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CPE NETWORK TAX REPORT

OCTOBER 2022 VOLUME 35, ISSUE 9

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Topics for future editions may include:

- Taxation of High-Income Individuals
- Changing Tax Risks

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EXECUTIVE SUMMARY

PART 1. CURRENT DEVELOPMENTS

Taxation is a dynamic field with everchanging rules and regulations. It is important that practitioners stay abreast of these important changes and interpretations to properly advise clients.

Learning Objectives:

Upon completion of this segment, the user should be able to analyze current issues in taxation, including applying the rules for joint property and tax debts in bankruptcy, evaluating the draft 2022 Form 1040 language on "digital assets," and assessing the applicability of the extinguishment regulations. [*Running time 36:15*]

PART 2. INDIVIDUAL TAXATION

One of the most significant tax concepts for a tax practitioner advising S corporations is that of basis. The rules for stock and debt/loan bases can be complicated and are often misunderstood. The rules applicable to partnership basis and that of S corporations is similar when looking at equity but varies dramatically in the treatment of debt/loans. It is imperative that practitioners understand how debts/loans possibly affect basis and the ability of shareholders to take the flow-through deductions/losses on their returns.

Learning Objectives:

Upon completion of this segment, the user should be able to analyze issues related to debt basis for S corporation shareholders, including determining what loans/debt will create basis, assessing the ordering of basis reductions and restorations, and assessing the basis reporting requirement. [*Running time 36:00*]

PART 3. BUSINESS TAXATION

One issue that must be regularly addressed by practitioners representing closely held C corporations is the deductibility of the compensation paid to owners also working as employees. It is important to understand the positions of the IRS and the various courts in addressing this issue with clients. The primary concern is the reasonableness of the compensation paid. Unfortunately, there is no "bright line" applied universally.

Learning Objectives:

Upon completion of this segment, the user should be able to analyze issues related to the reasonability of compensation in C corporations, including determining the general rules applicable to deducting compensation, assessing the multi-factor test, and applying the independent investor test. [*Running time 40:11*]

ABOUT THE SPEAKERS

Ian J. Redpath, JD, LLM, is a nationally recognized tax attorney and consultant from Buffalo, New York and is a principal in the Redpath Law Offices. Mr. Redpath has published numerous articles on contemporary tax issues and co-authored several books on tax topics. He has extensive national and international experience in developing, writing, and presenting professional CPE programs. In addition to his active tax practice, he serves as Chairman of the Department of Accounting and Director of Graduate Accounting Programs as well as Professor of Taxation and Forensic Accounting at Canisius College in Buffalo.

Jonathan Tretter, CPA is a director with Freed Maxick CPAs in Batavia, NY. Jonathan is a graduate of Canisius College, and a member of the American Institute of Certified Public Accountants and the New York State Society of Certified Public Accountants. His focus is on taxation and planning for C corporations, S corporations, Partnerships and LLCs, and high-net worth individuals. He also has extensive knowledge of federal and state tax credits and incentives, methods of accounting, UNICAP 263A, estate and business succession planning, along with tangible property and cost recovery.

Julie A. Welch, CPA, PFS, CFP is a partner/shareholder and Director of the Tax Department at Meara Brown Welch, P.C. in a suburb of Kansas City, Missouri. She has written numerous articles, is a co-columnist for the Journal of Financial Planning, and has co-authored a book entitled *101 Tax Saving Ideas*. She speaks nationally on tax-planning topics, has appeared on radio and television, and has been quoted in numerous publications. Julie is a member of several professional organizations including the AICPA, MSCPA, and FPA. She has over 30 years' experience advising individuals, business professionals, and their companies.

Be sure to include the completed sheet when you request certificates for this event.

Title of Course (Enter full title)	
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Learning Objectives (Refer to executive summary)	
Program Description (Refer to executive summary)	
Instructional delivery method	Group Live
Recommended CPE credit	3.0 Credits
Recommended field of study(ies) (Refer to executive summary)	
Program Level	Update
Prerequisites (Circle One)	• Basic Accounting and Auditing professional experience
	• Basic Tax professional experience
	• Basic Governmental professional experience
Advance preparation	None required
Course registration and, where applicable, attendance requirements (1)	

(1) Insert instructions for your students to register for the class and any other attendance requirements (e.g., bring your laptop, be prepared to work in groups, you will be required to sign in and sign out of the session, etc.)

PART 1. CURRENT DEVELOPMENTS

Experts' Forum

Experts' Forum is a popular feature in which we review recent developments in taxation. This month, we begin with a discussion about Notice 2022-36. This notice provides relief for certain taxpayers from certain failure-to-file penalties and international information return penalties with respect to tax returns for taxable years 2019 and 2020.

Let's join Ian.

A. IR-2022-155, Notice 2022-36

Mr. Redpath

Hi everybody. Welcome to the program, I'm Ian Redpath with Network Tax. This is the segment where we go over a number of issues that have happened since the last time we spoke, although you do know that the last time, we went over the inflation Reduction Act with my friend and colleague Bob Lickwar. So, we're back to our normal programming as they would say. Let's jump right in on some of the changes. We're going to look at things from the IRS, the courts, even potential legislation.

So again, let's jump in and start off with IR-2022-155. What does that matter? Well, this is Notice 2022-36. Your clients may come to you and say, "I heard there's penalty relief for returns filed in 2019 and 2020." Well, there's a lot of confusion on this as to exactly what does it apply to, what penalties does it apply to, and what do you have to do to get this penalty relief? So first, who qualifies? Well, essentially any eligible income tax return; however, that had to be filed by September 30th, 2022 to be eligible for the relief. So, anything filed after that is not eligible for this penalty relief. That's one thing we'll have to make sure that clients are aware of. For banks, employers, the 1099s; in 2019, it will be considered timely filed if it was filed by August 3rd, 2020, and a 2020 return considered timely filed if it was filed by August 2nd, 2021.

So, what returns? Well, basically 1040s, any in the 1040 series; 1041s for estates, they're also included, 1120s, 1120-S. They are all included. A number of others like homeowners' associations 1120-L, 1120-POLs for political organizations, the 1120-RIC for regulated investment companies; these are all included. Mortgage investments, REMICs, 1066s; those are going to be included. And then 990s, 990-PFs, 990-Ts; those will be included in this. So again, if in fact you were entitled to penalty relief, it's automatic if it was filed by that time. If you had paid the penalty, the IRS says don't do anything. You don't have to file anything for your clients, that they will make the adjustment and send them a check. It's believed that about 1.6 million taxpayers are going to get this automatic penalty relief and either get refunds or credits.

It's not going to apply if you have an offer in compromise that had been accepted, any fraudulent returns, or if you entered into a closing agreement for either one of those years, or if you had gone to court and the court had determined the penalties. Although for those two returns, it's doubtful that you would be in court by now. Again, it's limited just to the failure to file. It does not apply to the failure to pay. Again, another confusion. It doesn't apply to any other type of… penalty. But there's other relief. And so, for example, you could get automatic on the penalty for failure to file, but you also had a failure to pay. And that was very common during the pandemic. So, for 2019 and 2020 returns, not uncommon. For that, you could apply, for example, for the first-time abatement program. You could also apply for reasonable cause and try to get the abatement through reasonable cause.

So, failure to file, automatic. The other—don't think you're out of the woods on that, that you can just go ahead and file. You could file under the first-time abatement. Reasonable cause would also be available.

B. IRS Mission-Critical Functions Continue

So, good news, the IRS says they're finally catching up on the COVID-19 mission critical function. On the webpage of the IRS, they said that they are catching up on returns. As of August, they had 8.7 million unprocessed individual returns that were received in 2022. So, that would be 2021 returns, late filed returns from 2020 or 2019. But they said that they are in fact updating the backlog of returns and taxpayer correspondence. 1.7 million contain errors that require special handling, and 7 million are paper returns that have to be reviewed and processed. So, they are catching up. Again, remember that automatic relief if the return was filed by the end of September of 2022. The IRS indicated, and I'm just going to say the IRS indicated; I haven't quite found this to be my experience, but maybe you have. They said they're opening mail within the normal timeframes, and that all paper and electronic individual returns received prior to January of 2022 have been processed, as long as it had no errors and didn't require any further review. Those are in that process of the backlog.

Again, they also indicated that a tax refund for a return that needs special handling could take up to as much as 120 days to actually be processed. In addition, 1040-Xs, 1.9 million unprocessed returns as of the end of August. The IRS says it can take up the 20 weeks—up to, maybe even more, but 20 weeks is what they're saying is the target now to process these. In addition, 941s—the IRS is seeing just a ton of amended 941s. As the IRS has said, and we've mentioned in other programs, the IRS is going after what they call the employee retention credit mills. They're getting a ton of amended returns… 4.6 million unprocessed as of the end of August. And the number of amended 941s is significant. So, there's a real backlog on the 941s at this point. Interestingly, the IRS said in general that it's catching up on its backlog. But if you look at the numbers that they reported in June and the numbers they reported at the end of August, you'll see that the 941s, not the 1040s, the 941s have increased. Actually, they have a greater backlog in the 941s. So yes, there's less of a backlog on 1040s, more of a backlog on 941s. And again, I think that might be because of all of these amended 941s that they say have been filed.

C. Determination Letter for Retirement Plans

All right, so the IRS webpage for determination letter on retirement plans, plan sponsors—either defined benefit or defined contribution—you have to ask the IRS to make a determination whether or not it complies with the tax code and regs. And there are different forms for different types of actions you're requesting. So Form 5300, Application for Determination for Employee Benefit Plan; 5307, Application for Determination if you're using a master or prototype or for volume submitters; the 5310, Application for Determination upon Termination; and 5316, Application for Group or Pooled Trust Ruling. The IRS has indicated that once they receive this, that they are then assigned to a specialist who contacts you. They'll contact you if you've ever done work in this area. You know they'll contact you to go over the forms, make sure everything is in order, and ask questions if they have them or additional information. The IRS works these in the order that they are received, with priority given to the 5310 applications, those on termination. The IRS says that there is a large backlog of retirement plan determination letters. The IRS says if you want to check the status, there's two numbers—there's a toll-free number, (877)829-5500, that's toll free; or by fax, (855)224-1311—to check on the status of one of the forms that you have sent in. Also, they said you can just simply do it by mail, Internal Revenue Service, EP Determinations, Attn: Manager, EP Correspondence, P.O. Box 2508, Room 6-403, Group 7535, Cincinnati, OH 45202. And you can send similar information if you're doing it by private delivery. But that address is 550 Main Street, Cincinnati 45202, and again, Attn: Manager, EP Correspondence. Make sure if you call or if you're sending something, you have to give the name of the employer, the ID number of the employer, the name of the plan, plan number, application number, the date the application was submitted, and indicate who's doing it. If you're doing it as the practitioner, you have to make sure that you have a valid Power of Attorney, 2848, or Declaration of Representative, the 8821.

D. Legal Advice Issued by Field Attorneys 20223301F

We have interesting field advice. Sometimes, you look at these and say, how could the person make that mistake? Maybe this was a financial accounting group that made the determination for tax. Unfortunately, they made it wrong. So, we have legal advice issued by field attorneys, 20223301F. This is the IRS Chief Counsel's office, Field Attorney Advice. So, essentially what happened is that on their tax return, and this was from a consolidated group. On the tax return, their accounting firm told them that they could use the reserve method, the same method they were using on their financial statement. And so, what happened is they used the reserve method of accounting for tax purposes and included income items net of its reserves for anticipated discounts, bad debts, disputes. Obviously, that's wrong. Clearly, under Section 461 of the Code, that is not the appropriate way. Only certain financial institutions—and those are even narrow—can use reserve method. It's wrong. But what is important here is that the Chief Counsel's office says every professional should know this. They should be aware of Section 461 and the regulations whenever they give advice. Therefore, they determined that this was a willful violation by the accounting firm, and they assessed the penalties for willful violation under 6694(b). This is rather serious. So, they said everybody should have known this. Now, it's really unclear because it is a pretty set area of the law why this firm recommended it. My only belief would be, and you don't know facts, that maybe it was the financial accounting group that made this decision and not the tax group. But either way, they got hit with a willful violation, which increases the penalty significantly.

E. *IN RE: LITVINAS*, 130 AFTR 2d 2022-5524, (Bktcy. Ct VA)

Now, in the past, we gave a program on tax claims in bankruptcy. And that was with my friend and colleague, Gary Bluestein. Well, we have a couple of cases here that are coming out of bankruptcy courts. This is a bankruptcy court in Virginia. And what happened here is that the trustee in a Chapter 7—remember, that is a liquidation—objected to the IRS's proof of claim because they wanted to reclassify part of their debt as being secured rather than unsecured. Now, they had a secured debt; they actually had a lien. So, they got a secured debt—so says the IRS. Unfortunately, they released that lien voluntarily. Well, now they come in and they go, "Well, wait a second. We're still secured even though we voluntarily released the lien." And they took an argument that Section 6323 of the Code applies; and it basically says that the lien will continue even if it has lapsed, if the action had already been started.

Well, when they started the action, the lien was still secured. The court said, "Look, you released it voluntarily. That code section applies if the time to collect, the 10-year period on collection, has run up. That doesn't apply in this circumstance." They said to the IRS, "You took a voluntary action. Section 6325 says that the release is effective as of the date of the release. So, you don't have a secured position anymore as of the date you signed the release." So, the IRS comes back and says, "Wait a second. That might be true; but we want to apply the snapshot, take the picture." And the snapshot theory says that, essentially, if the lien was in existence at the time that the action was filed, that lien should still stay on the property, again because of the snapshot on the petition date. Their argument was that, at the time the petition was filed in the bankruptcy court, you take a picture, you take a snapshot. See, I'm aging myself; I don't have my cell phone out. So, I'll take my cell phone out and take my picture. No selfie sticks or anything like that. So, take the picture and we're secured. Therefore, we're secured forever. Well, you can imagine what the bankruptcy court said. They said, "Snapshot theory applies to determine the status, but it doesn't resurrect something that you voluntarily released. You released your tax lien; you can't reinstate it now by any of these theories."

F. *Morgan v. Bruton*, (DC NC)

130 AFTR 2d ¶2022-5123

We have another tax court [case], *Morgan versus Bruton*. This is again a case where the bankruptcy court, and this was appealed to the district court. So, it's a district court case out of North Carolina. And the bankruptcy court had to determine whether or not… and this is really interesting because the IRS had a lien on property that was in a tenancy by the entirety. It was property owned by a husband and wife. The wife does not file for bankruptcy. The debt is the debt of the husband. So, you have a tax debt of the husband. The wife doesn't file bankruptcy; only the husband does. And the tax lien is filed for that debt of the husband. Well, when they file for bankruptcy, they say it's exempt because, under North Carolina law, you can't go after tenancy by the entirety property for the debt of one of them. And that's very common in many states. In fact, most states say you can't go after the property and seize property for the debt of one of them. However, nonbankruptcy law, Section 522(b)(3) of the Bankruptcy Code, says that the exemption for property is only exempt to the extent it's exempt under applicable nonbankruptcy law. Well, the court said that includes federal tax law. Well, federal tax law says that you can go after this property because the lien is going to apply to any interest that the taxpayer may have, and the taxpayer does have an interest in that property. They also noted that, while general rule of North Carolina would be you couldn't take it, that would not supersede the lien of the United States government that was filed under Section 6321. The court referred to a Michigan case which was similar in fact, called *Craft*; that went to the United States Supreme Court. The U.S. Supreme Court in *Craft* said that tax lien attaches to the entirety's property even if only one spouse is liable for the tax debt. Therefore, after demand, if the person doesn't pay, then the tax debt becomes a lien on all of the property that this person has an interest in, including the entireties property. Therefore, that entireties property is not exempt.

G. Draft 2022 – Form 1040

We have some interesting things going on right now. I can't tell you where this is heading. But what I can tell you is it's really important that you talk with your clients about digital assets, virtual currency, whatever you want to call it. And I'm going to say that because the 2022 draft forms came out; and on the top, you have that question. Well, the question's been really changed. It never had a heading to it, a title. Now, it has a title called digital assets. So, if we go back in 2020, it started in 2019, and it was not on the front page. It moved to the front page in 2020; and it says, "Did you receive, sell, send, exchange, or otherwise acquire any financial interest in virtual currencies, yes or no?" Then in 2021, they changed it and said, "At any time during 2021, did you receive, sell, exchange,"—notice, send is out of there—"receive, sell, exchange, or otherwise dispose of any financial interest in virtual currency?" Yes, no. Not acquired, dispose.

Well, what is in the form, the draft form for 2022? Wow, what a change. And what does this mean? It's unclear. It says, "At any time during 2022, did you (a) receive, (as a reward, award, or payment for property or services), or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) Yes or no?" Well, part (a) refers to receiving any type of cryptocurrency, whether it's by reward, award, compensation—it doesn't matter—such as wages. Part (b) is designed to ensnare nearly any relinquishment, anything you give up in digital assets which would have capital gain, exchanging it, even gifting it, resulting in having to file a 709. The problem is what do these terms mean? Now, the AICPA on July 27th, wrote really kind of a scathing letter to the Internal Revenue Service saying, you're changing terms, you're using terms that we really don't know what the definitions are; and the instructions better give really good definitions. The 2022 draft borrows language from Sections 6045 and 6045(a), that's that new broker reporting and the $10,000 reporting that are going to come in, in 2024.

Well, okay, so what is the digital asset? In 6045, it says a digital asset is any digital representation of value recorded on a cryptographically secure distributed ledger or any similar technology as specified by the secretary. So that leaves wide open—what is that language? Because we don't know. Finally, the final regs, are they going to use virtual currency, digital asset? The AICPA says, "Which one are we talking about? Are they in fact different?" They said the definitions are inconsistent. The definitions that the IRS has used in 2014-21, the IRS uses the term virtual currency to refer only to convertible virtual currency. There's no examples really, at least in the 2021 instructions. We need to have those. The instructions in the 2021 said, the first series of frequently asked questions accompanying the form, it's treated as a virtual currency, creating again, a confusion. What is it? So, there's difference and there's significant difference in definition. For example, the form from 2021 lists three attributes of virtual currency. It functions as a unit of account, a store of value, or a medium of exchange. The emphasis here is on that word "or," implying that it could be any one of those three. But Revenue Ruling 2019-24 uses the exact same words but says "and," meaning it has to have all three. Well, we need definition here, but we need to start thinking about this and how do we change. For example, is there any change necessary to our client organizers to take into effect this potential change that the IRS is throwing out at us here? What is it going to mean? So again, the characteristics that it claims, the characteristics of, they aren't listed or defined; it's not used in a binding guidance anywhere. Number of ways to interpret it. And yet, we have some guidance that is conflicting.

Then, another question. We talked in another program about NFTs, nonfungible tokens. They don't appear to be a unit of account, but they certainly are a store of value. So, under 2019-24, it required them to have both and a medium of exchange, convertible. And so, it wouldn't be considered any type of virtual currency. Is it a digital asset now for this purpose? But since the form uses "or," NFTs then would be covered because they do store value. They store a lot of value in an NFT, nonfungible token. This is where someone could put a nonfungible token, they could put out an artwork and people who can buy tokens, buy interest in that artwork or their music. Could be a phrase, whatever anyone wants to invest in. So, huge issues here. Huge questions.

Another question that the IRS still hasn't answered; and they didn't answer it from 2019, 2020, or 2021. What if someone doesn't file a return? What if they don't have to file a return? Are you going to be required to file a return just to answer that question? Number two, a dependent, for example. If a dependent has virtual currency but is not required to file a return, do they have to file one just to check that box? Again, unanswered questions.

In addition, we mentioned in a previous program, Senate Bill 4356, which is a bipartisan bill, the Responsible Financial Innovation Act. And that talks about and defines for its purpose a digital asset; but that is a little bit different than what these definitions are. Is that going to pass? Who knows whether that will pass? But it did get bipartisan, at least, support. But they want to put the authority now to put regulatory authority on digital assets. And they want to put that under the commodity futures. And there's a case out there, the *Hoey* case, and they said we're going to apply the Hoey factors to determine whether the SEC looks at it or the Commodities and Exchange. For the most part, it would be the Commodities and Exchange. Again, the bill creates a *de minimis* exception, exemption. So, if you make nominal purchases in virtual currency, you may not have to report those. But again, that bill isn't the law; and there's nothing that says there's any *de minimis* exceptions in answering that question. Huge issue. Look at it. You may need to amend your client organizers to take into consideration what this may mean. Because again, we really don't know what they're going to come out with. But clearly, the guidance we have so far on defining virtual currency versus virtual asset versus digital assets, they are varying.

