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The Contemporary Tax
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Special Thanks to
Myra Sutanto Shen, JD
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Letter from the Editor

I and our editorial board are excited to present to you the Summer 2022 issue of The Contemporary Tax Journal, a publication of San Jose State University’s MS in Taxation (MST) Program. Over the past few months, we worked with SJSU MST students, professors and practitioners to present you this edition. The topics covered in this issue are current and thought-provoking.

Our 11th volume begins with our Tax Maven interview with Myra Sutanto Shen, who is a tax partner in the Palo Alto office of Wilson Sonsini Goodrich & Rosati. Ms. Shen has extensive experience in advising public and private companies in all corporate transactions. Our assistant editor Dale Loepp had the pleasure of conducting this interview with her and I hope you enjoy learning about her past experiences and accomplishments.

Our next section is dedicated to Tax Enlightenment. This section includes three articles written by SJSU MST students. The first article is written by Jakub Hench and covers a case that ruled over when a trade or business begins. The next article is written by Tiago Iorio and goes over the high-profile Whirlpool case that will greatly affect how companies report Subpart F income. The last article is written by Dale Loepp, CPA and determines whether a CEO of a C corporation received too much compensation.

Next is a section dedicated to A Focus on Tax Policy. This section we present the analysis of a tax proposal, H.R. 3321, Credit for Caring Act of 2021, by the Spring BUS 223A Tax research class and the tax journal editors. This tax bills were analyzed using the Guiding Principles of Good Tax Policy outlined in the AICPA Tax Policy Concept Statement No. 1.¹

Also, we have a section for Tax Features. Here, we have an article written about a presentation made by Associate Professor Caroline Chen updating the audience on new foreign tax credit regulations issued by the U.S. Department of Treasury on December 28, 2021. After that, we have fun tax facts written by Sheetal Partani, EA.

Finally, we are grateful to Gleim CPA Review for again providing us with practice CPA exam questions that we hope everyone finds interesting.

I would like to thank all the contributors of this issue, Assistant Editor Dale Loepp, and fellow MST students. Also, I would like to thank Professor Annette Nellen for her continuous support, her invaluable contributions to this journal, and for being a leader in the tax profession. I am also grateful to our MST coordinator and journal webmaster Catherine Dougherty. Their insights and hard work made this issue of the journal possible.

I invite you to enjoy reading our journal and hope you will consider contributing to our upcoming issues. I now present to you the Spring 2022 issue of *The Contemporary Tax Journal*.

Regards,
Tam Nguyen
Student Editor
Tax Maven

The Contemporary Tax Journal’s Interview with Ms. Myra Sutanto Shen

By: Dale Loepp, CPA, MST Student

For this issue of The Contemporary Tax Journal’s tax maven feature, I had the pleasure of interviewing Myra Sutanto Shen. Ms. Shen is a tax partner in the Palo Alto office of Wilson Sonsini Goodrich & Rosati, representing technology and life science companies in all aspects of U.S. federal income tax planning. She has extensive experience advising public and private companies in all corporate transactions, including domestic and cross-border mergers and acquisitions, equity and debt financings, IPOs and convertible note offerings, and corporate restructurings. Ms. Shen also advises founders, investors, and companies regarding the “qualified small business stock” exemption under Section 1202 of the Internal Revenue Code.

Ms. Shen participates in several firm committees, serving as co-chair of the firm’s Women of Wilson affinity group and actively participating in the Asian American Affinity Group.

During law school, Ms. Shen worked for the Bluhm Legal Clinic's Investor Protection Center, where she represented low-income investors in their disputes with broker-dealers.

Following are questions I asked Ms. Shen during our interview on May 26, 2022 in San Jose.

1. How did you get involved in the tax field? Was that your plan when you were in college?

   Absolutely not! I majored in molecular biology and integrated science in college, which was an honors program designed to give students an interdisciplinary foundation in all areas of science and math with a goal of pursuing scientific research. Law school never crossed my mind—I first considered medical school, and ended up going to MIT to pursue a PhD before realizing that I didn’t really want to work in a lab for the rest of my life. During the year I was at MIT, there were a number of panels about what to do with your science degree when you don’t want to do science anymore, and many of the panels had one theme in common: law. So, I went to law school, thinking I could spin my science background into a career in intellectual property law, health policy, or academic counseling.

   One of the advantages of being at Northwestern (in addition to the tax program, of course), is that we had access to many lawyers in downtown Chicago to serve as mentors. While I was a first-year law student, I met an employee benefits and
compensation lawyer at Mayer Brown who raved about her practice in a way that I found very appealing. I was especially attracted to the idea that tax is very rules driven, like a big puzzle.

2. What stands out as one or two of your most significant accomplishments in your career?

Making partner while working a reduced hours schedule. I reduced my schedule to 80% after having my second son in 2011, and continued to work between 80% and 85% after having my daughter in 2013. I went into the arrangement making it very clear that I planned to be available to the extent possible and I wanted to keep working on exciting, fast-moving transactions—I just wanted to work on one fewer project at a time. Wilson Sonsini never shied away from giving me great work, just a little less of it, and I made partner in 2016 and worked another two years on a reduced schedule as a partner before moving back to full-time when my kids were a bit older.

3. Balancing raising a family while simultaneously making partner at Wilson Sonsini is indeed quite an accomplishment. I noticed that you currently serve as the co-chair of your firm’s Women of Wilson affinity group. What are your thoughts on the general trajectory for women in the profession and achieving a positive work-life balance?

