys lacked the normal rights of equity owners.

The Tax Court did not accept this BGL argument. Rather, in its decision, the Tax Court noted: "the use of book value as a proxy for market value for the issuance and redemption of shares in a closely held corporation to avoid the practical difficulties of more precise valuation hardly means that the shareholder/attorneys do not really own the corporation and are not entitled to a return on their invested capital."

The Tax Court concluded that any BGL shareholders who were not also an employee would generally demand such a return on investment.

The Tax Court concluded that the provisions of Section 83 and its associated regulations actually undermined the taxpayer's argument that its attorneys were not really equity holders. BGL cited regulations that determined when property is considered to be "transferred" by an employer to an employee.

The Tax Court noted that, under those regulations, a transfer did occur if, upon termination of his or her employment, an employee is required to return the property to the employer for a price that "does not approach the fair market value of the property at the time of surrender."[9]

BGL argued that the obligation that its shareholder/attorneys sell back their stock upon employment termination in exchange for book value meant that the stock was never actually "transferred" to the shareholder/employee. Accordingly, BGL argued that all of the amounts it paid to its shareholders—even any amounts actually designated as dividends—should be treated as compensation for services.

Again, the Tax Court rejected this BGL argument: "But petitioner is mistaken in its claim that the book value of one of its shares does not approach its fair market value."

The Tax Court noted that Regulation 1.83-5(a) provides that: "If stock in a corporation is subject to a nonlapse restriction which requires the transferee to sell such stock only at a formula price based on book value . . . , the price so determined will ordinarily be regarded as determinative of the fair market value of such property for purposes of Section 83."

The Tax Court concluded that the Regulation 1.83-3(a)(7) examples cited by the taxpayer were readily distinguishable from the actual BGL fact set. The examples in the regulations involved the requirement to resell stock upon termination of employment for amounts that were demonstrably below the stock's fair market value.

On the issue that the BGL attorneys were not really shareholders, the Tax Court concluded: "More generally, petitioner's argument that its shareholder/attorneys have no real equity interests in the corporation that would justify a return on invested capital proves too much. If petitioner's shareholder/attorneys are not its owners, who are? If the shareholder/attorneys do not bear the risk of loss from declines in the value of its assets, who does?"

The Tax Court noted that the use of share book value as a proxy for share fair market value deprived the BGL attorneys of the right to share in any unrealized appreciation upon the sale of their stock. However, the same attorneys were correspondingly not required to pay for any unrealized appreciation upon the purchase of their stock.

The BGL attorney acceptance of these concessions to avoid difficult valuation issues did not compel those attorneys to forgo any current return on their investment based on the taxpayer's profitable use of its assets in conducting its business. The BGL arrangement effectively provided its attorneys with an ROE through amounts designated as compensation.

The Tax Court concluded this issue as follows: "Were this not the case, we do not believe the shareholder/attorneys would be willing to forgo any return on their investments."

The Other Authorities Cited by BGL at Trial

The Tax Court concluded that the other judicial precedent that BGL cited did not refute the principle that shareholders with significant capital are economically entitled to a rate of ROE. BGL cited the decision in *Law Offices—Richard Ashare, P.C. v. Commissioner*.[10]

However, that case did not demonstrate that an incorporated law firm with significant capital can pay out compensation that eliminates all book-basis net income. Although the Tax Court allowed the Ashare taxpayer to deduct compensation that exceeded the firm revenue for the particular tax year at issue (1993), that taxpayer in that case did not consistently pay compensation amounts intended to eliminate its book-basis income.

In fact, the Ashare law firm had reported substantial income for 1990, three years before the tax year in dispute.

In contrast to BGL, the Ashare law firm reported minimal equity capital. The sole shareholder Richard Ashare had only invested $1,000 as equity in that taxpayer corporation. Therefore, a fair rate

of return on equity capital (i.e., the independent investor test) was not an issue in the Ashare decision.

BGL Argued That Its Stock Is Really Debt

The Tax Court disagreed with the BGL argument that the portion of the year-end bonus determined to be nondeductible as compensation should nonetheless be deductible as interest expense.

The Tax Court concluded "We have already rejected petitioner's argument that its stock is not real equity. Despite a departing shareholder's obligation to sell his stock back to petitioner at cash book value, shares of petitioner's stock lack the hallmark characteristics of debt."

The Section 6662 Penalty and the Weighing of Authority

Regulation 1..6662-4(d)(3)(ii) required the Tax Court to consider the relative weight of the legal authority presented by BGL and the legal authority presented by the Service.

The Tax Court concluded against the taxpayer on this issue, as follows:

> We conclude that the authorities that support petitioner's deduction of the full amount of the year-end bonuses it paid to shareholder/attorneys are not substantial when weighted against the contrary authorities. The independent investor test weights strongly against the claimed deductions. Petitioner's efforts to characterize its situation as unique do not persuade us. If the hypothetical independent investor had provided the capital demonstrated by the cash book value of petitioner's shares—even leaving aside the possibility of valuable firm-owned intangible assets—the investor would have demanded a return on that capital and would not have tolerated petitioner's consistent practice of paying compensation that zeroed out its income.

That is, the Tax Court concluded that the taxpayer did not have substantial authority for the deduction of shareholder/employee compensation that completely eliminated its income and left its shareholders with a zero rate of ROE.

Because the taxpayer did not have substantial authority for its treatment of the year-end bonuses it paid, the agreed disallowance of a portion of the deductions BGL claimed for those payments increased a "substantial understatement," within the meaning of Section 6662(d)(1)(B). That is, the accuracy-related penalties would apply to the taxpayer unless BGL had "reasonable cause" for its treatment of the year-end bonuses and acted in "good faith" in pursuing that treatment.