H. *Sparta Pink Propertysuth, LLC, et al. v. Commissioner*

TC Memo 2022-88

We have another case, *Sparta Pink Properties LLC, et. al. v. the Commissioner*. It's a tax court case. Why is it important? It's important because it's one of our ongoing cases involving the Extinguishment Clause, the in perpetuity rules. So, in this particular case, interpreting the IRS rules for conservation easements, they have to be in perpetuity, the transfer. However, the courts have recognized, as has the IRS, things could change. Well, the Extinguishment Clause essentially in the regulations says that the grantee, the charitable organization, the conservation group, has to receive the proceeds of the sale; and it talks about how to do it. Well, this deed, what it did is granted it in perpetuity, had all the right language, except they said that they had the right, they reserved the right to make certain improvements; and that really wasn't a problem. Where the problem came in is, under the regs, they can't subtract from the value; when determining the value that the grantee or the conservation group will get, they can't deduct those improvements, the value. And they did in this case. Well, under the *Hewitt* case, the 11th Circuit said that the extinguishment regs are arbitrary, capricious, and unreasonable, they violate the APA. Sorry, they're invalid. So, what they had to come back here is say this case is going to be appealed from the tax court to the 11th Circuit under the Gholson rule. Remember the Gholson rule? The tax court says that they're bound to the law in the jurisdiction in which the taxpayer resides.

Well, in this particular case, it is the 11th Circuit. And so, they said, "We're bound. The 11th Circuit in the *Hewitt* case has already said that the regulation is invalid. Therefore, the regulation is invalid as it relates to this taxpayer." Keep in mind, however, that we also have another case where again, the same issue was brought forward, and the Sixth Circuit said the opposite. So, that is *Oak Brook Land Holdings, LLC v. the Commissioner*. Opposite holding. So, now we have a split in the circuits. We can see that it's affecting cases because the court said, "Look, we're bound to the 11th Circuit, so it doesn't matter what we think. The 11th Circuit has said that this regulation is invalid. We're bound to it." The appeal goes to the 11th Circuit. So, split in the circuit. Probably we're going to see some Supreme Court action. Where does that leave us? Well, if you're in an area that is not in the Sixth or the 11th and the court hasn't ruled, this is going to be a problem for practitioners. Because you're going to have to make a reasonable judgment from that whether or not your circuit is going to uphold it. Keep in mind that the odds are that this is going to end up in the Supreme Court because we have just far too many cases of conservation easements around the country. And this is a very important provision in determining that in perpetuity clause and the extinguishment regs.

Well, I want to thank you for joining me today, and please be safe.

Current Material: Experts' Forum

By Ian J. Redpath, JD, LLM

A. IR 2022-155, Notice 2022-36, 2022-36 IRB

The IRS is provided penalty relief to certain taxpayers who filed their 2019 and/or 2020 tax returns late. The penalty relief also extends to certain domestic and international information return filers. For income tax filers to qualify for this penalty relief, any "eligible income tax return" must be **filed on or before September 30, 2022.** It applies only to the failure-to-file penalty. For banks, employers, and other businesses required to file information returns, such as those in the 1099 series, a 2019 return will be considered timely if it was filed by August 3, 2020; and a 2020 return will be considered timely if it was filed by August 2, 2021. Eligible tax returns include: Forms 1040, 1040-C, 1040-NR, 1040-NR-EZ, 1040 (PR), 1040-SR and Form 1040-SS, 1041, 1041-N, 1041-QFT, 1120, 1120-C, 1120-F, 1120-FSC, 1120-H, 1120-L, 1120-ND, 1120-PC, 1120-POL, 1120-REIT, 1120-RIC, 1120-SF, 1066, 990, 990-EZ, Form 990-PF, 990-T, 1065 and 1120-S.

The relief is automatic, so no action is necessary. If a taxpayer has already paid a late-filing penalty, the filer will receive a credit or refund. It will not apply if: 1) it is a fraudulent return; 2) there is an accepted offer-in-compromise that included the penalties; 3) there is a closing agreement for either/both years; or 4) the penalties were finally determined by a court.

B. IRS Mission-Critical Functions Continue

In an update on its backlog of returns and taxpayer correspondence, the IRS said that, as of August 19, it had 8.7 million unprocessed individual tax returns it has received in 2022, a mix of returns for 2021 and late-filed returns for previous tax years. It says mail is being opened within normal timeframes, and all paper and electronic individual returns received prior to January 2022 have been processed if the return had no errors or did not require further review.

As of August 24, 4.6 million Form 941s remain unprocessed; this is actually an increase from previous updates.

C. Determination Letter for Retirement Plans

Sponsors of defined-benefit or defined-contribution plans require IRS determination that the proposed plan and any related trust comply with the tax code and regulations. Once the IRS receives an application for determination, it sends an acknowledgement notice to the applicant and assigns it to a specialist who contacts the employer concerning the plan. Priority is given to Form 5310 applications. The IRS has a significant backlog and some Forms 5300, 5307, 5310, and 5316 have not been assigned to a specialist Applicants can contact the IRS by phone, fax, or mail to check on their application's status. The IRS's Employee Plans group can be reached at (877) 829-5500 (toll-free) or by fax at (855) 224-1311. The mailing address for U.S. Postal Service delivery is: Internal Revenue Service; EP Determinations; Attn: Manager, EP Correspondence; P.O. Box 2508; Room 6-403, Group 7535; Cincinnati, OH 45202. For private delivery, the address is: Internal Revenue Service; Room 6-403, Group 7535; 550 Main St.; Cincinnati, OH 45202; Attn: Manager, EP Correspondence.

Include the following:

1. Name of the employer;
2. Employer's employer identification number;
3. Name of the plan;
4. Plan number;
5. Application number;
6. Date application was submitted; and
7. Indicate who is requesting the information (plan sponsor, employee of plan sponsor, plan participant, or practitioner representing plan sponsor. Practitioners may need to submit a valid Form 2848, *Power of Attorney and Declaration of Representative*, or Form 8821, *Tax Information Authorization*.).

D. Legal Advice Issued by Field Attorneys 20223301F

In a Field Attorney Advice, the IRS Chief Counsel's Office determined that a penalty should be assessed against a tax preparer who advised their client that a reserve for estimated liabilities could be excluded from income in disregard of §461 and the regulations. According to the Chief Counsel's Office, the §6694(b) is appropriate as tax professionals involved in giving the taxpayer advice had to have been aware of the law and regulations; so, their written advice to the taxpayer intentionally disregarded the rules and regulations.

E. *IN RE: LITVINAS*, 130 AFTR 2d 2022-5524, (Bktcy. Ct VA)

The trustee's objection to the IRS's proof of claim and request to reclassify a portion of their debt as secured was upheld. The IRS had entered into a lien release post-petition and was, therefore, bound to that release. The IRS was relying on §6323 and its lapse provisions. However, this lien did not lapse but was the result of an affirmative and voluntary action by the IRS, so this section was not applicable. Section 6325 is more applicable and provides that a release is effective as of the date of the release. The IRS also attempted to use a "snapshot theory" that looks at the nature of the claim—secured or unsecured—on the filing of the petition. This is generally correct; but the IRS cannot resurrect a lien that has been subsequently voluntarily released.

F. *Morgan v. Bruton*, (DC NC)

130 AFTR 2d ¶2022-5123

The Bankruptcy Court was upheld in determining that a taxpayer was not entitled to exempt from a Chapter 7 bankruptcy property jointly owned with his spouse. The tax debt was his personal debt, and the spouse did not file for bankruptcy. Bankruptcy Code §522(b)(3) allows an exemption for a joint property interest to the extent such interest was exempt from the process under applicable **nonbankruptcy law**, which include federal tax law. While under applicable state law, property in a tenancy by the entirety is exempt from the claims of non-joint creditors, IRC §6321 provides that if the taxpayer neglects or refuses to pay, the amount "shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." In *United States v. Craft*, 535 U.S. 274, 283 [89 AFTR 2d 2002-2005] (2002), the U.S. Supreme Court held that such a lien attaches to entireties property even if only one spouse is liable for the tax debt. Thus, the property cannot be exempted in a bankruptcy case.

G. Draft 2022 – Form 1040

The current 2022 draft Form 1040 proposes to change significantly the language dealing with "virtual currency." The AICPA has suggested in an August 29th letter to the IRS that the changes are inconsistent with how IRS guidance defines "virtual currency" and should be fixed.

In 2021, the wording was:

> "At any time during **2021**, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? Yes No"

For 2022, the IRS is proposing to add a marginal heading of **Digital Assets.** The language is substantially revised to:

> "At any time during **2022**, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) Yes No"

First, the language is changed from "**virtual currency**" to "**digital assets.**" Further, Part (a) is expanded and refers to receiving "digital assets," whether it is by a reward, award, or compensation (such as wages) rather than just acquire. The new definition is to require taxpayers to report what would be a taxable transaction. Meanwhile, Part (b) is designed to ensnare nearly any relinquishment of the "digital assets," whether by selling it (capital gain), exchanging it (various potential tax implications, depending on the nature of the transaction), or gifting it (which could result in 709 filing).

The definitions used in the 2021 Instructions and Form 1040 differ significantly from the definitions used in other formal IRS guidance, such as Rev. Rul. 2019-24 and Notice 2014-21. The term "digital assets" comes from §§6045 and 6045A of the Infrastructure Act with the new reporting. Section 6045(g)(3)(D) defines a "digital asset" as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary." Thus, the definition could change with expected upcoming regulations. Until such, the AICPA recommends continuing the use of "virtual currency" rather than "digital asset." It also recommended that the IRS modify the definition of "virtual currency" to align with the guidance in Notice 2014-21 and apply it only to convertible virtual currency. The 2021 instructions list three attributes of virtual currency—that it functions "as a unit of account, a store of value, or a medium of exchange." Using "or" implies that if any one of the three functions applies, the transaction may have involved virtual currency. Rev. Rul. 2019-24, however, lists these same functions, except it uses "and," implying that all three functions must be present. This is a significant difference.

Non-Fungible Tokens (NFTs) do not appear to be a unit of account, but they are a store of value. Rev. Rul. 2019-24 requires an asset to be both a unit of account and a store of value—and a medium of exchange; thus, an NFT is not a virtual currency. "However, using the term 'or,' would mean they are included.

An additional issue is whether a return must be filed to answer whether a taxpayer must file a return to answer that question if the taxpayer is otherwise exempt from filing.

H. *Sparta Pink Propertysuth, LLC, et al. v. Commissioner*

TC Memo 2022-88

The IRS was denied partial summary judgment on taxpayer/partnership's deduction claim for charitable donation of conservation easement. The IRS reduced the claimed deduction to $44,748, as opposed to the $15,632,748 claimed. Sparta claimed the extinguishment regulations are invalid for failing to follow the Administrative Procedures Act (APA). Since an appeal would be to the 11th Circuit, the Tax Court was bound to follow *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021), rev'g and remanding T.C. Memo. 2020-89 in which the Appeals Court held that the Commissioner's interpretation of §1.170A-14(g)(6)(ii) (the extinguishment regulations) to disallow the subtraction of the value of post-donation improvements…, is arbitrary and capricious and thus invalid under the APA's procedural requirements.

The easement deed recites the conservation purposes and generally prohibits commercial or residential development. But it reserves certain rights to Sparta, including the rights to repair, improve, enlarge, and replace existing improvements on the Property and construct additional improvements. Paragraph 17 expresses the parties' intention that "the Purpose of this Conservation Easement be carried out in perpetuity." However, "[i]f circumstances arise in the future that render the Purpose of this Conservation Easement impossible to accomplish," giving rise to a judicial extinguishment of the easement, then on any subsequent sale or conversion the grantee is entitled to a portion of the proceeds. Paragraph 19 defines the grantee's share of the proceeds as equal to "the current fair market value" (FMV) of the easement. The FMV of the easement is determined by multiplying the sale proceeds by a fraction specified in the regulations. But before this fraction is applied, the sale proceeds are reduced by "any increase in value after the date of this Conservation Easement attributable to improvements." The IRS objected to any reduction for improvements made by the grantor.

It should be noted that the Sixth Circuit Court of Appeals held the opposite to *Hewitt* in *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700, 717-18 (6th Cir. 2022), *aff'g* 154 T.C. 180 (2020). This issue is very important and will likely end up in the Supreme Court.

GROUP STUDY MATERIALS

A. Discussion Problems

Your client, Jose, came to you to discuss a number of tax issues:

1) He and his wife have been filing separately for many years, and he has discovered that she has very large past-due taxes with the IRS. He indicated that she recently filed bankruptcy, and the IRS claims the marital property held as tenants by the entirety is not exempt in regard to the tax debts. His lawyer told him that under state law, the property is exempt from the creditors of only one spouse. He asks why the IRS is still pursuing the property in bankruptcy.

2) He has, over the last three years, actively engaged in transactions in various forms of virtual currency, NFTs, and other digital assets. He is unclear of the reporting, if any, for these and asks your advice.

3) Jose's investment advisor has suggested he invest in a syndicated conservation easement. He brought in the easement documents. In your review, you noticed that the grantor can make improvements and, if there is an extinguishment, that amount is subtracted from what the grantee can get. He asks what you think of this investment.

Required:

Address the issues raised in the above independent facts.

B. Suggested Answers to Discussion Problems

1) The exemptions refer to nonbankruptcy law. While the lawyer may be correct under state law, other nonbankruptcy law includes the Internal Revenue Code. The Supreme Court in *Craft* upheld the IRS claim that property held as tenants by the entirety is not exempt from IRS debt because, if a taxpayer neglects or refuses to pay, then a lien attaches to any interest that the taxpayer has in property. This would include the tenancy by the entirety.

2) There is a significant proposed change to the language concerning the question on page 1 of the Form 1040. Most significantly, it uses the language "digital assets." There is conflicting guidance in what that might mean; and it could, for example, include NFTs. This needs to be closely monitored for any final changes and what further guidance may come from the IRS.

3) The language is problematic in general. The 11th Circuit Court of Appeals in *Hewitt* found the extinguishment regulations to be invalid as the IRS did not property follow the APA in adopting the regulations. However, the 6th Circuit Court of Appeals held the opposite in *Oakbrook Land Holdings*. If in the 11th Circuit, then this language will be upheld; and if in the 6th, it will not. If in any other Circuit, it is a risk that the taxpayer may not want to take. This will most likely go to the Supreme Court.

PART 2. INDIVIDUAL TAXATION

Debt Basis in an S Corporation

One of the most significant concepts for a tax practitioner that deals with S corporations is that of basis. The rules for stock and debt or loan basis can be complicated and are often misunderstood. It is imperative that practitioners understand how debt can affect basis and the ability of shareholders to take certain flow-through deductions or losses on their tax returns. Ian Redpath and Jonathan Tretter discuss issues related to calculation of debt basis in an S corporation.

Let's join Ian Redpath and Jonathan Tretter as they discuss the importance of properly computing a shareholder's debt or loan basis.

Mr. Redpath

Jonathan, welcome to the program.

Mr. Tretter

Hi, Ian. Thanks for having me again. Looking forward to it.

Mr. Redpath

It's great to have you here. And we left a teaser with our viewers with the stock basis in an S corp, our previous program. And now we're going to do loan basis. Can you kind of give us the general overview of the difference then, because there's a general thought out there that, you hear partnership, S corp, they're basically the same. And that's really not true, right? I mean, the concepts are the same. Conceptually it may be, but basis is really a huge difference. So, can you kind of give us just an overview of some of those differences?

Mr. Tretter

Yes. I think one of the largest differences between partnership basis and S corp basis is really when it ties to debt. If partnerships enter into debt agreements at the partnership level, generally the partners get basis in their pro rata share of that debt. That's not the case with S corporations. If an S corporation enters into a million-dollar loan, that does not impact the shareholder's debt basis at all. The loan really has to be between the corporation and the shareholder. The shareholder actually has to loan the money to the corporation and kind of formalize it in the form of a note in order to get basis that would allow you to deduct losses against that basis. So, that's really the biggest difference that I see between the two is really how debt is handled.

Mr. Redpath

Yes. And as you mentioned, in a partnership, you get basis. It's one basis. It's your capital account, which would be, let's call that equity, and it's the loan. And there are complicated rules on what your share is, but you get a share of the debt. Now, there's nonrecourse debt, there's recourse debt. And nonrecourse debt, you're going to get basis. And people get confused because in a partnership you get basis, but you don't get at-risk, unless it's that nonqualified, which is limited to real estate. Those concepts of allocating debt, and recourse, nonrecourse, all of that, really aren't S corporation issues, are they?

Mr. Tretter

No. Those really are not S corporation issues. On the S corporation K-1, there's really nowhere to even disclose recourse, nonrecourse, qualified. Those really are partnership issues, not tied to S corporations.

Mr. Redpath

And in a lot of respects, I think the amount of at-risk.… So, in many partnerships, especially real estate partnerships where you might have some nonrecourse debt, or when you're allocating nonrecourse deductions, that's a concept of partnerships. And so, very, very different here, and a lot of times the at-risk in the S corp is just basically the basis. I mean, the concepts are very similar. Is that what you find?

Mr. Tretter

Yes, that's exactly what I find. And not to get off on a tangent, but with partnerships, all your debt that goes to your K-1 is basis. But then, as we talked about with S corporations, there's an ordering, basis, and then the next rule is at-risk. So really the nature of the debt flows through the at-risk schedule for partnerships; again, not really a concept that impacts S corporation shareholders.

Mr. Redpath

So, we're talking about loan basis. And I think for the most part, this really becomes most relevant if you have distributions, right? Of losses. Or there are distributions, but let's assume the partnership has losses. All of a sudden, that loan basis becomes a real issue, right?

Mr. Tretter

Yes. Generally, if a shareholder wants to take a loss that flows through to them on their K-1, and there's no stock basis, then debt basis really becomes a critical item to identify how much of those losses can be deducted. And then, in future years, if there's income, restoring the debt basis, because repayment could trigger gain in the future.

Mr. Redpath

Essentially, I guess, there's an ordering rule. So, we know that you're going to be able then, from what you're saying, is you can write off losses to the extent of your stock basis and your loan basis in an S corp. So, is there a priority here? I mean, how are you applying these?

Mr. Tretter

I believe the ordering is stock basis comes first, with the ability to take income and then also to take losses against it. And then, once your stock basis gets exhausted down to zero, then debt basis kicks in to figure out if excess losses can be deducted against your debt that the shareholder may have.

Mr. Redpath

And then after that, they're suspended. They don't go anywhere. You can't take them any further. So, there's now—and the concept isn't new, but there's a form that was new for 2021—the 7203. The 7203, what is that for? And I know the IRS has said there's been kind of a lack of compliance that they're finding with the filing of it, at least for 2021. What is the 7203?

Mr. Tretter

The 7203 is basically a form that kind of formalizes a reporting requirement that S corporation shareholders kind of always had to track basis. 2018, it became more formal that a basis schedule had to be attached to a personal return. But the 7203 kind of formalizes in a format the way that the IRS wants to see basis computations. If a shareholder's trying to deduct a loss, if they took dividend distributions and the character of those distributions, if they sold any stock, those are some of the key things that require the Form 7203 to be generated and attached. But as we previously discussed, kind of best practice is to just always generate the 7203, even if it's not required. Keep it in your file, because you never know when it's going to be required in future years.

Mr. Redpath

Yes. And as you mentioned, Jonathan, we were talking off camera about this; and as you said, it's best practice to always do it even if you're keeping it in your file. Although, if you're claiming a current loss or a loss from a previous year, you still have to file the 7203. If you got a non-dividend distribution from an S corp, you've got to file a 7203. If you're disposed of any stock, even if there's no gain, you've got to file a 7203. Or if you received a loan repayment, you've got to file a 7203. So, for the most part, there aren't a whole lot of things when you're not filing a 7203, is the reality of it, especially in the situation where you have losses. And many S corps today have losses. We were mentioning off camera and I think it's important, some of the changes that have been made to the S corp K-1 that if we're preparing the 1040, we should really be looking at. Could you kind of go over those?

Mr. Tretter

Yes. On the K-1, and I think it was new for 2020 or 2021, there's some new information that's required on the face of the K-1. What's new is the K-1 has to report if there's any shareholder data or shareholder loans. It requires a beginning of the year balance and the end of the year balance. I think that notifies the IRS if there are loans. But it also notifies the tax practitioner of the shareholder if there were any advances or repayments on those loans; as well as number of shares held at the beginning of the year and the end of the year is also required on the K-1 now. Which again, it's information for the IRS, but also what helps the shareholders practitioner to determine if there's any change in stock or debt; because as we discussed and we'll continue to discuss, when it comes to stock, you're really supposed to look at each block of stock. So, if you acquired more shares during the year, that's its own block that really requires its own reporting. And each note or debt also has its own reporting requirements for each separate note; or I guess block of debt is not a true term, but that's required. So, those are some of the new requirements on the K-1.

Mr. Redpath

And the 7203, there's three parts. Part I deals with your stock basis. And then, so what's Parts II and III, which is really what this program will also deal with, Parts II and III? So, what do those deal with?

Mr. Tretter

So, Part II specifically deals with shareholder debt basis and breaks out the different types of debt, different types of notes as a mechanism to track beginning a year, and then current-year activity in the loans, as well as the ability to deduct losses. And then, if losses are deductible, then generally those carry over to Part III. And if they're not deductible, then it also goes to Part III for carryover. So, once you kind of do stock basis, then Part II goes to debt basis; and then kind of it all flows to Part III, depending on the deductibility of the losses.