I think the situation for women in the profession has improved significantly over time. But this doesn’t change the fact that as a practice, Biglaw (and our firm) still tend to lose more women than men along the way and that we continue to struggle to identify the reasons behind these trends and to find ways to retain more women. Part of the challenge is conveying the message that achieving some form of work-life balance is possible. But work-life balance can mean different things for different people in different situations and there is really no one-size-fits-all solution to this question. Also, there are many paths available in the profession and many women who have left Biglaw have been very successful in their other endeavors, which is great to see, but we would love to see more women stay at the firm.

4. Your bio also points out that you participate in an Asian American affinity group at Wilson Sonsini. What does this group do?

Part of the function of an affinity group at our firm is to get together and talk about common issues and provide avenues for support and team building, but the groups also provide opportunities simply to network with each other. The pandemic has encouraged our affinity group to expand our vision and do a better job of reaching out to some of our firm’s smaller offices that may not have the numbers of Asian Americans that are working, for example, in our Bay Area locations.
5. **How do you keep up to date with changes in tax law and new types of business transactions in the digital era?**

For changes in tax law, I regularly read Tax Notes, Bloomberg, and so on. I’m also involved in the ABA, IFA (the International Fiscal Association) and other organizations, which is a great way to get to know other tax lawyers and keep abreast of changes in tax law. Cryptocurrency and digital assets have really taken the technology sector by storm, and there’s very little guidance on how traditional tax principles apply to this burgeoning area. What I find most helpful is to have a really strong grasp of what the technology is and how the business works, because tax law is rooted in fundamentals. I’ve been known to call up a corporate colleague or two (especially a more technologically-savvy one!) and demand that they explain what exactly is going on.

6. **What do you think is one key area of our federal tax system that could/should be improved and why?**

Resources. The Internal Revenue Code is so complicated, and there are so many thorny tax issues that taxpayers confront every day, yet the IRS barely has the resources to process returns, much less audit complicated tax issues. We either need a much simpler Internal Revenue Code or the IRS needs the resources to manage the complexity for our current Code. Tax-free spinoffs are a great example—the IRS announced over four years ago that it was studying whether an active trade or business necessarily required the collection of income, asked for information, and indicated that it was considering issuing guidance. But now, four years later, we don't have formal guidance. The IRS has indicated that it would consider hypotheticals on a case-by-case basis through the ruling process, but for small companies, the cost, complexity and time involved in pursuing a ruling can equal or outweigh any current tax benefit.

7. **What advice do you have for students preparing for a career in tax?**

Learn about all the different areas of tax, both in terms of the substance but also how to practice. For example, transactional tax (mergers and acquisitions, capital markets transactions and so on) is fast-paced and exciting, but it also requires juggling a lot of moving pieces in a small amount of time. You’re also expected to be a generalist; you know enough to issue-spot, but not enough to thoroughly analyze 90% of the issues. Structuring, on the other hand, allows you to dive deeper into issues with a bit less time pressure. Think about how you like to work and what makes sense for your personality.

8. **As a follow-up on your advice to students, I’ve run across several people in the Masters in Taxation program who wonder whether they should also consider**
attending law school. How would you compare a tax career path in law to one in public accounting or as a tax accountant in private industry?

I didn’t enter tax law via accounting, but overall, I think tax law deals with tax issues more conceptually, while an accounting track is obviously more numbers oriented. For example, if someone really finds satisfaction in getting a numerical answer to a tax question, an accounting career might be a better option. Also, my overall perception is that a career in accounting might provide greater flexibility in terms of finding a practice or situation that best fits your personality and work-life goals. A career in Biglaw means you are “on” almost all the time.

9. If you could have dinner with anyone (living or not), who would it be?

Ruth Bader Ginsburg. I’d like to hear what she thinks about the SCOTUS opinion leak and the direction of the Court.

10. What is the most unusual item in your office or something in it that has special meaning to you?

These days I’m working out of my closet, which I highly recommend because there are two doors between me and the rest of the house. I have a plush farfalle named Bo, which was a stocking stuffer from my husband and reminds me of my middle son Matthew, whose most favorite food in the world is bowtie pasta, fried in olive oil and drenched in grated Parmesan. In my regular office, I have a giant plush cow that has been passed around from one Asian American attorney in our firm to the next, eventually passed on to me by Nathan Cao, who is now Corporate Counsel at Instacart. I fittingly named it Nathan Cow.
When Does a Trade or Business Begin?

By: Jakub Hench, MST Student

_Estate of Charles P. Morgan, et ux. v. Commissioner, TC Memo 2021 – 104_

_Estate of Charles P. Morgan, et ux. v. Commissioner, TC Memo 2021-104_, affirmed the position of the IRS that a former real estate developer and his wife were not entitled to Schedule C deductions of $819,956, Schedule E deductions of $648,118, and a Net Operating Loss (NOL) deduction of $966,121 for the 2012 tax year because the taxpayers were not engaged in an active trade or business.

Who are these mysterious taxpayers?

The taxpayers involved in claiming and deducting these Schedule C, Schedule E, and NOL deductions were Charles P. Morgan and his wife, Roxanna L. Morgan. However, it was Charles P. Morgan who engaged in the particular activities leading to the claimed deductions. Roxanna L. Morgan was appointed to be the personal representative of Charles P. Morgan’s estate after his death in April 2019.

Mr. Morgan was a successful, well-educated, and experienced real estate developer who earned an MBA in 1969 and worked at different real estate firms until 1983, when he founded his own home building company. This company came to consist of various firms, referred to here as the Morgan Entities, that he owned directly or indirectly while being involved in their operations and management. Mr. Morgan ran the Morgan Entities until 2009, when he was ordered by the Indiana Superior Court to relinquish control, owing to default and unpaid debts of $75 million due to the decline of the real estate and financial markets. LS Associates, LLC was appointed as the receiver for the Morgan Entities to manage and liquidate the assets of the Morgan Entities, which was completed in 2013.