Reasonable Cause and Good Faith

At trial, BGL argued that it should not be subject to the imposition of the Section 6662(a) accuracy-related penalty. BGL presented the argument that it had reasonable cause and acted in good faith with regard to its claimed bonus payment deductions. Accordingly, BGL asserted that it qualified for the Section 6664(c)(1) exception to the accuracy-related penalty.

The BGL position was that its reliance on McGladrey to prepare its tax returns for the years in dispute qualified as "reasonable cause" and demonstrated "good faith."

The Tax Court disagreed with this "reliance on McGladrey" argument for two reasons. First, BGL could not demonstrate that McGladrey, in fact, actually advised the taxpayer regarding the deductibility of the year-end bonuses. Second, the Tax Court concluded that BGL failed to provide McGladrey with accurate information with regard to the subject year-end bonus payments.

Consistent with Regulation 1.6664-4(b)(1), the Tax Court recognized that "[a] taxpayer's reliance on the professional advice of an attorney or an accountant may constitute reasonable cause and good faith." The taxpayer argued that McGladrey's failure to apprise BGL of any issue concerning the tax deductibility of the year-end bonuses constituted "advice" on which it could reasonably rely.

However, the facts were that, before filing its tax return for each of the years in issue, BGL did not specifically ask McGladrey whether the full amount of the year-end bonuses it paid to shareholders was deductible as compensation for services. And, McGladrey had never commented to BGL regarding the tax deductibility of the year-end bonuses.

The Tax Court noted that the Section 6664 regulations allow flexibility regarding the form of advice to taxpayers. However, the regulations provide detailed requirements as to the content of advice that can constitute the taxpayer's reasonable cause and good faith.

However, the Tax Court concluded that the regulations necessarily contemplate that professional advice, in some form, involves an explicit communication to the taxpayer. Silence cannot qualify as professional advice because there is no way to know whether the tax adviser, in failing to raise an issue, considered all of the relevant facts and circumstances, including the taxpayer's subjective motivation.

The tax adviser's failure to raise an issue could not indicate whether the adviser even considered a certain tax issue, much less engaged in any analysis, or reached a conclusion.

Therefore, the Tax Court concluded that McGladrey's failure to raise concerns about the tax deductibility of the year-end bonuses did not constitute "advice" within the meaning of Regulation 1.6664-4(c).

In addition, the Tax Court noted that BGL could not have relied in good faith on McGladrey's preparation of its tax returns for the years in dispute. This was because BGL had provided McGladrey with inaccurate information.

The Tax Court noted that the error that led to the claim of the disallowed tax deduction was, in the first instance, the taxpayer's error.

As a general matter, in the fulfillment of professional responsibilities, an accountant signing a tax return is entitled to rely on information furnished to it by the taxpayer. An accountant only has a limited obligation to make inquiries in the case of manifest errors. In this case, BGL provided to McGladrey Forms W-2 that characterized the amounts paid to its shareholders as employee compensation.

On this issue, the Tax Court concluded: "Therefore, petitioner's reliance on McGladrey in preparing its returns for the years in issue does not constitute reasonable cause and good faith and does not relieve petitioner of liability for the accuracy-related penalty."

The Tax Court's Final Conclusion

The Tax Court concluded that BGL failed to show that:

1. it had reasonable cause for deducting in full the year-end bonuses it paid to its shareholder/attorneys in the years in dispute or
2. it acted in good faith in claiming such tax deductions.

Section 6664(c)(1) provided BGL with no defense to the imposition of the Section 6662 accuracy-related penalties. The Tax Court also determined that BGL did not have substantial authority for the tax deductions at issue in the case.

The Tax Court noted that the parties' agreed upon treatment of part of the bonus payments in each year as a nondeductible dividend resulted in a "substantial understatement" within the meaning of Section 6662(d)(1)(A).

Therefore, the Tax Court concluded that the accuracy-related penalty applied to the portion of the BGL underpayment attributable to the recharacterization of that part of the bonus payments for each year.

Notes:

1. Brinks Gilson & Lione v. Commissioner, T.C. Memo. 2016-20 (Feb. 10, 2016).
2. Law Offices—Richard Ashare, P.C. v. Commissioner, T.C. Memo. 1999-282 (Aug. 24, 1999).
3. See Hubbard-Ragsdale Co. v. Dean, 15 F.2d 410 (S.D. Ohio 1926), *aff'd per curiam*, 15 F.2d 1013 (6th Cir. 1926); Regulation 1.704-1(e)(1)(iv); Regulation 1.911-3(b)(3); Regulation 1.1348-3(a)(3)(ii); and Regulation 1.1361-2(e)(2).
4. Pediatric Surgical Assocs., P.C. v. Commissioner, T.C. Memo. 2001-81 (April 2, 2001).
5. Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, 680 F.3d 867 (7th Cir. 2012), *aff'g* T.C. Memo. 2001-74.
6. Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999), *rev'g* Heitz v. Commissioner, T.C. Memo. 1998-220; Rapco, Inc. v. Commissioner, 85 F.3d 950, 954-955 (2d Cir. 1996), *aff'g* T.C. Memo. 1995-128; Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1245 (9th Cir. 1983), *rev'g and remanding* T.C. Memo. 1980-282.
7. Exacto Spring Corp. v. Commissioner, 196 F.3d at 838; Dexsil Corp. v. Commissioner, 147 F.3d 96, 100-101 (2d Cir. 1998), *vacating and remanding* T.C. Memo. 1995-135.
8. Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1322-1323 (5th Cir. 1987), *aff'g* T.C. Memo. 1985-267 and Elliotts, Inc. v. Commissioner, 716 F.2d at 1243.
9. See Regulation 1.83-3(a)(3), (5).
10. Law Offices—Richard Ashare, P.C. v. Commissioner, T.C. Memo 1999-282.

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