Mr. Redpath

In some respects, it's just tracking the law, right, as to how we're applying it?

Mr. Tretter

Yes, exactly.

Mr. Redpath

And it makes it a little easier if we're doing it, right? If we're doing the 7203, it makes it a little easier. But again, I want to emphasize something that you and I were talking about. You said best practice is to keep it. So, does your software at the S level generate a 7203 or is there an option to do it for each of the shareholders?

Mr. Tretter

Yes, our software does. There's an option to generate the 7203, kind of as supplemental or additional information for the K-1s. Previously, there was an option to do the same for shareholder basis in the S corporation. So, our software does generate a 7203 if requested for a K-1. But again, 7203s are only as good as the beginning basis number. And there are elections and decisions made at the shareholder level that the S corporation may not be aware of that could make the 7203 not entirely correct, which is why it's informational and not filed with the return, I would say.

Mr. Redpath

And I think the caveat here is, if you're just preparing the 1040 for the shareholder, you can't just automatically rely on that 7203 and think it's correct for your shareholder.

Mr. Tretter

Yes, absolutely. Because how you acquire the stock impacts basis, and the S corporation may not always know that. Deductibility of nondeductible losses before ordinary losses is an election that can be made, and that impacts your beginning basis. So, all those things, the practitioner at the shareholder level needs to be cognizant of and not completely rely on the S corporation 7203 presented.

Mr. Redpath

And it might also then… it affects the stock basis and then it could affect the loan basis too, depending on what losses you've taken, and depending on the election you've made. So, if you elected to, for example, treat the distributions as being the items, take nondeductible before deductible. Well, if you switch that around and say, we want to take deductible before nondeductible, that can affect everything, right?

Mr. Tretter

Yes. That changes everything, and that impacts year over year the calculations of the form.

Mr. Redpath

Right. So, loan. Loans seemed very straightforward; but the IRS came out with some regulations on that, which I don't think were really helpful. They kind of stated the obvious but didn't give us any real direction, and they didn't want to. So, I guess the first thing to qualify for basis in an S corp, because I don't know about you, Jonathan, but I can tell you, I have seen all sorts of crazy things where people have tried to say that, "Well, this generated basis." I had one where they had 93 entities and they were all intercompany, circular, going around and around, and saying they get basis in any one that had a loss come through. And that was on audit, unfortunately, is when I was involved. I think the IRS might've been right on that one, that there was no basis. So, what is an S corp basis? I mean, what does the IRS say that you have to have to really genuinely treat it as a basis for the shareholder in a loan?

Mr. Tretter

Generally, what should happen is there should be an executed formal note between the shareholder and the corporation. I think the IRS likes to see that document of evidence that it is a legitimate, formal note. There should be interest. There should be an interest component on the note, and a lot of times, just the normal components of what you would see in a formal note should be present to really legitimize it as a formal note. There is this concept of open indebtedness, which is more or less kind of a looser term, where clients don't always formalize the note. In the IRS's mind, if that open indebtedness exceeds $25,000 at the end of the year, on the next year's 7203, it is classified as a formal note. And the nature of repayment of those loans, whether it's open account indebtedness or formal note, there's different treatments of repayment and whether it's capital gain or ordinary income. It just kind of speaks to the complexity of debt basis, but also the importance of tracking it and knowing which character it is.

Mr. Redpath

Regulation 1.1366-2 and the IRS just simply said essentially, it has to be a loan running from the shareholder to the corporation and it has to be bona fide. And you were mentioning a number of things. If you're going to have a loan and you don't want to have a problem with the IRS, I agree with you 100 percent. You should have a note and it should be a real note, not some of the things that I've seen. It should be an actual note, interest. And you also really, the IRS will come in sometimes and say, "A real creditor would actually have done something if nothing had been repaid ever, for the last 15 years, you've been carrying it on the books." So, those are the types of things. I've seen situations where people have recorded it on the books as equity, but yet they've got a note. I actually saw a note once that had voting rights. Well, that's a second class of stock. You just got rid of your… And I think that's really something to be careful of because if you're trying to play fast and loose with the loan rules, the IRS could come in and go, "Wait a second.… We're going to recharacterize that debt as equity." Well, that's a second class of stock. That's a termination effect. So, you can't play too fast and loose with the rules when it comes to S shareholder debt.

Well, so you have this, and you mentioned the idea of open account, which I always view as being, the client comes in and you go, "What did you do?" "Oh, but I had to put more money in my company," and then you go, "Okay, how are we going to treat this? Are we going to treat it as a loan? Or are we going to treat it?" And sometimes it's just booked in as a loan and there is no note. As you said, maybe it's good on that to recharacterize it, do a note now, put it down as evidence of indebtedness.

Jonathan, how do distributions affect loans? How do guarantees? Because I know a lot of people, you go to borrow money and think because you incorporated, that I'm free and clear. Nobody's going to come after me. And then the bank says, "Hey, if you think it's such a great deal, you sign the guarantee." So, how do distributions affect loan basis? And how do guarantees affect your loan basis?

Mr. Tretter

Both really do not impact a shareholder's loan basis. Distributions do not impact it, as well as loans that a shareholder guarantees or co-signs are not part of a shareholder's loan basis. That's kind of a partnership concept, not an S corporation concept. The loan must really be between the shareholder and the S corporation in order to impact debt basis.

Mr. Redpath

And there's a case out there, *Oren*. And one of the things that people have often done is they do these so-called circular loans between entities, for example. You borrow and ultimately nobody, as the IRS might say, nobody's really liable. Can you really get this basis from all of these types of circular types of loans?

Mr. Tretter

I think the key is to make sure that the loan to the corporation is proper form if you do want to make that work. I think there's a lot of formalities that you need to make sure are in place if you're really trying to get that basis in those instances.

Mr. Redpath

Yes. I mean, if it's a real back-to-back loan… And back-to-back loan means that—or they're called back-to-back or mirror image—you borrow the money from the institution, you sign; now you then loan the same amount of money to the corporation. But the thing is, there are cases out there where the corporation has paid the bank directly rather than paying the shareholder. And they've said, "Well, wait a second. You didn't recognize that shareholder loan, so therefore, we're not going to. You get no basis." So, you've really got to be very careful when you're doing this. You've got to make sure that everything looks as it's supposed to be. It's a loan to the shareholder, and then the shareholder loaned under similar terms, because if you don't, you're not going to get any basis. So, don't have the corporation pay the bank or the lending institution directly, or you're not going to get anything. But circular related-party loans, general rule is you're not getting basis, right? You can't get basis if the loan is within a related party.

So, loan reductions. Okay, we're reducing our loan for losses because now we have no stock basis, reduced our stock basis to zero. Now, we've gone to our loans. Is there a priority? How do we reduce the loan basis?

Mr. Tretter

Losses reduce loan basis really on a pro rata basis, based on the ratio of the outstanding loans; but generally, it is a pro rata reduction based on all the loans outstanding.

Mr. Redpath

Yes, I think that really gets people. There's a misunderstanding there. It's not FIFO, it's not LIFO, it's not pick and choose. It's pro rata based upon what the loan basis at the time bears to the aggregate basis of all your loans. So, as you said, a pro rata share. But we have a concept of restoration, and in the opposite. We said, you reduce stock, then you reduce loan; but when you restore, you go loan, then stock. You go the opposite. What does that mean to restore the basis of debt, and how do you do it?

Mr. Tretter

So, to restore the basis of debt, I guess it more or less to the extent that there's income from the K-1, and there were previous losses that were deducted against the debt, it kind of brings your basis in the loan back to kind of what the true loan balance or formal note was when it originated.

Mr. Redpath

And so, I guess we should go back and say, if you have no basis in a loan or you have a basis that's lower than your payments. Let's say payments are being made on the loan, that loan basis becomes important because you can have income, right?

Mr. Tretter

Yes, absolutely right. If your loan basis is less than what the actual loan balance is, and there are repayments, then there's a calculation to be made to figure out how much of each repayment is essentially a repayment of debt, but also a restoration of basis, which could trigger either capital gain or ordinary income, just depending on the types of loans that are in place.

Mr. Redpath

And you mentioned the $25,000, that open account debt. Is there a difference if you're paid on a note or if you're paid on open account?

Mr. Tretter

Generally, a repayment on an open account would trigger ordinary income to the shareholder. Generally, a repayment on a formal note would be capital gain treatment. I think there are some exceptions to those; but that's kind of the general rule that we see. Generally. I always recommend that any shareholder debt does get formalized with a note. I think it substantiates in the eyes of the IRS that it's legitimate. And upon repayment, it kind of protects the taxpayer to treat it as capital gain and not ordinary income. So, it's generally best practice to formalize your shareholder debt.

Mr. Redpath

When you have restoration of basis, in other words, you had net increases, then how do you apply it? How do you know which debt to apply? Is there an ordering?

Mr. Tretter

Yes, generally, restoration of basis first gets applied to loans that had repayment during the year. And then, to the extent that there's restoration in excess of that, then it becomes pro rata to the other debt.

Mr. Redpath

So, hopefully, you can avoid having to have income for the year by doing that.

Mr. Tretter

I think just another thing to keep in mind with these notes is the interest component, making sure that the interest expense and interest income is accurately reported based on who the loans are made to.

Mr. Redpath

Yes, that's an important point. I think you're bringing up something that you have to treat it for all purposes as exactly what it is—a loan from the shareholder, not someone else involved at all. And then as you said, sometimes we may be reflecting it elsewhere as something different.

Mr. Tretter

Exactly.

Mr. Redpath

IRS catches that one, you're in trouble. So, let's talk about the 7203 kind of doing this 35,000-foot view of it, and here we're really Part II and Part III. So, can you kind of give us an overview of the 7203 Part II and III?

Mr. Tretter

Yes. Part II calculates the shareholder debt basis. A shareholder must complete this section of the form if they have personally loaned money to the corporation. You have to account for each formal note separately made to the S corporation in its own column; and to the extent you have more than three loans or debts, you have to create, attach additional 7203s. You're really not supposed to aggregate multiple loans into a single column, similar to what we talked about with blocks of stock. Each loan stands on its own. And as we also previously discussed, open account loans that exceed $25,000 at the end of the year really go to a formal note in the next year.

Mr. Redpath

And then also, if you refinanced a note, any increase, you're going to have to do that to account for that on line 17. But let me ask you about that. Should you treat it as a different note? In other words, enter into a new note? Or should you increase? And when you're increasing or refinancing the note with the shareholder, should you refinance an existing note or just say, "We're going to do additional debt. Here's a new note. Keep the old note." I mean, is there any complication there? Are we just maybe making it more complicated by trying to say, "Oh, we refinanced this note."

Mr. Tretter

I guess my opinion would be trying to refinance it probably complicates it a little more than it needs to be. I mean, I generally look to just creating a separate new note, but I don't know if you have a different practicing opinion on that.

Mr. Redpath

No, I agree with you on that. I don't like to do anything with formal notes that will cause a question with the IRS. So, if we're going to loan more, rather than treat it as a refinance, I would treat it as an additional note. The only time I would be involved with refinancing is if we were changing any of the security of a note. Well, usually the corporate shareholder notes usually don't have any security for them, or changing a term in the note, maybe changing the interest rate, for example. And there's a question for you, Jonathan. As we're talking, interest rates are going up significantly. I have had corporate notes that have had the AFR 1%. What about those older notes? Should we be considering looking at the interest and maybe adjusting the interest, or are we going to be safe? What is your firm doing on that?

Mr. Tretter

I think it really depends on, more or less, how the note is written. If it's a formal note with a locked-in interest rate and repayment terms, then I think you're probably okay. But if it's one of those notes that, interest accrues, there hasn't been a repayment on it, I think it's probably better to reevaluate current AFR rates to see if there should be an adjustment in the materiality of it.

Mr. Redpath

Yes, I think this goes to how formal has that note been. Do you actually have a real note? And if you have, that 1% is fine; because at the time, that was the interest rate and not an issue. But where you had things that may not have been exactly reflecting a note, you may want to go back now and see, do I have to adjust that? Or am I going to have an issue with the IRS? So, I completely agree with your analysis on that. Again, we have this repayment to increase the basis. What about, then, if we restore? Do we report that then? Are restorations of basis then reported on the 7203?

Mr. Tretter

Yes, restoration of basis does get reported on the 7203.

Mr. Redpath

As well as repayments, right? Line 34 deals with repayments. If you've gotten paid and you're going to have to pick up gain, that also is going to be reported. And then what about Part III? What really is Part III?

Mr. Tretter

Part III, more or less, kind of takes Parts I and II and then determines, if there is the loss for the current year or carryover losses, how much of those losses can get deducted, as well as the character of those losses. Because not all losses are treated equal, but you also can't pick and choose which losses you want to deduct in the current year. It's pro rata based on the total amount of the losses and the different buckets that those losses fall into.

Mr. Redpath

The 7203, to me, forces us to look at it; but it kind of does give us a roadmap. Yes, we had worksheets before, but I think this really provides us a great roadmap. And when you're talking to your staff, Jonathan, how do you go about talking to them about the 7203? Do you tell them, this is your roadmap to follow?

Mr. Tretter

Yes, generally, this is your roadmap. Read the instructions because they do kind of outline the ordering and some of the other details. But I do think the 7203, just from a teaching perspective for staff or people new to this concept, I do think it's more helpful than just the old worksheets because it does kind of lay out the items a little more clear and kind of the ordering and such.

Mr. Redpath

I know you're not sitting around every day preparing a return, but you also have to review returns, and I'm sure you're reviewing a number of S returns that a staff have prepared. How much do you think that you have to, when you look at that from the preparation, is there a lot more now that you have to look at when you're reviewing returns that were prepared before they're sent out?

Mr. Tretter

I guess I do think there's a little more that you have to, I guess, review. I guess it depends on how many loans there are and then if there are carryover losses. I mean, it really depends on what's going on in the current year. But I would say at least in the first year or two that these forms are generated and are going to be reported, I think probably it does make sense to spend a little more time making sure things are in order and that you're in agreement with what's being reported because it does impact future years.

Mr. Redpath

Jonathan, can you leave us with—you've given us a lot of great insight here—can you leave us with any kind of tidbits of information that everybody should remember when dealing with loan basis?

Mr. Tretter

Yes, I would say it's not always practical and clients don't always want to hear it. But really, make the suggestion to clients that any debt should be formalized, even if it is at the end of each year; because as we've discussed, it just kind of protects you and the client under exam, especially if there are losses or repayments that are happening in the year. So, that's really my biggest takeaway or suggestion is, making sure you can formalize this as much as possible; because as we discussed, the rules are complicated; and under exam, it could trigger some adverse results for your client.

Mr. Redpath

And I think one thing that you mentioned earlier is, if you're doing the 1040, you can't just rely on one that was supplied for information purposes from the preparer of the 1120-S. If you didn't prepare the 1120-S, then you can't just rely on the 7203 that you got. Is that a fair statement?

Mr. Tretter

Yes. That's a very fair statement. Exactly.

Mr. Redpath

Jonathan, thank you for being here today. I really appreciate it. You've given us some really great insight, and we'll have you back on another program soon. Jonathan Tretter, thank you very much for being here.

Mr. Tretter

Thank you. I enjoyed it.

Shareholder's Basis in S Corporation Debt/Loans

By Ian J. Redpath, JD, LLM

A. Introduction

Perhaps the most important tax concept for a tax practitioner advising S corporations is basis. While conceptually, both partnerships and S corporations are conduit entities that generally do not pay tax but flow the tax items through to the owners, the determination of basis is very different and can have a significant impact on the owners. The most significant different is in the treatment of debt. In theory, owners of these entities are responsible for calculating their own basis; however, realistically, it is the practitioner that has to do it. It is important that the practitioner understand the impact of debt on basis.

B. Loan/Debt Basis

For purposes of deducting losses and deductions from an S corporation, a shareholder first reduces the shareholder's stock basis. Once that stock basis is reduced to zero, the shareholder will be allowed to take such deductions and losses to the extent of the "shareholder's basis in an indebtedness of the S corporation to the shareholder." [§1366(d)(1)(B) and Reg. §1.1366-2(a)(2)] To the extent that the shareholder has taken deductions and losses against debt basis, the shareholder must reduce the shareholder's basis in such debt. The debts incurred by the S corporation, other than to the shareholder, do not create basis. Likewise, simply guaranteeing a debt of the S corporation will not get the shareholder additional basis. If the debt is repaid when the loan basis is reduced, a gain is triggered in the amount of the repayment in excess of the shareholder's basis in the loan. If the loan is evidenced by a note, it will be capital gain. Otherwise, if there is no note, as in open account debt, it will be ordinary income. (Rev. Rul. 64-162 and Rev. Rul. 68-537) The general rule is that, where the face amount of a debt is in excess of its basis, a part of each payment thereon must be included in income, being that fraction of the payment the numerator of which is the difference between the face amount and the basis of the debt and the denominator of which is the face amount of the debt. [*Joe M. Smith,* 48 T.C. 872 (1967) and *Novell v Commissioner*, TC Memo 1970-21]

Example: ABC, Inc., an S corporation, had a nonseparately computed loss for the year of ($100,000). Alice, the sole owner, had a stock basis of $25,000, had previously loaned the corporation $45,000, and had guaranteed $50,000 of corporation debt at the local bank. Alice can deduct $70,000 of the $100,000 loss. This is equal to her stock basis of $25,000 and her debt/loan basis of $45,000. The guarantee of the corporate debt does not provide any loan/debt basis for her. At the end of the year, her stock basis and loan/debt basis are both reduced to zero and the remaining loss of $30,000 is carried forward to the subsequent year when basis is restored.

The Code does not define the term "basis of indebtedness." The courts previously interpreted it as requiring "an actual economic outlay" by the shareholder. [*Estate of Daniel Leavitt, Deceased, Estate of Evelyn M. Leavitt, Deceased v. Commissioner,*_875 F.2d 420 (4th Cir. 1989)] This essentially requires that the shareholder must be "out of pocket" before a basis is created. For example, if a shareholder must start paying on a guarantee then, as each payment is an "actual economic outlay" to the extent of the payment.

To avoid this limitation, shareholders have often resorted to related-party loans, circular loans, and especially back-to-back loans. [See *Oren v. Commissioner,* .357 F.3d 854, 857-859 (8th Cir.2004) and *Bergman v. U.S.*, 174 F.3d 928, 932 (8th Cir.1999).] In back-to-back loans, the shareholder borrows from a lending institution or refinances an existing loan to become principally liable and then loans the same amount to the corporation on the same terms. The key is to make sure the loan to the corporation is proper as to form.

The Regulations address what loans will constitute "indebtedness of the S corporation to the shareholder." [Reg. §1.1366-2] The focus of the regulations is whether the loan is a "bona fide" loan applying traditional rules of federal taxation, essentially a facts-and-circumstances test. The IRS did not include the "actual economic outlay" approach. The following factors have been used:

- Documentary evidence of the transaction, such as an executed note;
- Whether there is a fixed schedule for repayment, including a maturity date;
- Whether interest is being charged on the outstanding debt;
- Whether collateral is obtained or requested;
- Whether demand for repayment is made;
- Whether any repayments have been made; and
- Whether the transaction is reflected as a debt in the books and records of the parties.

Example: Shareholder loan transaction. A is the sole shareholder of S, an S corporation. S received a loan from A. Whether the loan from A to S constitutes bona fide indebtedness from S to A is determined under general federal tax principles and depends upon all of the facts and circumstances. If the loan constitutes bona fide indebtedness from S to A, A's loan to S increases A's basis of indebtedness under paragraph (a)(2)(i). The result is the same if A made the loan to S through an entity that is disregarded as an entity separate from A under §301.7701–3.

Example: Back-to-back loan transaction. A is the sole shareholder of two S corporations, S1 and S2. S1 loaned $200,000 to A. A then loaned $200,000 to S2. Whether the loan from A to S2 constitutes bona fide indebtedness from S2 to A is determined under general federal tax principles and depends upon all of the facts and circumstances. If A's loan to S2 constitutes bona fide indebtedness from S2 to A, A's back-to-back loan increases A's basis of indebtedness in S2 under paragraph (a)(2)(i).

Example: Loan restructuring through distributions. A is the sole shareholder of two S corporations, S1 and S2. In May 2021, S1 made a loan to S2. In December 2021, S1 assigned its creditor position in the note to A by making a distribution to A of the note. Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. Whether S2 is indebted to A rather than S1 is determined under general federal tax principles and depends upon all of the facts and circumstances. If the note constitutes bona fide indebtedness from S2 to A, the note increases A's basis of indebtedness in S2 under paragraph (a)(2)(i).

Example: Guarantee. A is a shareholder of S, an S corporation. In 2021, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2022, S could no longer make payments on the loan; and A made payments directly to Bank from A's personal funds until the loan obligation was satisfied. For each payment A made on the note, A obtains basis of indebtedness under paragraph (a)(2)(ii). Thus, A's basis of indebtedness is increased during 2022 to the extent of A's payments to Bank pursuant to the guarantee agreement.