After handing over control of the Morgan Entities to the receivership of LS Associates, LLC, in 2009, Mr. Morgan spent six months relaxing with his family. However, being determined to stay busy, Mr. Morgan personally expressed interest in “acquiring a company ... or starting another company probably in the real estate building field, but approaching it differently than I did in my first career.” Mr. Morgan thus conducted research for trades or businesses to acquire between 2010 and 2012 in various real estate fields, using two firms that he had previously created, named Legacy and Falcon. In the end, despite employing 100 percent of his research time at Legacy as “business search/forward looking” and at Falcon engaging in “consulting” services, Mr. Morgan was unable to find or acquire a new trade or business.

What are Legacy and Falcon?

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1 _Estate of Charles P. Morgan, et ux. v. Commissioner, TC Memo 2021-104_

2 _Estate of Charles P. Morgan, et ux. v. Commissioner, TC Memo 2021-104_
Legacy was a single-member LLC founded by Mr. Morgan in December 2008 and used by him in his trade/business search between 2010 and 2012. It employed many former employees from the Morgan Entities, along with outside consultants to assist Mr. Morgan in his business search. While Mr. Morgan investigated a variety of industries, he did not find a trade or business by 2012. The firm was taxed as a disregarded entity, defined as any domestic entity “disregarded as an entity separate from its owner if it has a single owner,” between 2010 and 2012.

Falcon was an aircraft management and maintenance firm founded by Mr. Morgan in 1996, and used by him between 1996 and 2009 when managing the Morgan Entities, and between 2010 and 2012 while doing his business search. Falcon was first taxed as a partnership in 2010 and 2011, but later taxed as a disregarded entity in 2012 when Mr. Morgan became the firm’s sole owner. Falcon did not provide any services or lease any aircraft to any unrelated third parties; it only provided aircraft and services to Mr. Morgan and any related parties in his business search.

Did Mr. Morgan have any other industry involvement?

Mr. Morgan also maintained indirect contact with the real estate development industry. However, his only actual involvement in the industry since the receivership of the Morgan Entities occurred when he provided a $180,000 loan in 2009 to Pyatt Builders for help in acquiring property for home development. Mr. Pyatt, the owner of Pyatt Builders, was a former employee of the Morgan Entities and a close friend of Mr. Morgan. The loan was repaid to Mr. Morgan timely and with interest in 2010.

How did Mr. Morgan file his tax return?

Mr. Morgan filed a joint Form 1040 tax return in 2012, which was prepared by his certified public accountant of over three decades, Roy Rice, and the Somerset CPAs accounting firm. Mr. Morgan filed a Schedule C with a loss of $303,302 for Falcon, incurred from gross income of $516,654 and expenses of $819,956, and he filed a Schedule E with a loss of $648,118 for Legacy, reporting $0 of gross receipts and $648,118 of expenses. Mr. Morgan also claimed a NOL deduction of $966,121, accrued from NOL carryforwards of aircraft and business-search expenses from the 2010 and 2011 tax years.

Why did the IRS believe that Mr. Morgan was not entitled to deduct the Schedule E and Schedule C deductions or the NOL deduction?

The IRS disallowed the $819,956 Schedule C deduction for Falcon, the $648,118 Schedule E deduction for Legacy, and the $966,121 NOL deduction on the grounds that Mr. Morgan was not engaged in a trade or business. They claimed that Mr. Morgan’s business had ended in 2009 when he handed control of the Morgan Entities to LS Associates, LLC, for receivership, and that

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3 Reg. 301.7701-3(b)(1)(ii)
the expenses were either non-deductible personal expenses\textsuperscript{4} or startup expenses, which are not deductible until the taxpayer begins engaging in a trade or business.\textsuperscript{5}

**What was Mr. Morgan’s position in the case?**

In response, Mr. Morgan went to the Tax Court and laid out his case that his original business with the Morgan Entities had not ended due to his continued engagement with the homebuilding industry. These engagements include his collaboration with Legacy and Falcon in his trade/business search and his $180,000 loan to Pyatt Builders. Mr. Morgan also argued that his search for a new trade or business was itself a trade or business as it involved using Legacy and Falcon to explore various business opportunities, with Legacy hiring former Morgan Entities’ employees and outside consultants to help Mr. Morgan with his endeavor.

**What was the opinion of the Tax Court?**

The Tax Court recognized that to determine Mr. Morgan’s eligibility for the deductions on Legacy’s Schedule E, Falcon’s Schedule C, and the NOL deduction, it must first determine whether Mr. Morgan was actually engaged in a trade or business between 2010 and 2012 per IRC Sec. 162 through “an examination of the facts in each case.”\textsuperscript{6}

IRC Sec. 162 allows a “deduction [of] all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business” by identifying if (1) the taxpayer had engaged in a business or activity for profit motives, (2) there was any regular and active involvement in the business by the taxpayer, and (3) the trade or business was actually launched.

Any taxpayer to whom IRC Sec. 162 does not apply must comply with IRC Sec. 195, which defines that “no deduction shall be allowed for start-up expenditures.” Start-up expenditures are any expenses “(A) paid or incurred in connection with - (i) investigating the creation or acquisition of an active trade or business, or (ii) creating an active trade or business, or (iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and (B) which, if paid or incurred in connection with the operation of an existing active trade or business.”\textsuperscript{7} Start-up expenditures can only be deducted once a taxpayer declares an intention of whether they will engage in a trade or business, which specific trade or business they will enter, and if they are engaging in any relevant activities to that trade or business.

\textsuperscript{4} Section 262(a)

\textsuperscript{5} Section 195.

\textsuperscript{6} Commissioner \textit{v.} Groetzinger, 480 US 23 (1987).

\textsuperscript{7} Section 195(c)(1).
What was the final judgment on Mr. Morgan’s claim of continuous involvement in the homebuilding industry being a qualified trade or business?

The Tax Court concluded that Mr. Morgan’s original trade or business ceased to exist in 2009 upon the Morgan Entities being given up for receivership to LS Associates, LLC, when he laid off employees of the Morgan Entities, and no longer engaged in any homebuilding activities. If Mr. Morgan had continuously and regularly operated with the Morgan Entities, then the entities would have been classified as an ongoing trade or business. In contrast, Mr. Morgan spent six months relaxing while assessing, in his own words, his interest in engaging in another trade or business after the Morgan Entities went into receivership. Even then, Mr. Morgan was uncertain about which type of trade or business he wanted to enter and often expressed a lack of interest in continuing in the same type of business as the Morgan Entities. He wanted to look into other angles of the homebuilding industry. Hence, as Mr. Morgan did not answer the “whether” or “what” question required under IRC Sec. 195, the Tax Court determined that Mr. Morgan was not continuously engaged in his original trade or business with the Morgan Entities.

The Tax Court also identified the $180,000 loan made by Mr. Morgan to Mr. Pyatt as a one-time loan to a friend or trusted individual, and not part of a regular and continuous trade or business.

What was the final judgment on Mr. Morgan’s claim of general search for a new trade or business itself being a qualified trade or business?

The Tax Court concluded that Mr. Morgan’s general trade/business search does not qualify as a trade or business itself per IRC Sec. 162. Mr. Morgan had only incurred expenses for Legacy in researching various firms in different industries with the expectation of finding a trade or business, as is shown on the Legacy time sheets that he filed which were marked “100 percent Business Investigation/Looking Forward”. These expenses are more like startup expenditures per IRC Sec. 195, which include expenses “(A) paid or incurred in connection with - (i) investigating the creation or acquisition of an active trade or business.” As Mr. Morgan did not answer “whether” and “which” type of business he was going to enter by the end of 2012 and he did not have a profit motive with his trade/business search, Mr. Morgan did not engage in a trade or business.

The Tax Court also concluded that Falcon was not engaged in a separate trade or business in consulting, since it provided the same transportation services to Mr. Morgan and any related individuals during the new trade/business search as when Mr. Morgan operated the Morgan Entities. Falcon did not lease any of its airplanes to any unrelated third parties. Hence, Falcon

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8 Section 195(c)(1)(A)(i).
was not independent of Mr. Morgan or Legacy as it only incurred gross receipts and expenses from them and not in a separate trade or business during the trade/business search.

Conclusion

A trade or business exists after a taxpayer declares “whether” and “which” trade or business they intend to establish, they engage in relevant and regular activities for the trade or business, establish a profit motive for their trade or business, and the trade or business itself is continuous and regular. A trade or business does not legally exist when a taxpayer is simply conducting research into different trades or businesses. A trade or business only exists when taxpayers meet the necessary requirements to show that they are starting or continuing a trade or business. Hence, it is important for taxpayers to pay attention to all the facts surrounding their situation when filing tax returns in order to determine whether they are actually engaging in a trade or business and can deduct any business-related expenses.
Application of Branch Rule in Foreign Base Company Sales Income

By: Tiago Iorio, MST Student

*Whirlpool Financial Corporation v. Commissioner*, 19 F.4th 944 (6th Cir. 12/6/2021), affirmed the judgment of the Tax Court (154 T.C. 142 (2020)); rehearing en banc denied (6th Cir. 3/2/2022). The ruling was against the taxpayer and upheld that the sales revenue constituted foreign base company sales income (FBCSI) under the branch rule of Section 954(d)(2), and taxable as Subpart F income under Section 951(a). On June 30, 2022, Whirlpool asked the Supreme Court of the United States to review the Sixth Circuit’s decision.

**Introduction**

This case focused on whether the branch rule of Section 954(d)(2) applied or not to override the manufacturing exception under Treas. Reg. 1.954-3(a)(4). This paper discusses in detail how the Tax Court and the Sixth Circuit reached the conclusion that the branch rule should be applied to Whirlpool, resulting in Subpart F income.

This paper is divided into three parts. The first part summarizes Whirlpool’s structure before and after its 2009 reorganization. The second part assesses the main issues considered by the Tax Court and the Sixth Circuit. The third part concludes this paper.

**Background**

Whirlpool Financial Corp. is a Delaware corporation with its main place of business in Michigan. Through its foreign and domestic subsidiaries, Whirlpool manufactures and distributes household appliances, such as washing machines and refrigerators, in the United States and abroad.

**Whirlpool Structure before 2007**

Before 2007, Whirlpool US owned 100 percent of Whirlpool Mexico, a company created under Mexican law. Whirlpool Mexico owned 100 percent of Industrias Acros S.A. de C.V. (IAW) and Commercial Acros S.A. de C.V. (CAW), also created under Mexican law. These three companies, Whirlpool Mexico and its two subsidiaries, are considered controlled foreign corporations (CFC) for Federal income tax purposes. CAW is the administrative arm of Whirlpool Mexico. Its employees provided marketing, selling, accounting, finance, and other services to IAW and its Mexican parent. CAW is the administrative arm of Whirlpool Mexico. Its employees provided marketing, selling, accounting, finance, and other services to IAW and its Mexican parent.