C. Reduction and Restoration of Stock and Loan Basis

There is a specific ordering rule applicable to the adjustment of basis for decreases to basis other than distributions. Basis is first adjusted for items that increase basis and then for reduction items. The reduction of stock basis occurs first. Once that basis has been reduced to zero, then debt/loan basis is reduced but not below zero. Once both bases have been reduced to zero, the loss is suspended and carried over until basis is restored [§1367]. If the shareholder holds more than one debt at the end of the corporation's taxable year, the reduction of each loan is proportional to the basis of each loan and the aggregate bases of all S corporation debt. [Reg.§1.1367-2(b)(3)] This applies only to debts held by the shareholder at the end of the corporation's taxable year. It does not apply to any loan that has been satisfied, disposed of, or forgiven during the taxable year.

If loan/debt basis has been reduced, then the stock basis is zero. Reductions of stock basis are made before any reductions in debt/loan basis. If there is a net increase for a subsequent year, then the basis to loan/debt basis must be restored before the basis to stock is restored. A net increase means that the items that increase a shareholder's basis exceed basis reduction items. [Reg. §1.1367-2(c)] The restoration rules apply to loans/debt that shareholder held on the first day of the taxable year in which the net increase arises. The restoration is limited to the face amount of the debt reduced by any repayments made. If the shareholder has more than one debt/loan that has been subject to a prior basis reduction, the restoration is made first to any loan for which the shareholder received a payment during the year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness in proportion to the amount that the basis of each outstanding indebtedness has been reduced in prior years. [Reg. §1.1367-2(c)(2)]

Example: Jane Smith has three outstanding notes from her S corporation. She has reduced the taken losses against the loan/debt and reduced the bases as set forth below. This year, she has a net increase of $20,000. Assuming she has not received any payments on the notes, she will increase the notes as follows:

Note	Face Amount	Prior Reductions	Percentage	Basis Increase
1	$30,000	$15,000	15/30 = 50%	$10,000
2	$10,000	$ 5,000	5/30 = 17%	$ 3,400
3	$20,000	$10,000	10/30 = 33%	$ 6,600

If Note 3 is paid off during the year, Jane will apply the first $10,000 of net increase to Note 3 and then allocate the balance to Notes 1 and 2 under method above. As a result, there will be no income from the repayment of Note 3.

D. Notes or Open Account Debt

If the loan/debt owed to the shareholder is evidenced by a note, then each note will be adjusted on its own. Once paid off, the loan/debt ceases to exist. For book-entry loans/debts that are not evidenced by a note, there are special rules that apply. These are referred to as Open Account Debt. Such Open Account advances and repayments are treated as a single indebtedness. All advances and repayments on Open Account Debt during the S corporation's taxable year are netted at the close of the S corporation's taxable year to determine the amount of any net advance or net repayment. The net advance or net repayment is combined with the outstanding aggregate principal balance of the existing Open Account Debt and that amount is carried forward to the beginning of the subsequent taxable year as the outstanding aggregate principal amount of the open account debt. [Reg. §1.1367-2(d)(2)] This aggregation allows for possible abuse as the Service detected in the case of *Brooks v. Commissioner.* (TC Memo 2005-204, Aug. 25, 2005).The Service responded with the anti-Brooks regulations which provide that if the aggregate outstanding principal amount of Open Account Debt exceeds $25,000 at the close of the S corporation's taxable year, for any subsequent taxable year, the aggregate principal amount of that indebtedness is treated in the same manner as indebtedness evidenced by a separate written instrument for purposes of this section. For any subsequent taxable year, that indebtedness is not open account debt and is subject to all basis adjustment rules applicable to basis of indebtedness of an S corporation to a shareholder in this section. Any future advances would be to a new Open Account Debt account. Remember that this is treated like a note but is not; thus, repayment will result in ordinary income not capital gain.

E. Timing of Loan/Debt Basis Adjustments.

The amount of an adjustment to the basis of S corporation debt is determined at the end of the corporation's tax year. If the shareholder terminates his interest in the corporation during the year, then the adjustments are effective immediately before the shareholder terminates the shareholder's interest. Except for open account debt, if the debt is disposed of or repaid in whole or in part before the close of the tax year, any restoration of basis takes effect just before the disposition or the first repayment of the debt made during the year. [Reg. §1.1367-2(d)(1)] To the extent any debt is disposed of or repaid during the tax year and the shareholder's basis was reduced and not restored completely, the disposition or repayment causes gain to be realized immediately before the debt is disposed of or repaid. [Reg. §1.1367-2(d)(1)]

If an election is made under §1377(a)(2) to terminate the corporation's tax year in the case of a termination of a shareholder's interest or under Reg. §1.1368-1(g)(2) to terminate the year in the case of a qualifying disposition, the debt basis adjustment timing rules apply as if the tax year consisted of separate tax years, the first ending at the close of the day on which the shareholder either terminates his or her interest or disposes of a substantial amount of stock. [Reg. §1.1367-2(d)(2)]

F. Reporting Basis

Form 1040, Schedule E Part II line 28 column (e) provides a box to be checked if basis reporting is required. New in 2021, Form 7203 and its instructions were developed to replace the 3-part Worksheet for Figuring a Shareholder's Stock and Debt Basis and its related instructions formerly found in the Shareholder's Instructions for Schedule K-1, Form 1120-S. The purpose of Form 7203 is to figure potential limitations of a shareholder's share of the S corporation's deductions, credits, and other items that can be deducted. It is broken down into three parts:

- Part I, Shareholder Stock Basis;
- Part II, Shareholder Debt Basis; and
- Part III, Shareholder Allowable Loss and Deduction Items.

The IRS requires shareholders of an S corporation to disclose a stock and debt basis computation with their tax return if an S corporation shareholder does any of the following:

- Claims a deduction for their share of an aggregate loss;
- Receives a distribution;
- Disposes of stock; or
- Receives a loan repayment from an S corporation.

Because the requirement to maintain tax basis and to disclose tax basis on Form 1040 is the responsibility of the S corporation shareholder, there is no requirement for the S corporation itself to maintain tax basis schedules for its shareholders or to include basis information with the Schedule K-1s. However, even though it is part of the Form 1040, most software will prepare Forms 7303 with the 1120-S. If you are not preparing the corporate return, you should make a separate analysis and not just rely on that form from the corporate return preparer. It is a "best practice" to prepare Form 7203 each year, even if not required to file it. If not required, do not file it; rather keep it in your permanent client file.

G. Conclusion

The treatment of loan/debt in an S corporation is significantly different than in a partnership. Care must be taken by practitioners to assure that the debt will qualify for a basis under the regulations. Once that hurdle has been met, the adjustments to stock and loan/debt must be made in accordance with the Code and Regulations. There are many potential pitfalls that practitioners need to be aware of to properly allow clients to use any basis in loan/debt to allow the current write-off of losses/deductions flowing through from the S corporation.

A. Discussion Problems

Tammie Jones, your client, owns 100% of Jones, Inc., an S corporation. Tammie's basis in her shares at the end of 2021 was $150,000. During 2022, she made a loan, evidenced by a note, to the company of $150,000. She also signed a personal guarantee of a corporate loan from First Bank. The balance of the First Bank loan at the end of 2022 was $300,000. Prior to 2022, Tammie had made advances, not evidenced by a note, that your office had "booked" as loans from shareholders. At the end of 2022, the balance of those advances on the books was $20,000. The corporate note to Tammie was paid in full in August of 2022. The corporation experienced a net loss of $250,000 for 2022. During 2023, Tammie made an additional loan of $15,000 to the corporation. It was not evidenced by a note. For the year, there was a net positive income of $50,000.

Required:

1) Which loans/debts will Tammie use in determining the amount of loss she may use for 2022?

2) What are Tammie's stock and loan/debt bases at the end of 2022?

3) Are there any reporting requirements for Tammie in 2022?

B. Suggested Answers to Discussion Problems

1) In determining which loans will provide Tammie with a basis that can be used to take losses/deductions on her 1040, the IRS applies a "bona fide" debt approach by looking at all the facts and circumstances. [Reg. §1.1366-2] The IRS does not look to an "actual economic outlay." The following factors have been used:

- Documentary evidence of the transaction, such as an executed note;
- Whether there is a fixed schedule for repayment, including a maturity date;
- Whether interest is being charged on the outstanding debt;
- Whether collateral is obtained or requested;
- Whether demand for repayment is made;
- Whether any repayments have been made; and
- Whether the transaction is reflected as a debt in the books and records of the parties.

Based on this, the note and open account debt will provide basis, but the mere guarantee will not.

2) The reduction of stock basis occurs first. Once that basis has been reduced to zero, then debt/loan basis is reduced but not below zero. Once both bases have been reduced to zero, the loss is suspended and carried over until basis is restored. [IRC §1367] If the shareholder holds more than one debt at the end of the corporation's taxable year, the reduction of each loan is proportional to the basis of each loan and the aggregate bases of all S corporation debt. [Reg. §1.1367-2(b)(3)] This applies only to debts held by the shareholder at the end of the corporation's taxable year. It does not apply to any loan that has been satisfied, disposed of, or forgiven during the taxable year.

The loss for 2022 of $300,000 is first used to reduce the stock basis. Her stock basis was $150,000 and is reduced to zero. The $150,000 note was paid off during the year and, therefore, is not considered for this purpose. The $20,000 that is not evidenced by a note is open account debt. It provides basis and is reduced to zero. The stock basis at the end of 2022 is zero, as is the loan/debt basis. Any unused loss will carry forward until basis is restored.

The additional loan in 2023 will increase the basis in the open account debt to $15,000. It will also mean the balance due on open account now exceeds the $25,000 threshold. This must now be separated and adjusted like a note. If there is a net increase for a subsequent year, then the basis to loan/debt basis must be restored before the basis to stock is restored. A net increase means that the items that increase a shareholder's basis exceed basis reduction items. [Reg. §1.1367-2(c)] Thus, of the $50,000 net increase, $20,000 will be applied to restore the basis of the open account debt for the prior reduction; and the other $30,000 will be used to restore stock basis.

3) Tammie meets the reporting of basis because she receives a loan repayment from the S corporation and is reporting a share of losses/deductions. Therefore, she must check the corresponding box under line 28, column (e), complete Form 7203 for 2022, and attach a computation detailing her S corporation basis. The discussion about basis rules for S corporations in the Instructions for Schedule E (Form 1040) for Parts II and III does not limit or modify this requirement.

PART 3. BUSINESS TAXATION

Reasonable Compensation

Practitioners must pay close attention to compensation paid to owners that are also employees of small or closely held C corporations. In order to be deductible, the compensation must be reasonable. However, there is no universal bright-line test. It is important to understand the position of the Internal Revenue Service and various courts in addressing this issue. Ian Redpath and Julie Welch discuss key factors in determining reasonable compensation paid to shareholder-employees of C corporations.

Let's join Ian Redpath and Julie Welch as they discuss the rules and guidance related to reasonable compensation for C corporations.

Mr. Redpath

Julie, welcome to the program.

Ms. Welch

Thanks, Ian. Good to be here.

Mr. Redpath

Always great to have you and get your insight. You know, we did a previous program with our mutual friend, Bob Lickwar, on reasonable comp in an S corp. But you know, there's other factors that go on when you have a C corp. And a lot of our clients are in small, closely held C's. And I hear this all the time. "Well, they don't pay any tax. We don't pay any tax. We just bonus out everything at the end of the year. Obviously, they just take everything out. There's never tax. And that may not be what the IRS is going to look at as being the most appropriate way to do it. So, I think it's a good thing to look at this, not just from the S corp, but also just from the C corp. Because again, a lot of businesses, especially closely held, are really subjected to this reasonable comp. So, can a very large company that's closely held.

And I go back to the Menard case, a famous *John Menard* case where one of the largest retailers—for people who aren't familiar in the Midwest, it's like a Home Depot or Lowe's—very large compensation. The IRS came in and said unreasonable comp and challenged the compensation there in a company that's that large. And one of the things they pointed out is you can't use a comparable of Home Depot because that's publicly traded. And so, the market has an influence on that. So, it doesn't have to be Ma and Pa on the corner, although they're usually suspect. It can be a company as large as that, where they go after them for reasonable comp issues. So, where do we start? Obviously, what makes compensation deductible? And what are the things we need to look at as kind of a starting point?

Ms. Welch

Yes, and reasonableness of compensation is a huge issue. You talked about the program on the S corps, and it's kind of conflicting there because on an S corp, the goal is to pay as little compensation as possible and take everything out as a distribution. And on the C corp side, the goal is to pay as much compensation as possible and to take out as little dividends as possible, because you don't want to have that double tax, and you don't want to have something that's nondeductible at the corporate level. So, they're really conflicting. And Ian, I've seen some companies that have switched between C corp and S corp status, and now you've got history of what you've been paying. And now all of a sudden, if you're switching your mindset saying, "Hey, well, we're not that entity anymore. We've either switched to C corp because the rates are so low at 21%, or we're switching to S corp and we want to pay less in compensation." We really have to watch our history as well. So, that's some of things that we're looking at. But in terms of the general rules for deductibility you want to make sure that the amount that you pay, that the IRS doesn't come in and question it. And the IRS just says it has to be reasonable. What is reasonable, ordinary, and necessary expense, obviously, of carrying on a trade or business? And the IRS may find it's easier to challenge compensation on the grounds of reasonableness rather than ordinary and necessary because it's ordinary and necessary in order to get the work done. But is it reasonable in terms of dollar amount?

Mr. Redpath

Yes. I think the other thing that we don't always think about is it usually is low compensation is an S issue. But where you could find trouble is where you're paying, for example, you're paying people in a high tax bracket, you're paying them less. But maybe you've got related parties involved here where you're paying. So, you're paying them low, but you've got related parties who are in a lower tax bracket that you're paying more. The IRS may come in and go, "Well, wait a second here. Who's providing what services? That's unreasonably low compensation." So, you could also have that unreasonably low, especially if you had related-party types of situations in a C corp.

Ms. Welch

Yes, that's true. And that brings into the issue of maybe hiring kids. You've got a related party in there and "Hey, I'd rather pay the kid than myself because I'm in the highest tax rate bracket. And the child may not even have used up the standard deduction amount. So, I may much rather pay the kid and save the money there and it's going out as compensation. But again, in that case, we're not really looking at reasonableness. We are looking at reasonableness of too high, but it's a much lower amount than we're looking at in a lot of cases. With the main stockholder, we're looking at sometimes hundreds of thousands or millions of dollars. And with the child, usually it's not quite that much; but they really have to be doing something to earn that money. They have to be doing work. You want to document what they're doing, same thing that you're doing with the stockholder. And we'll talk about some of those issues later; but you want to be sure you're documenting all the work and everything that the employee is doing to be able to justify that reasonable compensation.

Mr. Redpath

And we should point out that we see it normally, especially in the small businesses, we'll see it normally in the shareholder-employee situation. But it doesn't have to be. The IRS can challenge anyone. Doesn't have to be a shareholder for them to challenge unreasonably high compensation. And there are cases, especially with related-party types of issues, where they've actually treated the excess compensation to one person as a dividend to the other. And so, there's that little twist in there that the IRS is often willing to do if there's related shareholder-employee and someone else. And there's a case out there, *Home Interiors and Gifts*, and this a tax court case. But it's interesting because the IRS came in and just basically said, "Oh my! You're paying way too much in salary, way too large." They disallowed 85% of the salaries to the officers of a closely held. And the tax court came in and went, "Wait a second. You can't just say the amount is all that you look at. It could be reasonable." You could have outrageously, what some people would say is outrageously high salaries. And they could be reasonable, especially if there was some type of formula, for example, that was reasonable in determining that compensation. So, I think the tax courts made it clear that just the amount, just looking at the gross amount of the number, is not what we look at. It's really well beyond that. We have to really dig into it in order to make that determination.

Ms. Welch

Yes, and looking at that *Home Interiors* case, Ian, that was a really good case. And it's really good to read through that, to look at the formula that you're talking about and what the tax court looked at to say, hey, we really think this is reasonable. Because Home Interiors, a lot of us are familiar with that. A lot of women used Home Interiors, and it was we're going to help you decorate; we're going to help you decorate your house, and you can buy these products. And it's kind of like you don't go through a store; you're doing it through your home. And so, you have these parties, and you have the hostess. Well, in this case, the employee here built this up. I mean, she masterminded the whole thing. She had worked for other companies similar in the past but had this set up a different way. And the formulas were all determined in advance, and she was being paid. And yes, it was a very high amount of money, but there was a reason for it. I mean, she's the one that grew the company; she was responsible for all the marketing, and the training, and on, and on. And so, all of these things are talked about in the case. And that's why it's so important to look back at these cases if you ever do have a situation on reasonable compensation. Look back at the case as number one. Hopefully, you have this history before you have the question and you can have the documentation. But number two, now, you know what they're going to be looking at to challenge your reasonableness on what you can have.

So, it's not just a dollar amount, because you said unrelated people can be challenged as well even if they're small. But it's not just a dollar amount like a kid. You might not pay them hundreds of thousands of dollars. You might pay them a small amount, but that still might not be reasonable if they didn't provide the services to justify it.

Mr. Redpath

And the other thing is it can apply to an independent contractor. So, the IRS doesn't just say it has to be an employee. They could come in, and you've decided, "Okay, well, we're not going to pay unreasonably high comp to an employee. We're going to pay it to an independent contractor." The IRS says, "Sorry, same thing. We're going to apply essentially the same type of rules. If you've applied an independent contractor, you're trying to throw that in here." You know, often, I think a lot of times, sometimes, most of the time, the IRS has thought of these things, I mean, if we've thought of it, it's probably somebody in the IRS at some point thought about this, the same type of thing. So, there are new and novel things that come out; but it's usually those new and novel things that get challenged and, quite often, aren't successful in court. Now, one thing and I'll point this out is the burden of proof because it's often misunderstanding. Yes, the IRS has the burden of proof with respect to factual issues, not legal issues, but factual issues. However, the IRS does not have the burden of proof in audit. They don't have the burden of proof in an issue at appeals. So, in tax court, yes; but at appeals, the IRS can take into consideration hazards of litigation. And so, the fact that, "Well, wait a second, you've got the burden of proof at the audit, but we have the burden of proof." So, how does that burden of proof shift? The taxpayer has credible evidence with respect to the issue, for example, a reasonable compensation formula. The taxpayers compiled the appropriate substantiation. If it's a strict substantiation issue, you've got the substantiation. Maintain the records required by law. Has cooperated—and this is a key—if you don't cooperate during the audit process, I'm sorry, you can't shift the burden to the IRS. You're going to maintain that burden in the court. So, you've got to cooperate with the IRS. You had a document information request; you've complied with it, you've provided them, you've provided the interviews they've requested. That's a precondition to have the IRS have that burden of proof when it gets to court. So, I think those are things to keep in mind. But again, you can bring that up at appeals that, "Well, remember, we're going to be able to meet the burden. You're going to have the burden of proof, IRS, that this is unreasonable. We don't any longer have to prove it's reasonable." So, that's a difference in that audit process versus the Internal Revenue Service going forward. So, we talk about comp. We're using that term. What does that mean, comp?

Ms. Welch

We have to think of all compensation. So, it's not just the salary, the paycheck that you get every day or every week., Some places, it's every day now with the pandemic. But it's not just that paycheck. It's also bonuses, pensions, all of the benefit package that you have out there, whatever you have in benefits. Obviously, health insurance is a benefit. That one's a little harder to argue with because they know that one is likely to be covered, but they look at everything. So, bonuses are a huge one where a lot of people get tripped up on this reasonable compensation. Especially like you talked at the beginning of the talk here, Ian, where people at the end of the year, they quick bonus out everything, and they don't have anything left. So, bonuses are considered part of the total compensation and anything indirect as well. So, if for some reason, you have some commissions, you get paid commissions, and based on a formula even; but all of that stuff is going to be pulled together and taken into total compensation.

Mr. Redpath

Yes. For example, maybe you've set up a separate entity through which you're providing services, like sales services, or something, or management services, or something like that. That's all going to be taken into consideration. And I also think that the other thing that we have to remember is that it's not. The compensation is looked… individually, not as a whole, so you can't say what we pay our employees is totally reasonable. Well, yes, it is. Except what you're paying this employee isn't. So, the IRS is going to look at it on an individual basis, not on an aggregate. And I know sometimes people go into court and they go, "Our overall compensation is very reasonable." And really, the courts have said, like the IRS, "Well, that's not what we're looking at. We're looking at this person's compensation. You can't say we offset that by paying other people too little."

Ms. Welch

That's a really good point.

Mr. Redpath

Not a valid argument. So, when do we really test all of this? When are we testing, looking at this, as far as what the compensation is?

Ms. Welch

Again, it's reasonableness; and you're really looking on an annual basis, your corporate year. Because again, you could pay a bonus at the beginning of the year or the end of the year, doesn't matter. The whole thing has to be reasonable. And you're looking year-by-year basis because the IRS has the benefit of hindsight. They're able to look back. And as you're setting up your compensation and how you're going to compensate people, generally, you're having to do it beforehand, before they earn the money. This is what you're going to do to earn the money. You may get a bonus if certain factors are met; but all that's going to fall within that time period.