IAW is the manufacturing arm of Whirlpool Mexico. It owned buildings, equipment, land and employed workers who manufactured washing machines, refrigerators, and other appliances (collectively referred as products). IAW manufactured these products in two different plants in Mexico, the Ramos plant and the Horizon plant. IAW sold these products to Whirlpool Mexico,

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1 According to the IRS, a foreign corporation is a CFC if more than 50 percent of its voting power or value is owned by U.S. Shareholders. A U.S. Shareholder of a foreign corporation is a U.S. person who owns 10 percent or more of the total voting power of that foreign corporation. [https://www.irs.gov/pub/irs-utl/FEN9433_01_03R.pdf](https://www.irs.gov/pub/irs-utl/FEN9433_01_03R.pdf).
which subsequently sold them to Whirlpool US and other unrelated distributors in Mexico. The figure below describes Whirlpool’s structure before 2007:

![Diagram showing Whirlpool’s structure before 2007]

Figure 1: “Whirlpool Structure before 2007”. Source: Tiago Iorio based on Whirlpool Financial Corporation v. Commissioner, Tax Court (154 T.C. 142 (2020))

**Whirlpool after its 2007-2008 Reorganization**


Whirlpool Luxembourg acted like a holding company\(^3\) with no employees. WOM had one part-time employee, who performed administrative tasks, such as payment of utilities, rent, and other expenses related to the Luxembourg office. For the sake of simplicity, this paper refers to WOM and Whirlpool Luxembourg collectively as Whirlpool Luxembourg.

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\(^3\) “A holding company is a parent business entity, usually a corporation or LLC, that doesn’t manufacture anything or conduct any other business operations. Its purpose, as the name implies, is to hold the controlling stock or membership interests in other companies. Some of the subsidiary companies it owns actually do manufacture, sell, or otherwise conduct business. These are called operating companies”. https://www.wolterskluwer.com/en/expert-insights/using-a-holding-company-operating-company-structure-to-help-mitigate-risk#what.
On June 2007, Whirlpool US created Whirlpool International, S.de.R.L. de C.V. (WIN), an entity organized under Mexican law and also known as the IMMEX Maquiladora\(^4\). WIN elected to be treated as a disregarded entity\(^5\) for US federal income tax purposes by making the “check the box” election. On August 2007, Whirlpool US transferred its ownership of WIN to Whirlpool Luxembourg.\(^2\)

WIN had no employees, but instead high-level employees of CAW and IAW were “seconded” to WIN. In July 2007, WIN and Whirlpool Luxembourg entered a “manufacturing assembly services agreement”\(^6\) with the Ramos plant, and in March 2008 they also entered into a similar agreement with the Horizon plant. Under this agreement, WIN would be responsible to provide services necessary to manufacture products using workers subcontracted from CAW and IAW.\(^2\)

Figure 2: “Whirlpool Structure after 2007-2008 Reorganization”.
Source: Tiago Iorio based on Whirlpool Financial Corporation v. Commissioner, Tax Court (154 T.C. 142 (2020))

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\(^4\) IMMEX Maquiladora, which is the legal entity that applied for and received an IMMEX Maquiladora approval (basically a permit) to carry out manufacturing activities (in compliance with agreed-upon requirements).

\(^5\) “A foreign disregarded entity or “DRE” exists when a Taxpayer makes an election to treat a foreign entity with a single owner as disregarded from its owner (i.e., a branch) for U.S. tax purposes. The election is commonly referred to as a “check-the-box election” and is made on Form 8832.” Thus, WIN was distinct from Whirlpool Luxembourg.

\(^6\) Contract Manufacturing constitutes the legal agreement between the principal “WIN” and the IMMEX Maquiladora that sets the economic and operating terms for the latter to provide its manufacturing services to the principal. [https://vdocuments.mx/pwc-immex-maquiladora-guide-doing-business-in-maquiladora-guide-doing-business.html](https://vdocuments.mx/pwc-immex-maquiladora-guide-doing-business-in-maquiladora-guide-doing-business.html).
During 2009, the Horizon plant produced more than 500,000 washing machines and the Ramos plant produced close to one million refrigerators. About 96 percent of the products manufactured were sold to Whirlpool US, and the other 4 percent sold to Whirlpool Mexico. From these sales, Whirlpool Luxembourg had gross receipts of more than $800 million.²

**Tax Considerations**

A. Mexico

IMMEX Maquiladoras are subject to a reduced tax rate of 17 percent, instead of the normal 30 percent income tax rate, and they would still be in compliance with transfer pricing rules provided that they follow certain requirements.⁷ WIN qualified as a Maquiladora, and therefore, paid Mexico a 17 percent tax rate (instead of 28 percent) on the income WIN earned from providing manufacturing services under the Manufacturing Assembly Services Agreement. Whirlpool Luxembourg did not have to pay taxes to Mexico for the sale of products to Whirlpool US and Whirlpool Mexico. ⁸

B. Luxembourg

The taxes in Luxembourg were even more advantageous. Even though the Luxembourg corporate tax rate was 28 percent, under certain provisions of the Mexico-Luxembourg tax treaty, all the income earned by a Luxembourg company that was attributable to a permanent establishment in Mexico was exempt from Luxembourg income tax. The Luxembourg taxing authorities provided Whirlpool Luxembourg tax rulings confirming that Whirlpool Luxembourg did have a permanent establishment in Mexico. As a result, all income earned by Whirlpool from sales of products to Whirlpool US and Whirlpool Mexico was attributable to Whirlpool Luxembourg’s permanent establishment in Mexico. Thus, Whirlpool Luxembourg did not pay income tax to Luxembourg on the income from the sale of finished products to Whirlpool Mexico and Whirlpool US. ⁸

**Discussion**

On Form 1120 for the tax year 2009, Whirlpool US stated that none of its income derived from Whirlpool Luxembourg (from the sale of products to Whirlpool Mexico and Whirlpool US) constituted Subpart F income⁹. However, on audit, the IRS had a different interpretation and considered Whirlpool Luxembourg’s sale of products to Whirlpool Mexico and Whirlpool US as approximately $50 million of Foreign Base Company Sales Income (“FBCSI”) under sections 951(a)¹⁰ and 954(d)(2). Whirlpool petitioned the Tax Court, and shortly thereafter, filed motions

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⁷ Ibid.
⁹ According to the IRS, there are three requirements under 951(a) for the applicability of the Subpart F rules to a U.S. person: the U.S. person must be a U.S. shareholder, the foreign corporation must be a CFC, and the CFC must have Subpart F income. The main categories of Subpart F income are foreign base company sales income (FBCSI), foreign base company service income, and foreign personal holding company income (FPHCI).
¹⁰ Under section 951(a) “Amounts included in gross income of United States shareholders”: “If a foreign corporation is a controlled foreign corporation at any time during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day of such year, on which such corporation is a controlled foreign corporation
for partial summary judgment arguing that Whirlpool Luxembourg’s sales should not be considered FBCSI under section 954(d)(1) because the products it sold were “substantially transformed by its Mexican branch from the raw materials it had purchased”. 11 Respondent did not agree with that motion, contending if Whirlpool Luxembourg actually manufactured the products. 2

Tax Court

The Tax Court started its review of the rule for FBCSI, which is defined in Section 954(d)(1)12, and applied that in the context of Whirlpool’s structure after its 2007-2008 reorganization. Whirlpool Luxembourg was created under the laws of Luxembourg, and all of its products sold were manufactured in Mexico and sold for use in the United States or Mexico. Since the products were manufactured and sold for use outside Luxembourg, the conditions stated under Section 954(d)(1) subparagraphs (A) and (B) were met. Thus, Section 954(d)(1) applies if the income derived by a CFC are in connection with any of the four categories of property transactions listed under this section. The Tax Court determined that the third fact pattern “the purchase of personal property from any person and its sale to a related person” applied because Whirlpool Luxembourg purchased raw materials from suppliers and made sales to “related person[s]”, namely Whirlpool US and Whirlpool Mexico. 2

However, Whirlpool contended that the products it sold were not the same as the raw materials it had purchased. Rather, the raw materials were converted into washing machines and refrigerators during the manufacturing process. In other words, Whirlpool argued that it qualified for the “CFC manufacturing exception” per Treas. Reg. 1.954-3(a)(4)13 and thus the income should not be considered FBCSI. 2

shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends his pro rata share (determined under paragraph (2)) of the corporation’s subpart F income for such year”. Additionally, “the term “United States shareholder” means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation”. https://www.law.cornell.edu/uscode/text/26/951.


12 Section 954(d)(1) applies to income derived by a CFC in connection with four categories of property transactions: (i) “the purchase of personal property from a related person and its sale to any person,” (ii) “the sale of personal property to any person on behalf of a related person,” (iii) “the purchase of personal property from any person and its sale to a related person,” and (iv) “the purchase of personal property from any person on behalf of a related person.” Commissions, fees, or other profits derived by a CFC from such transactions constitute FBCSI if: (A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, or constructed outside the country under the laws of which the *** [CFC] is created or organized, and (B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country”. https://www.law.cornell.edu/cfr/text/26/1.954-3.

13 According to the IRS LB&I International Concept Unit, “when Congress enacted the FBCSI rules, it was focused on “income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation” (S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 CB 703, 790). As such, Treas. Reg. 1.954-3(a)(4) provides that FBCSI does not include income in connection with the purchase or sale of property manufactured, produced, or constructed by the CFC itself (“CFC manufacturing exception”). A CFC is generally
The Tax court questioned whether Whirlpool Luxembourg carried its activities in Mexico “through a branch or similar establishment”. Even though Whirlpool Luxembourg did not have employees in Mexico, it owned assets and had a manufacturing assembly services agreement in Mexico. Whirlpool Luxembourg even received from the Luxembourg tax authorities a ruling stating that it had a “permanent establishment” in Mexico. The Tax Court concluded that Whirlpool Luxembourg carried on transactions in Mexico “through a branch or similar establishment”, thus subject to Section 954(d)(2)\(^{14}\), also known as the “branch rule”. This rule would override the manufacturing exception, causing Whirlpool US to have FBCSI included as Subpart F income\(^{15}\).

**Appeal to Sixth Circuit**

The taxpayer, Whirlpool, appealed to the Sixth Circuit. The majority opinion considered exclusively the two preconditions for the application of the “branch rule” from Section 954(d)(2). The first condition is that the CFC must “carry on activities through a branch or similar establishment” outside its country of incorporation. The majority ruled that this condition was met because Whirlpool Luxembourg operated through Whirlpool International and Whirlpool International’s operations were carried outside of Luxembourg. The second condition specifies that the branch establishment must have “substantially the same effect” as if such branch were a “wholly owned subsidiary” of the CFC deriving such income. The majority also ruled that this