Mr. Redpath

Yes. And I think one of the things that you're pointing out here is important, especially in times like right now, with the economy and with all the issues with COVID. You entered into a compensation package, for example, had a formula, which at the time you entered into, there's no question. We can argue that this is totally reasonable. So, now you have a contract to pay this individual under this formula. The IRS can't come in later and say, "Well, circumstances changed. So, you had to change your formula." No, for that period, that formula is still valid; because the formula was reasonable when it was entered into. As you said, they can't just come back in hindsight and say, "Well, you should have known." Well, no, we didn't know. If it was reasonable at the time we entered into it, then you can't tell us that hindsight, because the economy changed or anything, that that became unreasonable. So, at least it's the factors existing on the date when the contract for the services was made. So, good reason though, here, I think, to recommend to our clients something that is often not done. If you have a corporation, have a contract. It's not wrong to have a contract for the services, especially in an economic time like this, because you're going to test it again at the time. Now, right now, you might want to test it down at the lower end of the scale with that formula. That, I think becomes extraordinarily important. Again, the seventh circuit. So, personal services, we have the seventh circuit, and we have everybody else.

We have the *Elliott* case that kind of put all the factors together, but we have some general rules that the IRS are going to look at. So, we're going to put this up for our viewers to look at. Can you kind of go over these and tell us a little bit about how in your experience these are applied?

Ms. Welch

Yes. And these are the nine factors; and these are also important to document in advance before you ever get a question on anything. It's so hard to do, because people don't think about it, but this is kind of like writing the history, right? The reasoning for the reasonableness. And the first one they look at is the employee's qualifications. One of the examples in a case was they hired the son, and the son wasn't even trained in whatever the industry was. I mean, you don't have those special qualifications. If you have special qualifications, make sure they're known. Make sure you document what those qualifications are, whether it's education, whether it's specific work in an industry. You want all of that stuff—the qualification that they have, how long they've been in it, family history in the business, et cetera.

The second one is the nature, extent, and scope of the employee's work. So, this is exactly now what the work is of the employee. Before we were documenting what their qualifications were. Now, we're saying, this is exactly what they had to do, whether they were managing the employees, whether they were training employees, whether they were actually out there greasing the equipment, the relationship with vendors. I mean, what was their specific work supposed to be? And what did they do? Because you have to remember that whatever you assign somebody to do, their job duties may grow as you realize what their qualifications are. So, continually document this and beef this up. If you ever think you have a reasonableness issue with compensation, you want to make sure you have the best facts possible. Put everything up front.

Mr. Redpath

I'll give you a good example. I had a client that was trying to argue with me that the individual that they were paying, that was very reasonable. And I explained to them. I said, "You have an untrained person that you are trying to have them learn to be your bookkeeper. And I can hire a CPA for less than this. That's not reasonable. I don't want to get into your personal reasons for paying this person that much. But I'm guaranteeing you, this is not reasonable because I can hire a CPA to come in and take that job, and it would be for less than that." So, those are the types of things they will look at.

Ms. Welch

Yes. Another one they look at is the size and complexities of the business, whether it's just one little single small business or there's lots of complexities to it, whether the complexities are in the number of businesses and locations or whether the complexities deal with the intricacies of the actual work that's being done, if it's a real technical area. We always say, you're not a rocket scientist; maybe it's rocket scientist business, more complex type of thing. So, you're looking at that. And then also the size of the business. There is a difference between a small single location. Although today you can't really define single location because we have all this remote work and everything, but you know, small-dollar type of businesses compared to something that's a conglomerate. Lots of different entities, lots of different people that you're dealing with, and all of that.

Factor four is comparison of the salaries paid with the gross income and net income. So, you're actually doing some… This is more the financial side. Let's look at the finances and lay out some numbers and see if that makes sense based on how much. And you have to look at gross income and net income because some businesses have a very high cost of goods sold situation; but they may have a very small margin, but they get a lot of transactions. So, it's very high net income for that purpose. But that's one of the financial sides of it.

The fifth factor that the courts look at is the general economic conditions. Like right now, we're in a down-trend type of situation; but if you're booming economic conditions, things are going really good. You're taking all those things into consideration as you're developing the reasonable compensation of the employees.

A comparison of salaries with distributions to stockholders. Are there dividends being paid to the stockholders, and how much are those dividends? The history of that. Is it very small or is it very large to stockholders? So, if the stockholders are getting a lot of money, they're getting a rate of return on their money. Maybe the salaries can be higher and justify higher compensation. But you can't justify real high compensation and give nothing to the stockholders, in the IRS's opinion, because that's not reasonable. Stockholders want a return on their money. Even if the stockholder is the employee, you have to look at that situation.

The seventh factor, the prevailing rates of compensation for comparable positions and comparable concerns. So, an industry search of what are other people in the industry being paid for similar duties. Now, as a stockholder employee, you may think, "Well, they've got more duties than another person and another comparable position that doesn't have that." And you can take that into consideration. But again, you need to look not just, oh, I found somebody who makes a lot of money. I'm going to look at lots of different things. I want to know all of it out there before I devise my reasonable compensation amount and have a good argument. I don't want to know just the things in my favor. I need to know both sides so I can really evaluate it.

Mr. Redpath

Comparables though, can be difficult. And I mentioned the Menard case and one of the comparables they were using. They said, "That's not valid because that's a publicly traded company." And the shareholders, the fact that they're shareholders and investors like that puts a… Let's say there's a temper on what they can do when it's considered reasonable. And basically, your board of directors are family and friends. And so, there's really nothing, no check and balance on the salary. the IRS often will come in and go, "Well, that's not really a comparable, so yeah, you're in the same industry, but..." And sure, you have a small tech company, you're not going to be able to use a large, publicly traded, Silicon Valley company as being a comparable. So, you really have to understand what the market is that you're in when you determine comparables. Comparable could be different in different parts of the country, too.

Ms. Welch

That's a good point. Geographic location has a big difference. If you're in New York City versus a small town in a rural community where the cost of living is a lot different, that's a big factor to look at.

Mr. Redpath

Number eight?

Ms. Welch

Number eight, the salary policy of the employer as it relates to all employees. So, you're kind of looking at all employees. If all the employees are paid a very small amount of money, as conservatively as possible. We're going to pay minimum wage and nothing more, and then a huge amount to the shareholder employee owner, you may have a situation. So, you want to look at reasonableness of everybody. Doesn't guarantee that, because you pay other employees very well, that the compensation of their stockholder-employee may not be questioned. But it gives you a better feel if all the employees are compensated on a very reasonable, high reasonable basis.

And then, the last factor they list really only applies where you might have underpayments in some years, so you're making up for it in other years. But the amount of compensation paid to that specific person in prior years; so, you're looking at a history. Like I said, the IRS has the ability of hindsight. They can look back to see what was paid in history. But you can say, "Well, in those years, that we just came off a pandemic, we had to pay very low in those years. We didn't have the cash flow. We were worried about being able to make normal payroll. But this person was still out there doing all their duties. They were still developing the relationships with the vendors. They were still motivating the employees and training the employees and kept that… employee base in place. They didn't lose employees. They continued to grow it. They kept the employees rather than taking the compensation themselves." That may give an argument for higher compensation in a future year to be able to make up for that lower compensation. But again, you can't just rely on that forever now. You just have to always take that into consideration.

Mr. Redpath

And unfortunately or fortunately, I guess we could look at it either way. Some of our viewers are in the seventh circuit. And for those in the seventh circuit, kind of what you said, doesn't apply at all. So, the seventh circuit has rejected the tax court and other circuit courts looking at the multi-factor test. They've rejected it and said, "Really, it's the independent investor test is what should apply." And quite frankly, they've been somewhat scathing of the court of the multi-factor saying, "It's just potential for abuse. And it's vague. It's hard to understand." They've really not looked at it as being very informative to determine what is reasonable comp. So, what is this independent investor test for those of our viewers in the seventh circuit?

Ms. Welch

This test is really looking at, you have the owner of the assets and a person hired to manage those assets. And the higher the rate of return that the manager can generate, the greater the salary they can get. So, it's really based on the overall transaction on what would an independent person pay you or pay this employee that you're looking at in terms of the reasonable compensation? What would an independent investor be willing to own to be able to have you manage their assets?

Mr. Redpath

And I view it this way, if you've got $200,000 of profit and you bonus out $200,000 at the end of the year, and there's zero return, that's clearly not reasonable. And again, they don't care if it's the stockholder-employee. I mean, it doesn't matter. They're saying a reasonable investor wants a return. So, if a reasonable investor would take a 10% return, then you could pay yourself quite a bit, as long as they're getting what a reasonable investor would get. But if they're only getting a 2% return as a dividend, and you're taking a large salary, that doesn't work. That doesn't work because some of that should be going to that "independent investor." So, it's a very different test. Now, shareholder-employees, we mentioned that there are kind of seven factors that the courts will look at. And I'm going to put up a slide here. Can we quickly go over these seven factors?

Ms. Welch

Sure. The first one is if compensation is paid in proportion to stock holdings, and I've seen that before, where, okay, well, we have four owners. They each own 25% of the company, and guess what? Their compensation, they each get 25% of the compensation. That's an indication of not necessarily being reasonable because different employees have different job duties and all of that. So, corporation's dividend history, that's the one we hear a lot. If the corporation doesn't pay dividends, then the shareholders aren't getting anything. And so, they're really scrutinizing the compensation to make sure it's not all being paid out as salary. Adequacy of the corporation's capitalization to make sure that there's enough capitalization there to run and sustain the business. Whether the compensation was increased at the end of the year. So, that big bonus at the end of the year. Is that what happened? Is that what caused the total compensation? So, you're looking at the total compensation for the year. This is the employment agreement, whether provisions in the employment agreement are characteristic of compensation for services. So, you're really looking… Ian, you mentioned, it's always good to have an employment agreement. This is a good indication of what it should be there. And watch out if somebody dies before the end of the year and then still is getting compensation. I mean, you really have to watch what the employment agreement calls for because the employment agreement may have certain things. When somebody dies, they may get an extra amount of compensation.

The sixth one is the existence of an agreement for the stockholder-employee to repay the compensation that's found to be nondeductible. And that is a factor that is considered. People put it out there, and some people just put it out there all the time. I'm always going to have this out there because if the IRS comes in for any employee, I want to make sure that we can recoup that at the company level and not have to have a nondeductible. But sometimes, it's out there because, "Hey, we're going to do this huge year-end bonus." And you know what, Ian, if we gave you this big bonus at the end of the year, will you pay it back if you can't deduct it?

Mr. Redpath

If we get caught.

Ms. Welch

If we get caught, are you going to help us fix the situation? And then, the last one, again, is the financial one, a comparison of the compensation to gross and net income, similar to the one we talked about on the other nine factors, more of a financial one looking at history and actual finances of the numbers.

Mr. Redpath

Yes. These are general factors. Another one that I think is an issue. And we talked about the repayment agreements, and they're usually really suspect, because the IRS is often saying, "Well, wait a second. Why do you have this repayment? You must know that they're unreasonable. You only have the agreement because you know it's going to be unreasonable if you get caught." And that's kind of what the IRS says on that. What about contingent? Can you kind of get around it by making it contingent on earnings, for example?

Ms. Welch

Contingent payments? They help. But again, it's not a free ride. You have to have a formula. We talked earlier about having a formula and that type of thing that turns out to be a reasonable amount. Contingent compensation doesn't have to be available to other employees to make it reasonable. You can have different officers receiving contingent compensation. That doesn't make it unreasonable just because we're going to give you this percent on every sale above this number; or every time we have gross income over this number, you're going to get a percentage on that. Again, you have to look at the overall compensation package to see is it reasonable based on the services that employee is performing. Because it can be contingent compensation, but if this person has no control over meeting that goal, how does that give it contingent compensation? How is that giving them more reasonable compensation? Just because they're an employee-owner over here, they may or may not have control over everything. Whereas a lot of times, we'll see contingent compensation paid where they're supervising all of the operations and they're preparing government reports and all of that. So, arms-length, increased compensation, you just have to watch. It's helpful if it's set up in advance. I think you've got the formula set up and especially if other people in similar industries are using similar types of formulas, I think that's helpful.

Mr. Redpath

And I think also, a good argument that you could make would be a comparative thing to say, "Okay, it's very high right now, but hey, look at last year." It's relating to the business. So, therefore, last year when the business didn't do as well, the individual didn't do as well. And so, it's reasonable because at the time we've entered into it, it could be up or down. We don't know what that contingent payment is going to end up being. And so, it essentially becomes arm's length. Would someone enter into this in an arms-length transaction, a willing employee and a willing employer enter into this type of agreement? And you know, kind of in general, that's a way to look at it. Is this really what willing employee, willing employer would pay under these circumstances? That's kind of an overriding principle to look at.

Ms. Welch

Yes. And will you keep it in place if things go bad? Will you keep it in place or are you going to make up for it? So, we're going to make sure… It's not a guarantee that you're going to get a certain amount. You have that in there. It's less likely that the contingent compensation formula is going to be held up because if you say, "Okay, well you're always going to make this." And then the contingent things don't happen, or the economy goes down, or we have a pandemic, and all of a sudden, "Well, that's okay, we're going to give you this money anyway."

So, then looking back at history, well, you've always given him this money to get up to over and above what they should have gotten on that contingent compensation. You know, if you look at real estate agents, they totally fluctuate by the number of houses that they sell. So, if houses are selling very good, they're making a lot of money because they're making a lot of commissions. And if all of a sudden, houses aren't selling, it's not like somebody's going to hand them some money and say, "Oh, that's okay. It's lean times. Here's some money for it."

Mr. Redpath

Right. Well, a lot of issues to take into consideration here. Julie, thank you very much for all your insight. We've provided our viewers, I think, with a lot of things to think about and talk with their clients about. I don't think it's something you want to wait to get audited on. So, I think, and especially in our closely held businesses, this is something to get ahead of. And as you mentioned, having the appropriate paperwork justifications so that, if you do get audited, you're able to step right up and say, "No, this is reasonable. We've got all of our documentation in line." Julie, thank you very much again for being here. You always provide our viewers with some excellent information, and I love having you on. We'll have you on another program soon. Thanks a lot, Julie.

Ms. Welch

Thanks, Ian.

Reasonable Compensation in a C Corporation

By Ian J. Redpath, JD, LLM

A. Introduction

One of the most frequent audit issues with closely held corporations is the reasonableness of the compensation being paid. Section 162 provides in part:

"In general:

There shall be allowed as a deduction all the **ordinary and necessary** expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a **reasonable** allowance for salaries or other compensation for personal services actually rendered;"

Thus, to be a deductible business expense, the expenditure must be both ordinary and necessary in relation to the taxpayer's business. These terms should not be taken as an onerous bar to meet to deduct compensation. Ordinary means an expense that is customary or usual in the taxpayer's business. However, an unusual or one-time expense may be ordinary if it's reasonably related to the taxpayer's trade or business. Necessary does not mean required or essential; it only means appropriate and helpful in developing and maintaining the taxpayer's business. This is generally a matter of the taxpayer's judgment. In addition, another requirement is imposed on compensation—the expense must be reasonable. This will be looked at differently in different context. Further, and perhaps obvious, the expenditure must be for services actually rendered. This often is an issue with related parties and an attempt to assign income to lower-income related taxpayers.

Section 3231(e)(1) defines compensation as "any form of money remuneration paid to an individual for services rendered as an employee to one or more employers." It does not include any payments on account of sickness or disability, tips, or any payments for traveling. Reg. 1.162-7(3) provides that, "In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."

B. Publicly Traded Companies

In publicly traded companies, it may be raised, but usually there is some control by the board of directors or shareholders that, in theory, will not allow excess compensation.

The Code provides certain limitations on the deductibility of compensation. They do not limit the ability to pay it, only for the corporation to take a deduction. Two common limitations are the Golden Parachute rules of §280G (see Reg. §1.280G-1) and the $1million executive compensation rules of §162(m).

A portion of the payments made by a corporation to key personnel that exceeds their usual compensation may not be deductible. This occurs when the corporation has an agreement (golden parachute) with these key employees to pay them these excess amounts if control of the corporation changes.

The $1 million limitation applies to:

- The principal executive officer or principal financial officer of the corporation (or an individual acting in that capacity) at any time during the tax year;
- An employee whose total compensation must be reported to shareholders under the Securities Exchange Act of 1934 because the employee is among the three highest compensated officers for that tax year (other than the principal executive officer or principal financial officer, or an individual acting in that capacity); or
- A covered employee of the corporation (or any predecessor) for any preceding tax year beginning after December 31, 2016.

There are certain exceptions based upon the type of compensation.

C. S Corporations

The reasonableness of compensation in an S corporation setting has become a significant issue with the IRS. The major issue in this context is "unreasonably low" compensation. The compensation is subject to FICA while distributions are not subject to S/E tax. This is a major benefit for S corporations. The issue then is whether the corporation is paying sufficient salary or is it paying unreasonably low compensation and flowing more through as distributions. This issue became heightened when the Treasury Inspector General issued a scathing report that the IRS was not adequately addressing this issue in S corporation audits. This topic was the subject of a recent program.

D. General Rules

An employer ordinarily has the right to contract to pay an **employee or an independent contractor** any amount that they agree on. That does not make it deductible. The IRS will generally find it easier to attack compensation as being unreasonable than to try to allege that it isn't ordinary and necessary.

It is not automatically assumed that compensation above the norm is excessive. For example, in *Home Interiors & Gifts Inc. v Commissioner*, (1980) 73 TC 1142, the IRS disallowed up to 85% of the "very large" salaries paid to officers of a closely held corporation. The Tax Court held that the salaries were reasonable and fully deductible under the facts and circumstances. In addition, a large compensation might be justifiable if it's paid under a formula that's reasonable.

There are no specific guidelines for reasonable compensation in the Code or the Regulations. Thus, it has generally been left to the courts to determine the factors to be reviewed. The courts have consistently held it is a facts-and-circumstances analysis. The IRS has pointed out some factors considered by the courts:

- Training and experience;
- Duties and responsibilities;
- Time and effort devoted to the business;
- Dividend history;
- Payments to nonshareholder employees;
- Timing and manner of paying bonuses to key people;
- What comparable businesses pay for similar services;
- Compensation agreements; and
- The use of a formula to determine compensation. [IRS Fact Sheet 2008-25]

In general, no one factor is overriding.

The IRS rarely challenges the compensation of a nonstock holder or an unrelated employee or independent contractor. The compensation in those situations is generally set by arm's-length negotiations which is generally considered reasonable. That doesn't mean they can't challenge it. For example, a salary of $37,000 paid to an inexpert bookkeeper was held to be unreasonably high. [*Patton, James*, (1947), 6 CCH TCM 482, affd (1948, CA6) 36 AFTR 1009]

It should be noted that the IRS has the burden of proof with respect to factual issues related to imposition of tax provided the taxpayer:

(1) introduces credible evidence with respect to the issue;

(2) has complied with the requirements to substantiate any item;

(3) has maintained all records required under the Code and Regs;

(4) has cooperated with reasonable IRS requests for witnesses, information, documents, meetings, and interviews; and

(5) in the case of a partnership, corporation, or trust, the taxpayer is described in §7430(c)(4)(A)(ii). [§7491(a)]

These rules do not apply to administrative proceedings such as Appeals.

The reasonableness compensation looks at the overall compensation. It is the collective total compensation that must be reasonable under all the facts and circumstances. [*Neils, William C.,* (1982) TC Memo 1982-173] Reasonableness also includes indirect forms of compensation. For example, where a corporate officer was also employed on commission by an independent selling agency for the corporation, the indirect payments from the sales agency as well as his corporate salary were taken into consideration in determining the reasonableness of his compensation as an employee of the corporation. [*Flagg, J. T. Knitting Co Inc,* (1949) 12 TC 394] However, stock options generally are not considered unless they resulted in taxable compensation or that the purchase price was less than the fair market value of the shares. [*Lumber City Corp (f/k/a Neiman-Reed Lumber & Supply Co Inc)*, (1996) TC Memo 1996-171]

The analysis is on individual compensation and not aggregate compensation paid by the corporation. Excessive compensation paid to one cannot be offset by low compensation paid to another. [*William Heyman,* (1949, CA2) 38 AFTR 338, cert den (1949, S Ct) 338 US 904] The IRS has even aggregated salaries in related corporations to determine whether the compensation paid to each individual was reasonable. [*Trinity Quarries Inc v. U.S.,* (1981, DC AL) 48 AFTR 2d 81-5596, affd (1982, CA11) 50 AFTR 2d 82-5151]

Unfortunately, there is not one standard test applied to determine if compensation is reasonable. This makes the ultimate analysis difficult for practitioners advising C corporations.