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\(^{14}\) According to the IRS LB&I International Concept Unit, “the FBCSI rules are intended to prevent a US shareholder from using a CFC to shift sales income from the US or a high-tax foreign country to a low-tax foreign country. The branch rules prevent a US shareholder from using a branch, in lieu of a separate CFC, to shift sales income from a high-tax foreign country to a low-tax foreign country. The branch rules prevent a US shareholder from using a branch, in lieu of a separate CFC, to shift sales income from a high-tax foreign country to a low-tax foreign country. Absent the branch rules, a CFC and its branch would be treated as a single entity for US tax purposes. However, when a CFC carries on selling, purchasing or manufacturing activities by or through a branch outside its country of incorporation and the use of the branch has substantially the same tax effect (SSTE) as if the branch were a separate CFC, the branch and the remainder of the CFC will be treated as separate corporations in determining whether the CFC has FBCSI from the sale of property. Purchases or sales will be treated as made on behalf of the remainder of the CFC (in the case of purchases or sales made by or through a branch), or on behalf of the branch (in the case of manufacturing activities performed by or through a branch), which generally results in FBCSI to the CFC. Three key factors are relevant with respect to the CFC in determining whether to apply the branch rules for FBCSI: whether the CFC has a branch or similar establishment outside its country of incorporation; whether the CFC derives sales income from products purchased, sold or manufactured by or through that branch or similar establishment; or whether there is TRD when the actual ERT (in the sales jurisdiction) is compared to the hypothetical ERT (in the manufacturing or CFC remainder jurisdiction)”.


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\(^{15}\) According to the IRS LB&I International Concept Unit, “under Subpart F, certain types of income earned by a CFC are taxable to the CFC’s U.S. shareholders in the year earned even if the CFC does not distribute the income to its shareholders in that year. Subpart F operates by treating the shareholders as if they had actually received the income from the CFC. There are many categories of Subpart F income. In general, it consists of movable income. For example, a major category of Subpart F income is Foreign Base Company Income (FBCI), as defined under I.R.C. § 954(a), which includes foreign personal holding company income, or FPHCI, which consists of investment income such as dividends, interest, rents and royalties. Other forms of FBCI includes income received by a CFC from the purchase or sale of personal property involving a related person (i.e., foreign base company sales income, or FBCSI) and from the performance of services by or on behalf of a related person (i.e., foreign base company services income, or FBC Services Income)”.

https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF.
condition was met because Whirlpool Luxembourg carried its activities through Whirlpool International, substantially deferring its tax until the repatriation of such income. Therefore, the Sixth Circuit held that because the two conditions of Section 954(d)(2) were satisfied, the income “shall constitute foreign base company sales income,” and be included as Subpart F income.\footnote{Whirlpool Financial Corporation v. Commissioner, 19 F.4th 944 (6th Cir. 12/6/2021).}

**Conclusion**

Whirlpool US relied on the “CFC manufacturing exception” per Treas. Reg. 1.954-3(a)(4) in structuring its Mexican activities to qualify for the IMMEX Maquiladora program without creating FBCSI. In this case, the court decided against Whirlpool solely based on Section 954(d)(2), without consulting the regulations. On June 30, 2022, Whirlpool asked the Supreme Court of the United States to review the Sixth Circuit’s decision, arguing that the Sixth Circuit’s decision on FBCSI solely relied on the statute, and not regulations.
Applying the Reasonableness Test to Executive Compensation

By: Dale Loepp, CPA, MST Student

Clary Hood, Inc. v. Commissioner, T.C. Memo 2022-15

In this era of comparatively low marginal tax rates, executive compensation in its myriad of forms has skyrocketed to levels previously unimaginable.¹ In such an environment it is sometimes easy to overlook that there are limitations on what constitutes a reasonable compensation deduction under Internal Revenue Code Section 162(a)(1). In Clary Hood, Inc. v. Commissioner, the Tax Court found that the CEO’s compensation indeed exceeded a reasonable amount, limiting the corporation’s deduction for Mr. Hood’s compensation for the years 2015 and 2016.

Case summary

In 1980, Clary Hood and his wife founded Clary Hood, Inc., a subchapter C corporation in the land grading and excavation contracting business. Mr. and Mrs. Hood were the sole shareholders and board members, and Mr. Hood served as the CEO. In light of the company’s striking success, the Hoods concluded in 2014 that Mr. Hood had been significantly undercompensated in his role as CEO during prior years. To rectify this perceived inequity, Mr. Hood and his wife set Mr. Hood’s forthcoming salary in 2015 at $168,559 and 2016 salary at $196,500 and his 2015 and 2016 bonus at $5 million. Other than Mr. Hood, no other executive at Clary Hood, Inc. had ever been compensated in excess of $234,000 and none had ever received a bonus greater than $100,000, and for the years in question, the amounts paid to Mr. Hood represented almost 90 percent of all compensation paid to all officers of the corporation.

The Tax Court held that the Clary Hood Inc.’s compensation deduction for Mr. Hood was limited to $3,681,269 and $1,362,831 for the 2015 and 2016 tax years respectively, due to the fact that Clary Hood, Inc. could not adequately establish any rationale for its calculation of Mr. Hood’s salary and bonus.

The IRS issued a notice of deficiency, claiming that the compensation for 2015 and 2016 exceeded reasonable compensation as set out in Internal Revenue Code §162(a)(1). Total tax deficiencies amounted to $1,581,202 and $1,613,308 for 2015 and 2016 tax years respectively. Clary Hood, Inc. was also held liable for an accuracy-related penalty in the

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¹ See for example, Lawrence Mishel and Jory Kandra, “CEO Pay Has Skyrocketed 1,322% since 1978,” Economic Policy Institute: August 10, 2021, https://www.epi.org/publication/ceo-pay-in-2020/. Mishel and Kandra observe that “using the realized compensation measure, compensation of the top CEOs increased 1,322.2% from 1978 to 2020 (adjusting for inflation). Top CEO compensation grew roughly 60% faster than stock market growth during this period and far eclipsed the slow 18.0% growth in a typical worker’s annual compensation…. (T) he CEO to worker compensation ratio was 65-to-1 in 1965…. In 2020 the ratio was 351-to-1.”
amount of $322,662 for 2016 since the corporation could provide no evidence that it had relied on the advice of competent professionals related to the compensation question for the 2016 tax year.