In *Elliott's Inc v. Com.,* (1983, CA9) 52 AFTR 2d 83-5976, the Tax Court grouped the factors employed by courts in determining reasonableness of compensation into the following categories:

(1) The employee's qualifications and role in the company, including factors such as hours worked; the employee's position, duties performed, and his overall contributions to the company;

(2) the character and condition of the company, including factors such as the size of the company, the complexity of its business, and the general economic conditions;

(3) a comparison of the employee's compensation with the compensation paid by similar companies for comparable services;

(4) the salary policy of the company for all its employees, and the particular employee's salary history with the company;

(5) the likelihood that a hypothetical, independent investor would be willing to compensate the employee at the levels paid by the company taking into account dividends paid and capital growth; and

(6) whether there is any conflict of interest which might permit the company to disguise nondeductible corporate distributions as salary. Obviously, this is of major concern when the employee is the sole shareholder or there are few shareholders all of whom are employees.

The Seventh Circuit has rejected the Tax Court's multi-factor analysis in favor of a single "independent investor" test. The relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he/she was compensated. The nature and quality of the services, as well as the effect of those services on the return the investor is seeing, must be considered. One reason, according to the Court is that the "test doesn't indicate how the factors are to be weighed in the event they don't all line up on one side and thus the test can't self-determine the outcome of a dispute, it invites the making of arbitrary decisions based on 'unanalyzed discretion or unprincipled rules of thumb.'" Additionally, it finds many of the factors to be vague; and there is no clear relation either to each other or to the primary purpose of the reasonable compensation rules (to prevent dividends, or in some cases gifts, which aren't deductible from corporate income, from being disguised as salary, which is deductible). Moreover, the multi-factor test invites the Tax Court to set itself up as a "super personnel department" for closely held corporations, a role the Seventh Circuit finds unsuitable for courts. Finally, because the reaction of the Tax Court to a challenge to the deduction of executive compensation is unpredictable, corporations run unavoidable legal risks in determining a level of compensation that may be indispensable to the success of their business. [*Exacto Spring Corp v. Com*, (1999, CA7) 84 AFTR 2d 99-6977, revg Heitz, William J., (1998) TC Memo 1998-220, RIA TC Memo ¶98220] In the Seventh Circuit, passing the independent investor test will establish a presumption of reasonableness. The Tenth Circuit has specifically declined to adopt the independent investor approach; the Tenth Circuit will continue to use a multi-factor approach. [*Eberl's Claim Service Inc v. Com*., (2001, CA10) 87 AFTR 2d 2001-2075]

The IRS applies the following, from the Fifth Circuit decision in *Owensby & Kritikos, Inc*. are:

(1) the employee's qualifications;

(2) the nature, extent, and scope of the employee's work;

(3) the size and complexities of the business;

(4) a comparison of salaries paid with gross income and net income;

(5) the prevailing general economic conditions;

(6) comparison of salaries with distributions to stockholders;

(7) the prevailing rates of compensation for comparable positions in comparable concerns;

(8) the salary policy of the employer as to all of its employees; and

(9) the amount of compensation paid to the particular employee in previous years.

The last factor is relevant only if it's argued that payments to the employee for the years at issue were made to compensate for underpayments in previous years. The Court in *Owensby* specifically noted that the independent investor test is just one factor to be considered in determining reasonableness. [*Owensby Kritikos, Inc. v. Commissioner,* 819 F.2d 1315]

E. Additional Inquiries

For nonstockholder-employees, the size of the amounts received as compensation will generally be determinative of the issue. For stockholder-employees, large amounts may legitimately be received; but the characterization of these payments as compensation or dividends becomes another issue. Other factors to consider include:

(1) whether "compensation" is paid in proportion to stockholdings;

(2) the corporation's dividend history;

(3) the adequacy of the corporation's capitalization;

(4) whether compensation was increased at the end of the year;

(5) whether provisions in the employment agreement are characteristic of compensation for services;

(6) the existence of an agreement for the stockholder-employee to repay compensation that's found to be nondeductible; and

(7) comparison of compensation to gross and net income.

A sole stockholder's salary might reasonably be larger than that of a comparable nonstockholder-employee because a sole stockholder's compensation is essentially payable only after other expenses are paid. Contingent salaries are often larger than noncontingent.

An agreement for the repayment of compensation found to be excessive may be considered a sign that the payments made as compensation were unreasonable. The Seventh Circuit, reversing the Tax Court, stated the company's requirement that the shareholder/chief executive officer (CEO) return any part of his bonus that the IRS successfully determined wasn't deductible didn't indicate an intent to pay a dividend. It referred to this argument as "flimsy." It stated that, given the "fondness" of the IRS and the Tax Court to find excessive compensation based on a totality of circumstances approach, it was only prudent to require a reimbursement of compensation determined not to be deductible. [See Plastics Universal Corp, (1979) TC Memo 1979-355, PH TCM ¶79355, 39 CCH TCM 32, affd on other issue sub nom L. Roger Wells Jr., (1981, CA6) 49 AFTR 2d 82-523, 673 F2d 1331, 82-1 USTC ¶9151 and Menard, Inc v. Comm, (2009, CA7) 103 AFTR 2d 2009-1280, 2009-1 USTC ¶50270, revg (2004) TC Memo 2004-207, RIA TC Memo ¶2004-207.]

If salaries and/or bonuses are raised significantly, especially toward the end of the tax year, the corporation should be prepared to defend why the increase is reasonable, such as increased responsibilities, workload, etc. The IRS will otherwise determine it to be unreasonable and determine it is a distribution of profit/dividend.

Compensation, including bonuses, is sometimes set as a percentage of profits, sales etc. The compensation is, thus, partially or wholly contingent. This does not make it unreasonable on its face. The same inquiry will apply as with other compensation. The courts recognize that the compensation in good years may be significantly more than in down years if contingent compensation is paid under an agreement between the employer and the individual that is:

(1) a "free bargain,"

(2) made before services are rendered, and

(3) not influenced by any consideration on the part of the employer other than that of securing, on fair and advantageous terms, the services of the individual.

Thus, an arrangement for compensation payments of a percentage of gross charges to a customer in the trucking business was held to be reasonable because the arrangement was made at arm's length and the increased compensation was due to increased trucking operations. [*Roy Marilyn Stone Trust U/A*, (1965) 44 TC 349, act]

Reg. §1.162-7(b)(2) provides factors the IRS will apply to contingent compensation arrangements. The relevant inquiries are:

(1) the contingent compensation agreement provides incentive for an employee to make his best efforts (e.g., the employee is not a controlling stockholder-employee),

(2) the employer has adhered to the contingent compensation agreement in good and bad years,

(3) the company has distributed a significant amount of earnings as dividends,

(4) the contingent compensation agreement was entered into before the corporation was successful, and

(5) there has been no change of circumstances warranting the abandonment of the agreement.

In general, bonuses paid to employees if paid in good faith as additional compensation for services actually rendered by the employees will be allowed if the total of bonus plus salary doesn't exceed a reasonable compensation. It doesn't matter how the bonus is paid.

F. Conclusion

The determination of reasonable compensation in C corporations, especially closely held corporations is a matter of serious concern for clients and practitioners alike. The practitioner must be aware of the multitude of factors and issues in advising a client in this area.

GROUP STUDY MATERIALS

A. Discussion Problems

Your clients, Jade and Kaylee, form a corporation. They are the only shareholders. They employ other employees. They ask you if they can simply take "profits" out as they earn them to compensate them for their work.

Required:

1) Address the general rules on deducting compensation.

2) What issues/factors should be looked at to be sustained on audit relative to setting compensation?

3) How would this proposal be viewed in light of the reasonable investor test?

B. Suggested Answers to Discussion Problems

1) To be a deductible business expense, the expenditure must be both ordinary and necessary in relation to the taxpayer's business. These terms should not be taken as an onerous bar to meet to deduct compensation. Ordinary means an expense that is customary or usual in the taxpayer's business. However, an unusual or one-time expense may be ordinary if it's reasonably related to the taxpayer's trade or business. Necessary does not mean required or essential; it only means appropriate and helpful in developing and maintaining the taxpayer's business. This is generally a matter of the taxpayer's judgment. In addition, another requirement is imposed on compensation—the expense must be reasonable. This will be looked at differently in different contexts. Further, and perhaps obvious, the expenditure must be for services actually rendered. This often is an issue with related parties and an attempt to assign income to lower-income related taxpayers. Section 3231(e)(1) defines compensation as "any form of money remuneration paid to an individual for services rendered as an employee to one or more employers." It does not include any payments on account of sickness or disability, tips, or any payments for traveling. Reg. 1.162-7(3) provides that, "In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."

2) The primary concern is if this meets the factors relevant to the particular jurisdiction. Some courts apply a multi-factor test and some the independent investor test. Others include the independent investor in the other factors. It must determine which analysis to apply. Next, this may be considered contingent compensation. Reg. §1.162-7(b)(2) provides factors the IRS will apply to contingent compensation arrangements. The relevant inquiries are:

    1. the contingent compensation agreement provides incentive for an employee to make his best efforts (e.g., the employee is not a controlling stockholder-employee),
    2. the employer has adhered to the contingent compensation agreement in good and bad years,
    3. the company has distributed a significant amount of earnings as dividends,
    4. the contingent compensation agreement was entered into before the corporation was successful, and
    5. there has been no change of circumstances warranting the abandonment of the agreement.

3) The independent investor test can be applied even to a closely held company of this type. The relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he/she was compensated. The nature and quality of the services, as well as the effect of those services on the return the investor is seeing must be considered. It is not based on the specific shareholders.

GLOSSARY OF KEY TERMS

Debt Basis—For loss and deduction items, which exceed a shareholder's stock basis, the shareholder is allowed to deduct the excess up to the shareholder's basis in loans personally made to the S corporation. Debt basis is computed similarly to stock basis but there are some differences. If a shareholder has S corporation loss and deduction items in excess of stock basis and those losses and deductions are claimed based on debt basis, the debt basis of the shareholder will be reduced by the claimed losses and deductions. If an S corporation repays reduced basis debt to the shareholder, part or all of the repayment is taxable to the shareholder.

Inflation Reduction Act of 2022—Signed into law on August 16, 2022, this $430 billion bill over 10 years has a stated goal of taming inflation and addressing the climate, tax, and health care issues. According to many economists, however, it will boost the level of GDP by about 0.2%-0.3% by the end of 2031 and will have no measurable impact on inflation. It is a slimmed down version of the $4.3 trillion Build Back Better plan.

Infrastructure Investment and Jobs Act—Public Law No. 117-58, also known as the Bipartisan Infrastructure Framework, was signed into law by President Biden on November 15, 2021 and includes approximately $1.2 trillion in spending to include funding for broadband access, clean water, electric grid renewal, and transportation and road provisions, along with tax-related provisions.

Non-Fungible Token (NFT)— Non-fungible tokens are unique cryptographic tokens that exist on a blockchain and cannot be replicated. They can be anything digital such as artwork, music, and tweets.

Stock Basis—It is important that a shareholder know his/her stock basis when: (1) The S corporation allocates a loss and/or deduction item to the shareholder. (2) The S corporation makes a non-dividend distribution to the shareholder. (3) The shareholder disposes of their stock. Since shareholder stock basis in an S corporation changes every year, it must be computed every year. In computing stock basis, the shareholder starts with their initial capital contribution to the S corporation or the initial cost of the stock they purchased (the same as a C corporation). That amount is then increased and/or decreased based on the pass-through amounts from the S corporation. An income item will increase stock basis while a loss, deduction, or distribution will decrease stock basis.

Tax Cuts and Jobs Act (TCJA)—Public Law No. 115-97, an act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, was signed into law by President Trump on December 22, 2017. Although not the official name for the new legislation, it is most commonly referred to as the Tax Cuts and Jobs Act (TCJA).

Setting Every Community Up for Retirement Enhancement (SECURE Act)—Part of the Further Consolidated Appropriations Act, 2020 (H.R. 1865, P.L. 116-94, the SECURE Act was enacted on December 20, 2019. It provides expanded opportunities for individuals for retirement savings and makes a number of administrative simplifications. It also includes a change to the kiddie tax.

CUMULATIVE INDEX 2022

BY TOPIC

BY CITATION

BY SPEAKER

Choose the best response and record your answer in the space provided on the answer sheet.

1. According to Ian Redpath, Notice 2022-36 addresses Form 1040 penalty relief for which of the following?

   A. Failure to timely file 2020 Form 1040
   B. Failure to timely file 2021 Form 1040
   C. Failure to pay 2020 Form 1040 taxes due
   D. Failure to pay 2021 Form 1040 taxes due

2. According to Ian Redpath, although the IRS processes determination letters for retirement plans in the order they are received, it gives priority to which of the following?

   A. Form 5300, Application for Determination for Employee Benefit Plan
   B. Form 5307, Application for Determination for Adopters of Master or Prototype or Volume Submitter Plans
   C. Form 5310, Application for Determination upon Termination
   D. Form 5316, Application for Group or Pooled Trust Ruling

3. According to Ian Redpath, which of the following addresses a lien on property that was in a tenancy by the entirety?

   A. Legal Advice Issued by Field Attorneys 20223301F
   B. *In Re: Litvinas*
   C. *Morgan v. Bruton*
   D. *Sparta Pink Propertysuth, LLC, et al. v. Commissioner*

4. According to Ian Redpath, how does the question regarding digital assets on the draft 2022 Form 1040 compare to the question on the 2021 Form 1040?

   A. The question has been added to the 2022 form since there was no such question on the 2021 form.
   B. The question has been deleted from the 2022 form.
   C. The question on the 2022 form is identical to the question on the 2021 form.
   D. The question on the 2022 form is significantly expanded compared to the question on the 2021 form.

5. According to Ian Redpath, which of the following will likely end up in the Supreme Court because of a split in the circuits?

   A. *Sparta Pink Propertysuth*
   B. *Morgan v. Bruton*
   C. *Litvinas*
   D. *Hoey*

Continued on next page

6. According to Ian Redpath and Jonathan Tretter, how is an S corporation shareholder's debt basis affected if the S corporation takes out a bank loan?

   A. The shareholder's debt basis is not affected by the loan.
   B. The shareholder's debt basis is decreased by a pro rata share of the loan.
   C. The shareholder's debt basis is increased by a pro rata share of the loan.
   D. The shareholder's debt basis is increased by the amount of the loan.

7. According to Ian Redpath and Jonathan Tretter, which of the following is accurate regarding an S corporation's ability to write off their proportionate share of S corporation losses?

   A. The shareholder's debt basis is applied after the shareholder's stock basis is exhausted.
   B. The shareholder's debt basis never impacts an S corporation shareholder's ability to write off losses.
   C. The shareholder's stock basis is applied after the shareholder's debt basis is exhausted.
   D. The shareholder's stock basis never impacts an S corporation shareholder's ability to write off losses.

8. According to Ian Redpath and Jonathan Tretter, which of the following is ***incorrect*** regarding Form 7203?

   A. It must be filed with each Form 1120-S.
   B. It must be filed by an individual who is deducting an S corporation loss.
   C. It must be filed by an individual who receives a nondividend distribution from an S corporation.
   D. It must be filed by an individual who sold S corporation stock.

9. According to Ian Redpath and Jonathan Tretter, which part of Form 7203 must an S corporation shareholder complete if they have personally loaned money to the S corporation?

   A. Part I
   B. Part II
   C. Part III
   D. Part IV

10. According to Ian Redpath and Jonathan Tretter, which of the following is accurate regarding restoration of debt basis in an S corporation?

   A. Debt basis and stock basis are restored concurrently.
   B. Debt basis cannot be restored.
   C. Debt basis is restored before stock basis
   D. Stock basis can be restored before or after debt basis.

Continued on next page

11. According to Ian Redpath and Julie Welch, compensation for which of the following is generally found to be unreasonably low rather than unreasonably high?

    A. Stockholder-employee of S corporation
    B. Owner-employee of closely held C corporation
    C. Manager of a small business
    D. CEO of a large corporation

12. According to Ian Redpath and Julie Welch, which of the following is ***not*** one of the nine factors that the IRS looks at when determining reasonable compensation?

    A. Qualifications of an individual employee
    B. Total compensation of all employees
    C. Comparison of salaries to stockholder distributions
    D. The employer's salary policy

13. According to Ian Redpath and Julie Welch, which circuit has rejected the tax court and other circuit courts looking at the compensation multi-factor test?

    A. 1st Circuit
    B. 2nd Circuit
    C. 5th Circuit
    D. 7th Circuit

14. According to Ian Redpath and Julie Welch, which of the following has the burden of proof with respect to factual issues related to imposition of tax for compensation issues?

    A. Employee
    B. Employer
    C. IRS
    D. Stockholders

15. According to Ian Redpath and Julie Welch, which of the following is the best example of contingent compensation?

    A. Non-exempt employee's monthly salary
    B. Real estate commission
    C. Sales tax paid on services
    D. Waiter's hourly rate of pay

CPE Network®
Tax Report
Volume 35, Issue 9 **October 2022**

Subscriber Survey

Evaluation Form

Please take a few minutes to complete this survey related to the **CPE Network® Tax Report** and return it by mail to 2395 Midway Road, Carrollton, Texas 75006, Attn: Managing Editor. All responses will be kept confidential. Comments in addition to the answers to these questions are also welcome. Please send comments to **CPLgrading@thomsonreuters.com.**

How would you rate the topics covered in the October 2022 **CPE Network® Tax Report?** Rate each topic on a scale of 1–5 (5=highest):

	Topic Relevance	Topic Content/ Coverage	Topic Timeliness	Video Quality	Audio Quality	Written Material
Experts' Forum	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|
Debt Basis in an S Corporation	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|
Reasonable Compensation	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|

Which segments of the October 2022 issue of **CPE Network® Tax Report** did you like the most, and why?

____

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Which segments of the October 2022 issue of **CPE Network® Tax Report** did you like the least, and why?

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What would you like to see included or changed in future issues of **CPE Network® Tax Report**?

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Are there any other ways in which we can improve **CPE Network® Tax Report**?

____

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How would you rate the effectiveness of the speakers in the October 2022 **CPE Network® Tax Report**? Rate each speaker on a scale of 1–5 (5 highest):

	Overall	**Knowledge of Topic**	**Presentation Skills**
Ian Redpath	|______|	|______|	|______|
Jonathan Tretter	|______|	|______|	|______|
Julie Welch	|______|	|______|	|______|

Which of the following would you use for viewing CPE Network® A&A Report? DVD ☐ Streaming ☐ Both ☐

Are you using **CPE Network® Tax Report** for: CPE Credit ☐ Information ☐ Both ☐ ______________________

Were the stated learning objectives met? Yes ☐ No ☐ ______________________________________

If applicable, were prerequisite requirements appropriate? Yes ☐ No ☐ ______________________________

Were program materials accurate? Yes ☐ No ☐ ____

Were program materials relevant and contribute to the achievement of the learning objectives? Yes ☐ No ☐ __________

Were the time allocations for the program appropriate? Yes ☐ No ☐ ______________________________

Were the supplemental reading materials satisfactory? Yes ☐ No ☐ ______________________________

Were the discussion questions and answers satisfactory? Yes ☐ No ☐ ______________________________

Were the audio and visual materials effective? Yes ☐ No ☐ ______________________________

Specific Comments: ____

____

Name/Company ____

Address ____

City/State/Zip ____

Email ____

Once Again, Thank You…
Your Input Can Have a Direct Influence on Future Issues!

CPE Network®

CPE Group Attendance Sheet

Firm/Company Name: ______________________

Account #: ______________________

Location: ______________________

Program Title: CPE Network Tax Report, October 2022 Date: __________

Name	Email	Total Hrs	IRS PTIN ID (if applicable Tax only)	Sign In	Sign Out

I certify that the above individuals viewed and were participants in the group discussion with this issue/segment of the CPE Network® newsletter, and earned the number of hours shown.

Instructor Name: ______________________ Date: __________

E-mail address: ______________________

License State and Number: ______________________

CPE Network/Webinar Delivery Tracking Report

Course Title	
Course Date:	
Start Time:	
End Time:	
Moderator Name, Credentials, and Signature Attestation of Attendance:	
Delivery Method:	Group Internet Based
Total CPE Credit:	3.0
Instructions:	During the webinar, the moderator must verify student presence a minimum of 3 times per CPE hour. This is achieved via polling questions. Sponsors must have a report which documents the responses from each student. The timing of the polling questions should be random and not made known to students prior to delivery of the course. Record the polling question responses below. Refer to the CPL Network User Guide for more instructions. Partial credit will not be issued for students who do not respond to at least 3 polling questions per CPE hour.
Brief Description of Method of Polling	Example: Zoom: During this webinar, moderator asked students to raise their hands 3 times per CPE hour. The instructor then noted the hands that were raised in the columns below.

			First CPE Hour			**CPE Hour 2**			**CPE Hour 3**			**FOR TR USE ONLY**
First Name	**Last Name**	**Student Email**	**Poll 1**	**Poll 2**	**Poll 3**	**Poll 1**	**Poll 2**	**Poll 3**	**Poll 1**	**Poll 2**	**Poll 3**	**Certificate Issued?**

CHECKPOINT LEARNING NETWORK

CPE NETWORK®
USER GUIDE

REVISED SEPTEMBER 3, 2021

Welcome to CPE Network!

CPE Network programs enable you to deliver training programs to those in your firm in a manageable way. You can choose how you want to deliver the training in a way that suits your firm's needs: in the classroom, virtual, or self-study. You must review and understand the requirements of each of these delivery methods before conducting your training to ensure you meet (and document) all the requirements.

This User Guide has the following sections:

- **"Group Live" Format:** The instructor and all the participants are gathered into a common area, such as a conference room or training room at a location of your choice.
- **"Group Internet Based" Format:** Deliver your training over the internet via Zoom, Teams, Webex, or other application that allows the instructor to present materials that all the participants can view at the same time.
- **"Self-Study" Format:** Each participant can take the self-study version of the CPE Network program on their own computers at a time and place of their convenience. No instructor is required for self-study.
- **What Does It Mean to Be a CPE Sponsor?:** Should you decide to vary from any of the requirements in the 3 methods noted above (for example, provide less than 3 full CPE credits, alter subject areas, offer hybrid or variations to the methods described above), <u>Checkpoint Learning Network will not be the sponsor and will not issue certificates.</u> In this scenario, your firm will become the sponsor and must issue its own certificates of completion. This section outlines the sponsor's responsibilities that you must adhere to if you choose not to follow the requirements for the delivery methods.
- **Getting Help:** Refer to this section to get your questions answered.

IMPORTANT: This User Guide outlines in detail what is required for each of the 3 formats above. Additionally, because you will be delivering the training within your firm, you should review the Sponsor Responsibilities section as well. To get certificates of completion for your participants following your training, you must submit all the required documentation. (This is noted at the end of each section.) Checkpoint Learning Network will review your training documentation for completeness and adherence to all requirements. If all your materials are received and complete, certificates of completion will be issued for the participants attending your training. Failure to submit the required completed documentation will result in delays and/or denial of certificates.

IMPORTANT: If you vary from the instructions noted above, your firm will become the sponsor of the training event and you will have to create your own certificates of completions for your participants. In this case, you do not need to submit any documentation back to Thomson Reuters.

If you have any questions on this documentation or requirements, refer to the "Getting Help" section at the end of this User Guide **BEFORE** you conduct your training.

We are happy that you chose CPE Network for your training solutions. Thank you for your business and HAPPY LEARNING!

Copyrighted Materials

“Group Live” Format

CPE Credit

All CPE Network products are developed and intended to be delivered as 3 CPE credits. You should allocate sufficient time in your delivery so that there is no less than 2.5 clock hours:

50 minutes per CPE credit TIMES 3 credits = 150 minutes = 2.5 clock hours

If you wish to have a break during your training session, you should increase the length of the training beyond 2.5 hours as necessary. For example, you may wish to schedule your training from 9 AM to 12 PM and provide a ½ hour break from 10:15 to 10:45.

***Effective November 1, 2018:** Checkpoint Learning CPE Network products ‘group live’ sessions must be delivered as 3 CPE credits and accredited to the field(s) of study as designated by Checkpoint Learning Network. Checkpoint Learning Network will not issue certificates for “group live” deliveries of less than 3 CPE credits (unless the course was delivered as 3 credits and there are partial credit exceptions (such as late arrivals and early departures). Therefore, if you decide to deliver the “group live” session with less than 3 CPE credits, your firm will be the sponsor as Checkpoint Learning Network will not issue certificates to your participants.

Advertising / Promotional Page

Create a promotion page (use the template after the executive summary of the transcript). You should circulate (e.g., email) to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

Monitoring Attendance

You must monitor individual participant attendance at “group live” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **attendance sheet.** This lists the instructor(s) name and credentials, as well as the first and last name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant arrives late, leaves early, or is a “no show,” the actual hours they attended should be documented on the sign-in sheet and will be reflected on the participant's CPE certificate.

Real Time Instructor During Program Presentation

"Group live" programs must have a **qualified, real time instructor while the program is being presented.** Program participants must be able to interact with the instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

Elements of Engagement

A "group live" program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

Make-Up Sessions

Individuals who are unable to attend the group study session may use the program materials for self-study either in print or online.

- If the print materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Quizzer Answer Sheet. Send the answer sheet and course evaluation to the address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual Checkpoint Learning account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his/their CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

Awarding CPE Certificates

The CPE certificate is the participant's record of attendance and is awarded by Checkpoint Learning Network after the "group live" documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early.

Subscriber Survey Evaluation Forms

Use the evaluation form. You must include a means for evaluating quality. At the conclusion of the "group live" session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to Checkpoint Learning Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

Retention of Records

Regardless of whether Checkpoint Learning Network is the sponsor for the "group live" session, it is required that the firm hosting the "group live" session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Group Study Attendance sheets; indicating any late arrivals and/or early departures)
- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations.

Finding the Transcript

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- https://get.adobe.com/reader/

Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your "group live" session should be sent to Checkpoint Learning Network by one of the following means:

Mail: Thomson Reuters
PO Box 115008
Carrollton, TX 75011-5008

Email: **CPLgrading@tr.com**

Fax: 888.286.9070

When sending your package to Thomson Reuters, you must include ALL of the following items:

Form Name	Included?	Notes
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Attendance Sheet		Use this form to track attendance during your training session.
Subscriber Survey Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to Thomson Reuters any evaluations that were completed. You do not have to return an evaluation for every participant.

Incomplete submissions will be returned to you.

“Group Internet Based” Format

CPE Credit

All CPE Network products are developed and intended to be delivered as 3 CPE credits. You should allocate sufficient time in your delivery so that there is no less than 2.5 clock hours:

50 minutes per CPE credit TIMES 3 credits = 150 minutes = 2.5 clock hours

If you wish to have a break during your training session, you should increase the length of the training beyond 2.5 hours as necessary. For example, you may wish to schedule your training from 9 AM to 12 PM and provide a ½ hour break from 10:15 to 10:45.

***Effective November 1, 2018:** Checkpoint Learning CPE Network products ‘group live’ sessions must be delivered as 3 CPE credits and accredited to the field(s) of study as designated by Checkpoint Learning Network. Checkpoint Learning Network will not issue certificates for “group live” deliveries of less than 3 CPE credits (unless the course was delivered as 3 credits and there are partial credit exceptions (such as late arrivals and early departures). Therefore, if you decide to deliver the “group live” session with less than 3 CPE credits, your firm will be the sponsor as Checkpoint Learning Network will not issue certificates to your participants.

Advertising / Promotional Page

Create a promotion page (use the template following the executive summary in the transcript). You should circulate (e.g., email) to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

Monitoring Attendance in a Webinar

You must monitor individual participant attendance at “group internet based” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **Webinar Delivery Tracking Report.** This form lists the moderator(s) name and credentials, as well as the first and last name of each participant attending the seminar. During a webinar you must set up a monitoring mechanism (or polling mechanism) to periodically check the participants’ engagement throughout the delivery of the program.

In order for CPE credit to be granted, you must confirm the presence of each participant **3 times per CPE hour and the participant must reply to the polling question**. Participants that respond to less than 3 polling questions in a CPE hour will not be granted CPE credit. For example, if a participant only replies to 2 of the 3 polling questions in the first CPE hour, credit for the first CPE hour will not be granted. (Refer to the Webinar Delivery Tracking Report for examples.)

Examples of polling questions:

1. You are using **Zoom** for your webinar. The moderator pauses approximately every 15 minutes and ask that participants confirm their attendance by using the "raise hands" feature. Once the participants raise their hands, the moderator records the participants who have their hands up in the **webinar delivery tracking report** by putting a YES in the webinar delivery tracking report. After documenting in the spreadsheet, the instructor (or moderator) drops everyone's hands and continues the training.
2. You are using **Teams** for your webinar. The moderator will pause approximately every 15 minutes and ask that participants confirm their attendance by typing "Present" into the Teams chat box. The moderator records the participants who have entered "Present" into the chat box into the **webinar delivery tracking report**. After documenting in the spreadsheet, the instructor (or moderator) continues the training.
3. If you are using an application that has a way to automatically send out polling questions to the participants, you can use that application/mechanism. However, following the event, you should create a **webinar delivery tracking report** from your app's report.

Additional Notes on Monitoring Mechanisms:

1. The monitoring mechanism does not have to be "content specific." Rather, the intention is to ensure that the remote participants are present and paying attention to the training.
2. You should only give a minute or so for each participant to reply to the prompt. If, after a minute, a participant does not reply to the prompt, you should put a NO in the webinar delivery tracking report.
3. While this process may seem unwieldy at first, it is a required element that sponsors must adhere to. And after some practice, it should not cause any significant disruption to the training session.
4. **You must include the Webinar Delivery Tracking report with your course submission if you are requesting certificates of completion for a "group internet based" delivery format.**

Real Time Moderator During Program Presentation

"Group internet based" programs must have a **qualified, real time moderator while the program is being presented.** Program participants must be able to interact with the moderator while the course is in progress (including the opportunity to ask questions and receive answers during the presentation). This can be achieved via the webinar chat box, and/or by unmuting participants and allowing them to speak directly to the moderator.

Make-Up Sessions

Individuals who are unable to attend the "group internet based" session may use the program materials for self-study either in print or online.

- If print materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Quizzer Answer Sheet. Send the answer sheet and course evaluation to the address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual Checkpoint Learning account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

Awarding CPE Certificates

The CPE certificate is the participant's record of attendance and is awarded by Checkpoint Learning Network after the "group internet based" documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who may not have answered the required amount of polling questions.

Subscriber Survey Evaluation Forms

Use the evaluation form. You must include a means for evaluating quality. At the conclusion of the "group live" session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to Checkpoint Learning Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

Retention of Records

Regardless of whether Checkpoint Learning Network is the sponsor for the "group internet based" session, it is required that the firm hosting the session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Webinar Delivery Tracking Report)
- Copy of the program materials
- Timed agenda with topics covered
- Date and location (which would be "virtual") of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations

Finding the Transcript

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. It should look something like the screenshot below. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- https://get.adobe.com/reader/

Alternatively, for those without a DVD drive, the email sent to administrators each month has a link to the pdf for the newsletter. The email may be forwarded to participants who may download the materials or print them as needed.

Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your "group internet based" session should be sent to Checkpoint Learning Network by one of the following means:

Mail: Thomson Reuters
PO Box 115008
Carrollton, TX 75011-5008

Email: **CPLgrading@tr.com**

Fax: 888.286.9070

When sending your package to Thomson Reuters, you must include ALL the following items:

Form Name	Included?	Notes
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Webinar Delivery Tracking Report		Use this form to track the attendance (i.e., polling questions) during your training webinar.
Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to Thomson Reuters any evaluations that were completed. You do not have to return an evaluation for every participant.

Incomplete submissions will be returned to you.

“Self-Study” Format

If you are unable to attend the live group study session, we offer two options for you to complete your Network Report program.

Self-Study—Print

Follow these simple steps to use the printed transcript and DVD:

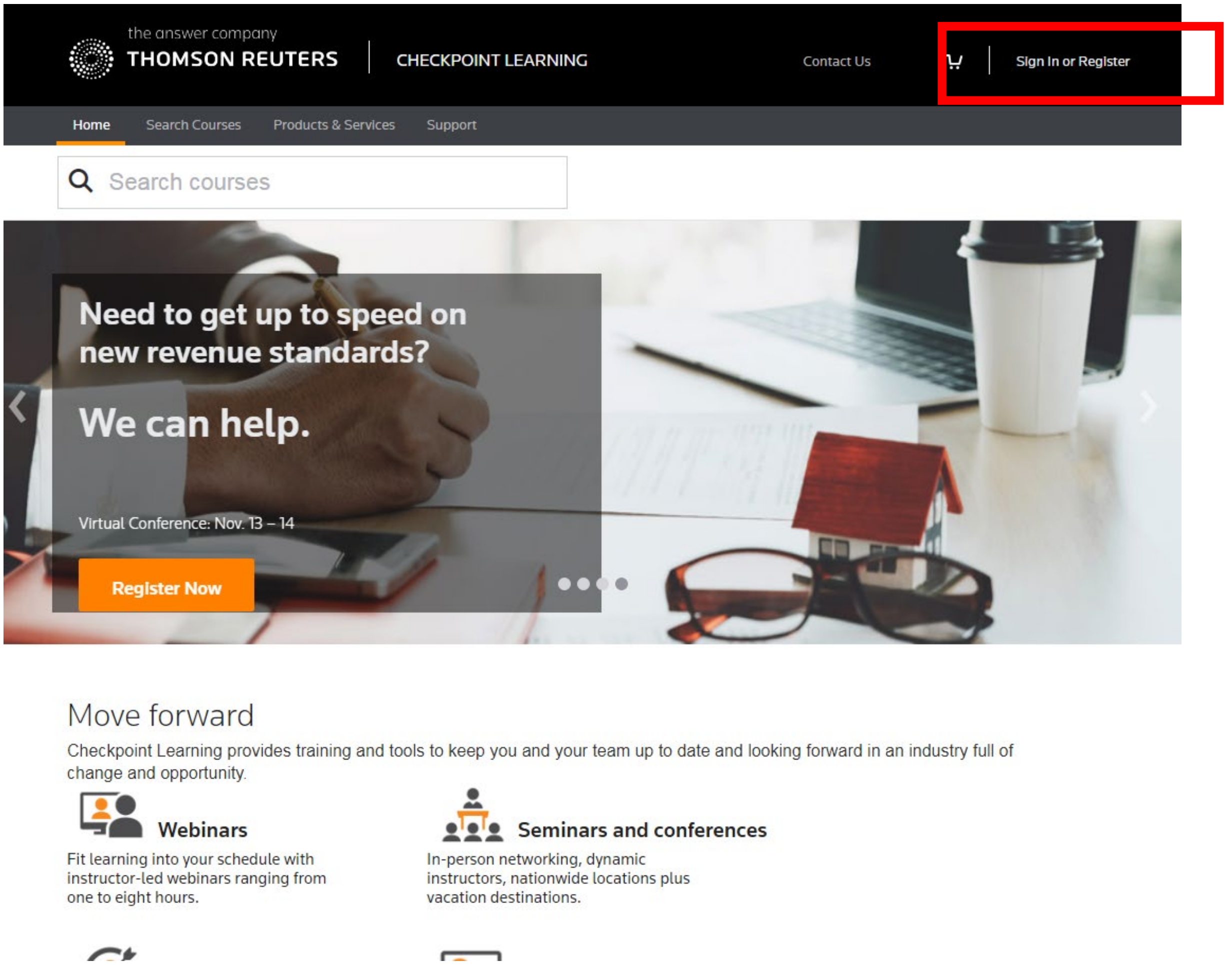
- Watch the DVD.
- Review the supplemental materials.
- Read the discussion problems and the suggested answers.
- Complete the quizzer by filling out the bubble sheet enclosed with the transcript package.
- Complete the survey. We welcome your feedback and suggestions for topics of interest to you.
- Mail your completed quizzer and survey to:

  Thomson Reuters
  PO Box 115008
  Carrollton, TX 75011-5008

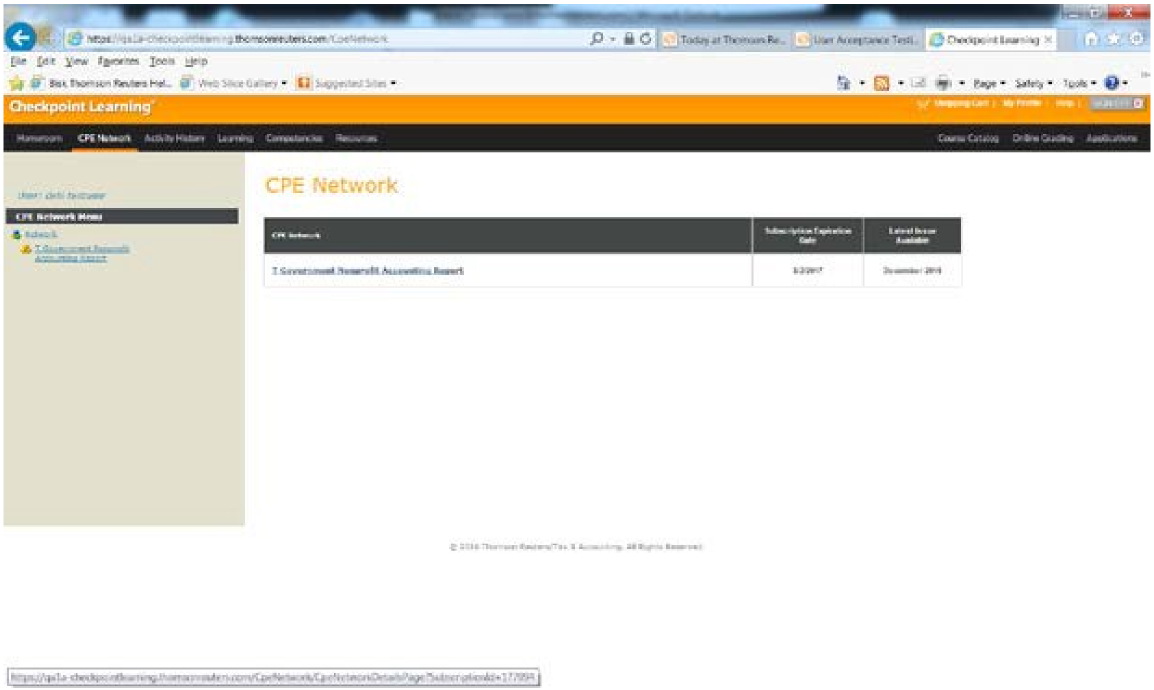
Self-Study—Online

Follow these simple steps to use the online program:

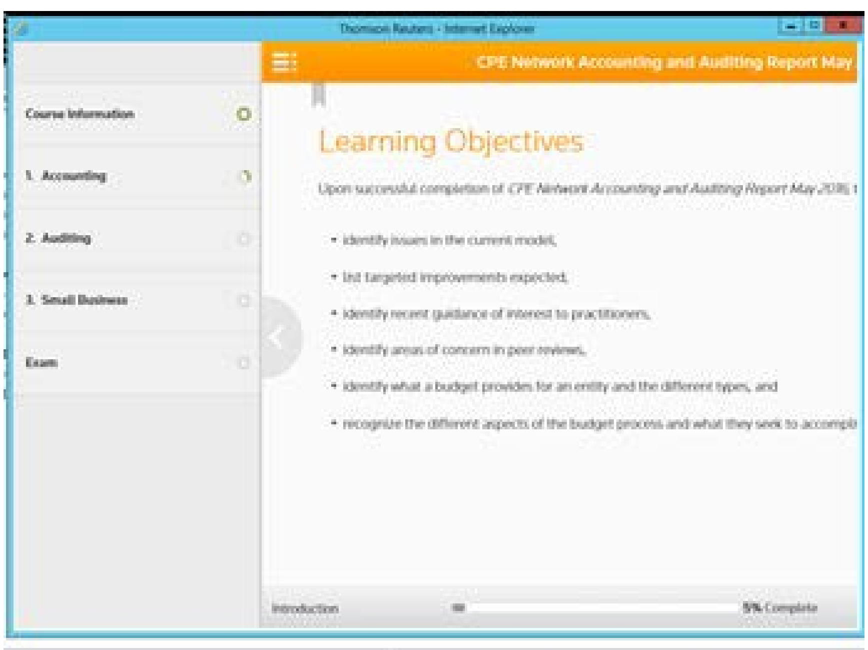
- Go to www.checkpointlearning.thomsonreuters.com .
- Log in using your username and password assigned by your firm’s administrator in the upper right-hand margin (“Sign In or Register”).


the answer company
THOMSON REUTERS
CHECKPOINT LEARNING
Contact Us
Sign In or Register
Home
Search Courses
Products & Services
Support
Search courses
Need to get up to speed on new revenue standards?
We can help.
Virtual Conference: Nov. 13 – 14
Register Now
Move forward
Checkpoint Learning provides training and tools to keep you and your team up to date and looking forward in an industry full of change and opportunity.
Webinars
Fit learning into your schedule with instructor-led webinars ranging from one to eight hours.
Seminars and conferences
In-person networking, dynamic instructors, nationwide locations plus vacation destinations.

- In the **Network** tab, select the Network Report for the month desired.

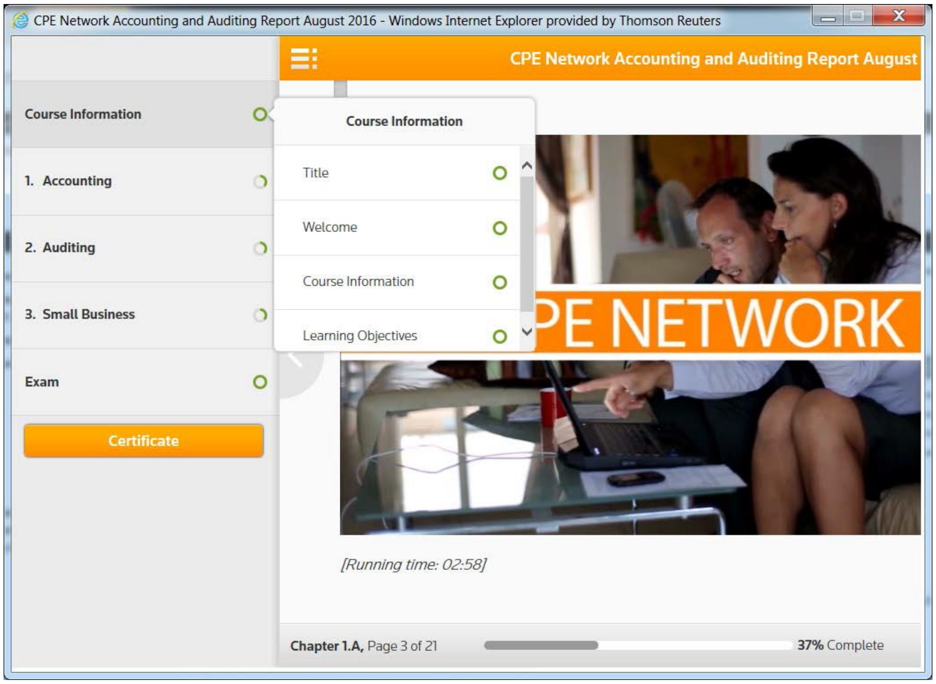


The Chapter Menu is in the gray bar at the left of your screen:

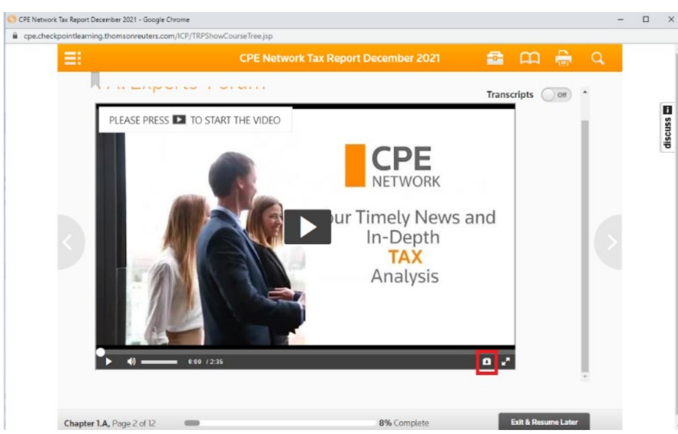


Click down to access the dropdown menu and move between the program Chapters.

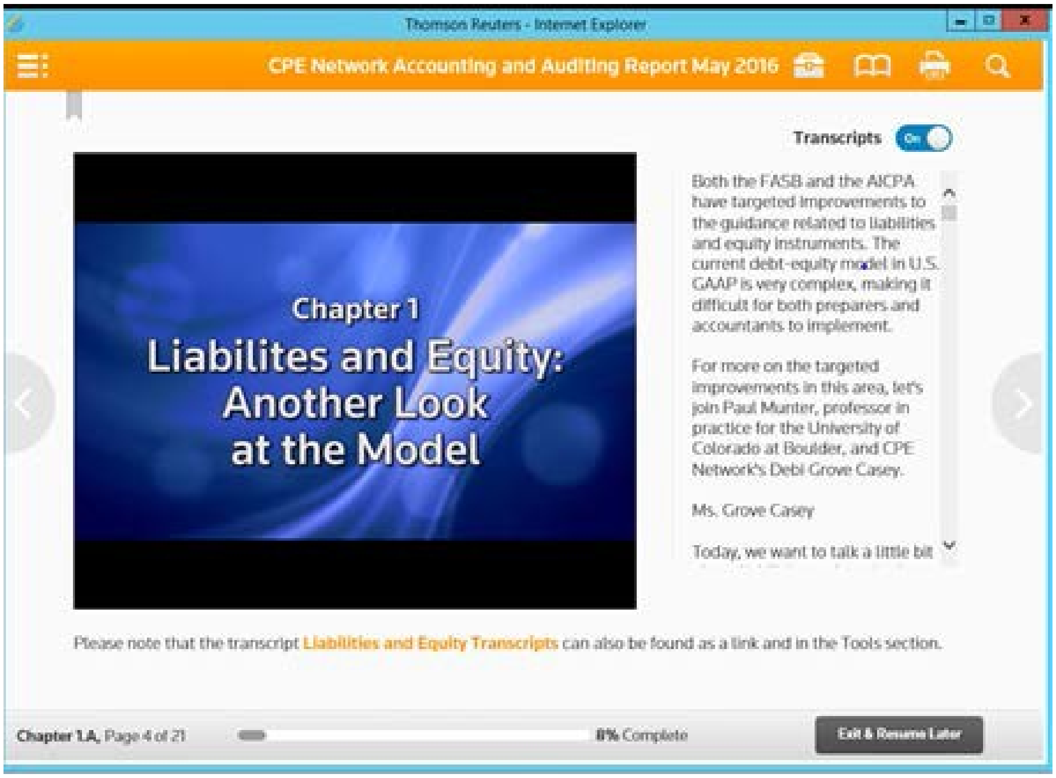
- **Course Information** is the course Overview, including information about the authors and the program learning objectives



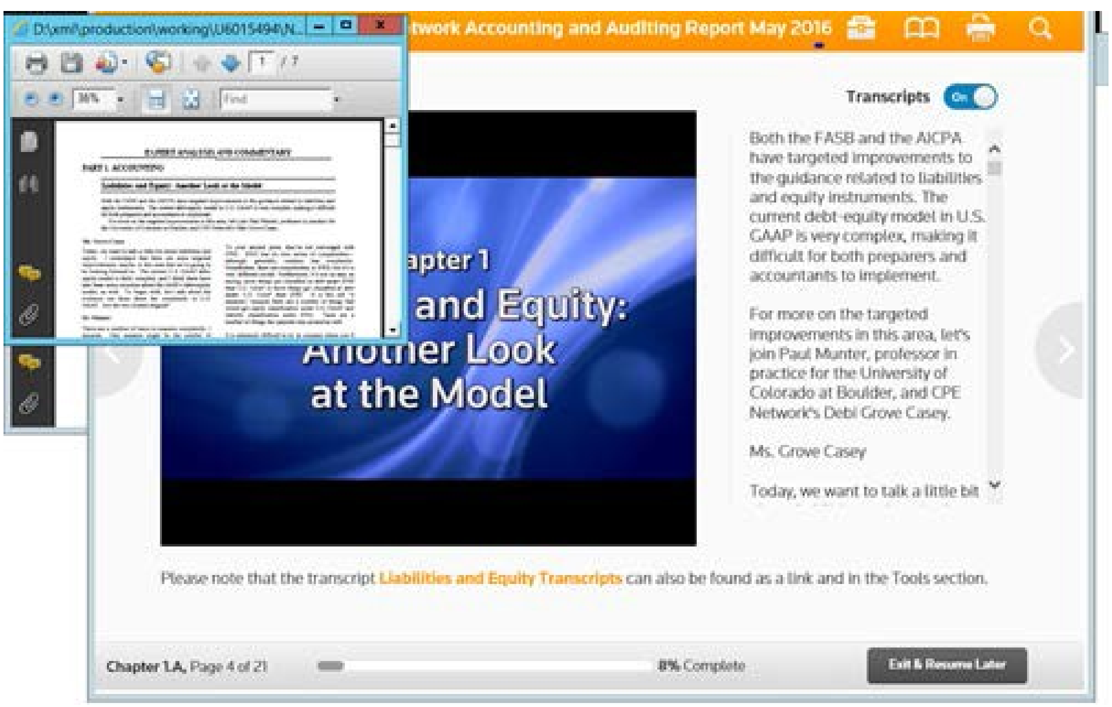
- **Each Chapter is now self-contained.** Years ago, when on the CPEasy site, the interview segments were all together, then all the supplemental materials, etc. Today, each chapter contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental materials, and then the discussion questions. This more streamlined approach allows administrators and users to more easily access the related materials.



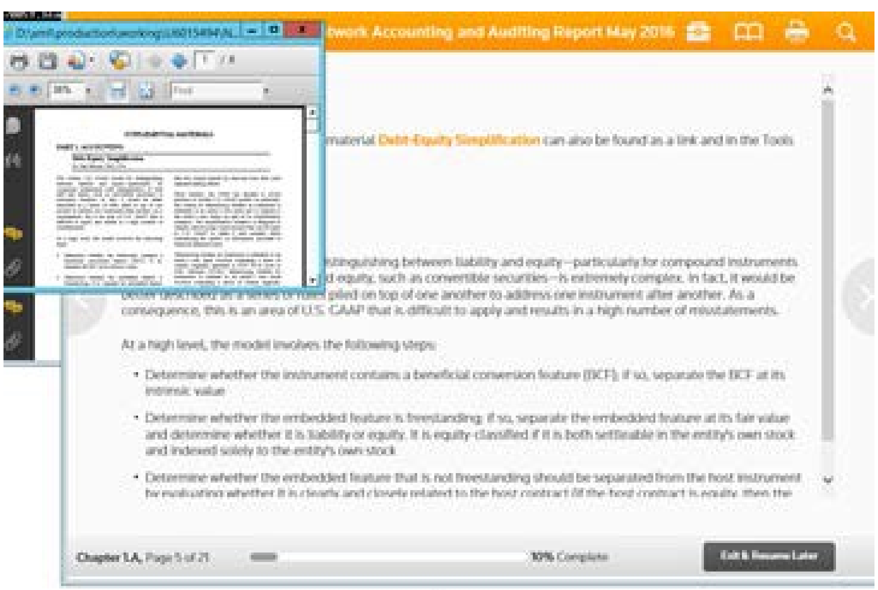
Video segments may be downloaded from the CPL player by clicking on the download button.



Transcripts for the interview segments can be viewed at the right side of the screen via a toggle button at the top labeled **Transcripts** or via the link to the pdf below the video (also available in the toolbox in the resources section). The pdf will appear in a separate pop-up window.

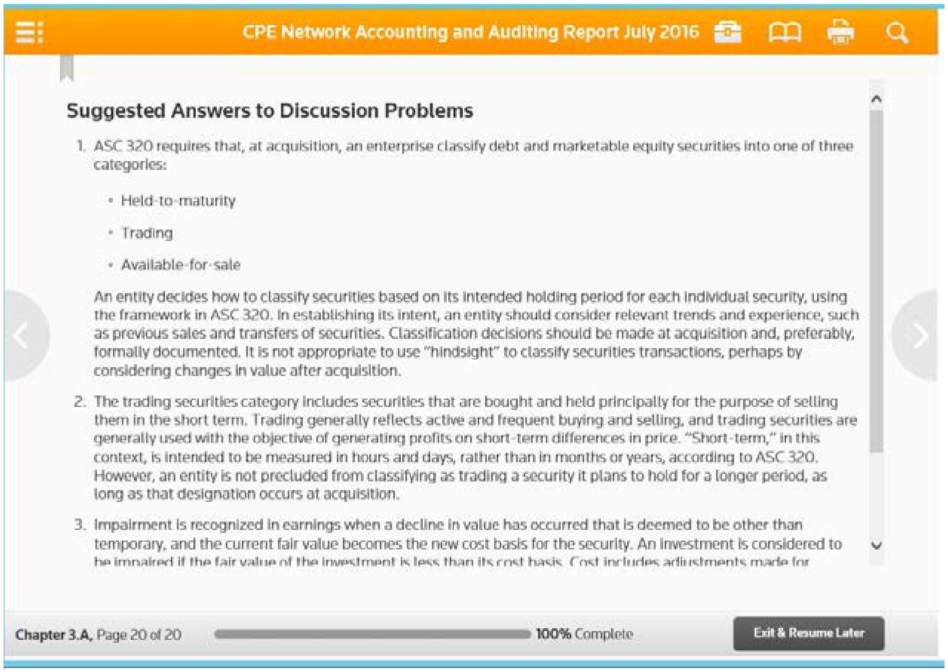


Click the arrow at the bottom of the video to play it, or click the arrow to the right side of the screen to advance to the supplemental material. As with the transcripts, the supplemental materials are also available via the toolbox and the link will pop up the pdf version in a separate window.



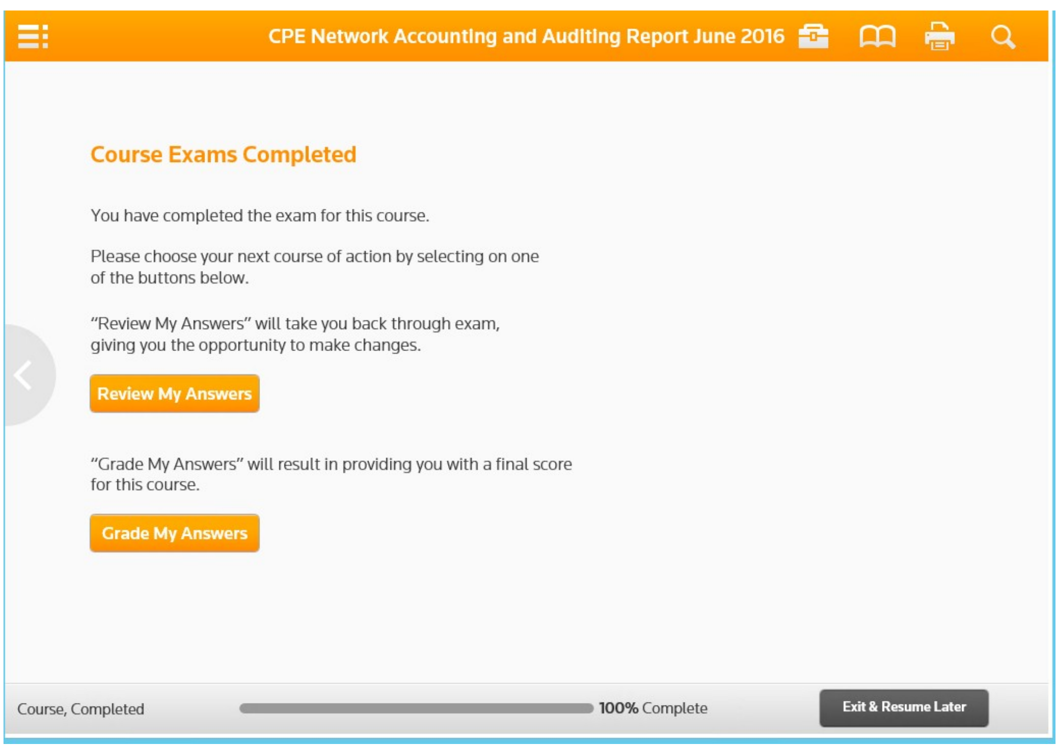
Continuing to click the arrow to the right side of the screen will bring the user to the Discussion p roblems related to the segment.

The Suggested Answers to the Discussion Problems follow the Discussion Problems.



The **Exam** is accessed by clicking the last gray bar on the menu at the left of the screen or clicking through to it. Click the orange button to begin.

When you have completed the quizzer, click the button labeled **Grade or the Review button**.



- Click the button labeled **Certificate** to print your CPE certificate.
- The final quizzer grade is displayed and you may view the graded answers by clicking the button labeled **view graded answer**.

Additional Features Search

Checkpoint Learning offers powerful search options. Click the **magnifying glass** at the upper right of the screen to begin your search. Enter your choice in the **Search For:** box.

Search Results are displayed with the number of hits.

Print

To display the print menu, click the printer icon in the upper bar of your screen. You can print the entire course, the transcript, the glossary, all resources, or selected portions of the course. Click your choice and click the orange **Print**.

What Does It Mean to Be a CPE Sponsor?

If your organization chooses to vary from the instructions outlined in this User Guide, your firm will become the CPE Sponsor for this monthly series. The sponsor rules and requirements noted below are only highlights and reflect those of NASBA, the national body that sets guidance for development, presentation, and documentation for CPE programs. **For any specific questions about state sponsor requirements, please contact your state board. They are the final authority regarding CPE Sponsor requirements.** Generally, the following responsibilities are required of the sponsor:

- Arrange for a location for the presentation
- Advertise the course to your anticipated participants and disclose significant features of the program in advance
- Set the start time
- Establish participant sign-in procedures
- Coordinate audio-visual requirements with the facilitator
- Arrange appropriate breaks
- Have a real-time instructor during program presentation
- Ensure that the instructor delivers and documents elements of engagement
- Monitor participant attendance (make notations of late arrivals, early departures, and “no shows”)
- Solicit course evaluations from participants
- Award CPE credit and issue certificates of completion
- Retain records for five years

The following information includes instructions and generic forms to assist you in fulfilling your responsibilities as program sponsor.

CPE Sponsor Requirements

<u>Determining CPE Credit Increments</u>

Sponsored seminars are measured by program length, with one 50-minute period equal to one CPE credit. One-half CPE credit increments (equal to 25 minutes) are permitted after the first credit has been earned. Sponsors must monitor the program length and the participants’ attendance in order to award the appropriate number of CPE credits.

<u>Program Presentation</u>

CPE program sponsors must provide descriptive materials that enable CPAs to assess the appropriateness of learning activities. CPE program sponsors must make the following information available in advance:

- Learning objectives.
- Instructional delivery methods.
- Recommended CPE credit and recommended field of study.
- Prerequisites.
- Program level.
- Advance preparation.
- Program description.
- Course registration and, where applicable, attendance requirements.
- Refund policy for courses sold for a fee/cancellation policy.
- Complaint resolution policy.
- Official NASBA sponsor statement, if an approved NASBA sponsor (explaining final authority of acceptance of CPE credits**).**

Disclose Significant Features of Program in Advance

For potential participants to effectively plan their CPE, the program sponsor must disclose the significant features of the program in advance (e.g., through the use of brochures, website, electronic notices, invitations, direct mail, or other announcements). When CPE programs are offered in conjunction with non-educational activities, or when several CPE programs are offered concurrently, participants must receive an appropriate schedule of events indicating those components that are recommended for CPE credit. The CPE program sponsor's registration and attendance policies and procedures must be formalized, published, and made available to participants and include refund/cancellation policies as well as complaint resolution policies.

Monitor Attendance

While it is the participant's responsibility to report the appropriate number of credits earned, CPE program sponsors must maintain a process to monitor individual attendance at group programs to assign the correct number of CPE credits. A participant's self-certification of attendance alone is not sufficient. The sign-in sheet should list the names of each instructor and her/his credentials, as well as the name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant leaves early, the hours they attended should be documented on the sign-in sheet and on the participant's CPE certificate.

Real Time Instructor During Program Presentation

"Group live" programs must have a qualified, real time instructor while the program is being presented. Program participants must be able to interact with the real time instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

Elements of Engagement

A "group live" program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

Awarding CPE Certificates

The CPE certificate is the participant's record of attendance and is awarded at the conclusion of the seminar. It should reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early. Attached is a sample *Certificate of Attendance* you may use for your convenience.

CFP credit is available if the firm registers with the CFP board as a sponsor and meets the CFP board requirements. IRS credit is available only if the firm registers with the IRS as a sponsor and satisfies their requirements.

Seminar Quality Evaluations for Firm Sponsor

NASBA requires the seminar to include a means for evaluating quality. At the seminar conclusion, evaluations should be solicited from participants and retained by the sponsor for five years. The following statements are required on the evaluation and are used to determine whether:

1. Stated learning objectives were met.
2. Prerequisite requirements were appropriate.
3. Program materials were accurate.
4. Program materials were relevant and contributed to the achievement of the learning objectives.
5. Time allotted to the learning activity was appropriate.
6. Individual instructors were effective.
7. Facilities and/or technological equipment were appropriate.
8. Handout or advance preparation materials were satisfactory.
9. Audio and video materials were effective.

You may use the enclosed preprinted evaluation forms for your convenience.

Retention of Records

The seminar sponsor is required to retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (the original sign-in sheets, now in an editable, electronic signable format)

- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name(s) and credentials
- Results of program evaluations

Appendix: Forms

Here are the forms noted above and how to get access to them.

Delivery Method	Form Name	Location	Notes
"Group Live" / "Group Internet Based"	Advertising / Promotional Page	Transcript	Complete this form and circulate to your audience before the training event.
"Group Live"	Attendance Sheet	Transcript	Use this form to track attendance during your training session.
"Group Internet Based"	Webinar Delivery Tracking Report	Transcript	Use this form to track the 'polling questions' which are required to monitor attendance during your webinar.
"Group Live" / "Group Internet Based"	Evaluation Form	Transcript	Circulate the evaluation form at the end of your training session so that participants can review and comment on the training.
Self Study	CPE Quizzer Answer Sheet	Transcript	Use this form to record your answers to the quiz.

Getting Help

Should you need support or assistance with your account, please see below:

Support Group	**Phone Number**	**Email Address**	**Typical Issues/Questions**
Technical Support	800.431.9025 (follow option prompts	checkpointlearning.techsupport@ thomsonreuters.com	• Browser-based • Certificate discrepancies • Accessing courses • Migration questions • Feed issues
Product Support	800.431.9025 (follow option prompts	checkpointlearning.productsupport@ thomsonreuters.com	• Functionality (how to use, where to find) • Content questions • Login Assistance
Customer Support	800.431.9025 (follow option prompts	checkpointlearning.cpecustomerservicet@ thomsonreuters.com	• Billing • Existing orders • Cancellations • Webinars • Certificates