Tax issue addressed in this case

The primary issue addressed in this case is whether Mr. Hood’s compensation met the test of reasonableness as set out in Code Section 162(a)(1) and relevant Treasury regulations, particularly Reg. 1.162-7, which requires that payment only be for actual services rendered and “only such amount as would normally be paid for like services by like enterprises under like circumstances” [(§1.162-7(b)(3)]. Although the corporation is free to pay its employees any amount it chooses, compensation in excess of a reasonable amount set by the Code cannot be deducted as an ordinary and necessary business expense for tax purposes, and any excess compensation would then be taxed as a dividend to Mr. Hood [§1.162-7(b)(1)].

Background

Since its founding, Clary Hood, Inc. had continually struggled with irregular revenue and net income. The Great Recession of 2008 significantly compounded these financial issues, forcing Clary Hood, Inc. to seek a more reliable source of work and cash flow at a time when many of his competitors were going out of business. Eventually the corporation turned to bidding on grading contracts with Walmart, with such contracts over time comprising 20 percent of its annual revenue. After experiencing constant downward pricing pressure and other frustrations with Walmart, in 2011 Mr. Hood decided (without input from other company executives) to discontinue bidding on Walmart contracts and to significantly diversify the corporation’s customer base. This decision proved to be remarkably successful, and over the course of the next five years, the corporation’s revenue grew by 342 percent. This increase in revenue reversed the corporation’s net loss of $120,530 in 2011 to a net income of $14,537,867 in 2016.

Although the Hoods had periodically sought input from their accountants regarding Mr. Hood’s salary and bonuses, they admittedly did not rely on any particular formula or industry comparisons to compute these amounts. Also, there were no pre-existing compensation agreements tying Mr. Hood’s pay to corporate profitability. During the less profitable period from 2000-2011, Mr. Hood’s salary varied, but averaged $87,472, with a bonus averaging $213,726 for the equivalent period. Thus, the $168,559 salary plus $5 million bonus set by the Hoods for 2015 and $196,500 salary plus $5 million bonus for 2016 represented a dramatic increase—though an increase that the Hoods claimed to be justifiable considering the corporation’s profitability and via their discussions with internal accounting staff and external tax accountants. According to the Board of Director’s minutes, the rationale behind the salary and bonus increases rested largely on Mr. Hood’s performance at the company since 2011 and in large part was considered a correction of under-compensation in prior years.
Findings of the court

Generally speaking, determining whether compensation is reasonable as to amount depends on a consideration of all the facts and circumstances in any given situation;\(^2\) compensating an employee for work done in a prior year is not in and of itself unreasonable.\(^3\) However, closely-held corporations are under particular scrutiny via Treasury regulations and the courts\(^4\) in discerning whether an “ostensible salary” is in actuality a disguised dividend that is “in excess of those ordinarily paid for similar services” [§1.162-7(b)(1)].

To evaluate reasonableness, the U.S. Court of Appeals for the Fourth Circuit, to which an appeal in this case would be referred, has a history of using what is known as the multifactor approach to determine reasonable compensation. As the term implies, the multifactor approach looks at a range of indicators to consider reasonableness; no one factor is decisive and the totality of the evidence must be weighed.\(^5\)

In contrast, other courts have at times considered what is known as the independent investor test, wherein the corporation determines what an independent investor would be willing to compensate an employee based on the employee’s performance and the resulting return on investment.\(^6\) However, courts in the Fourth Circuit have not entertained such a test, relying instead, as noted, on the multifactor approach.

In this particular case, Clary Hood, Inc. attempted (unsuccessfully) to apply the independent investor test and partially lost their case. The corporation argued that Mr. Hood’s fifty years of experience in the industry, his great reputation in the industry, and the impeccable timing of his decision to diversify the customer base made his work so extraordinary and uniquely valuable to Clary Hood, Inc. that Mr. Hood’s compensation could not be accurately gauged against any industry comparisons. The corporation also argued that Mr. Hood should be compensated for guaranteeing the debt and surety bonds of the corporation, a practice which the court found customary under similar circumstances.

In applying the multifactor test to arrive at an amount deemed to be reasonable compensation, the court considered Mr. Hood’s background, his experience and qualifications and any unique services provided to the corporation; his position, the importance of the duties performed and number of hours worked; the size and complexity of the business; the proportion of compensation to net income of the corporation; past history of dividends; comparable compensation for comparable businesses; and the shareholder-employee’s salary history, especially when compared to non-shareholders’ salaries.

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\(^2\) See for example, Vernon E. Martens, T.C. Memo. 1990-42.
\(^3\) See Lucas v. Ox Fibre Brush Co. 8 FTR 10901 and Pacific Grains v. Commissioner 22 AFTR 2d 5413 (8/16/68).
\(^4\) For examples, see Richland Medical Association v. Commissioner TC Memo 1990-660 and Estate of Wallace 95 TC 525.
\(^5\) Again see Vernon E. Martens, T.C. Memo. 1990-42.
\(^6\) For an example of this principle as applied by the U.S. Court of Appeals, Ninth Circuit, see Elliotts, Inc. v. Commissioner, 52 AFTR 2d 83-5976.
Of these factors, the court found comparable industry compensation, the corporation’s regular methods of setting compensation, and the corporation’s dividend history to be the most compelling. While the court recognized the invaluable and pivotal contribution that Mr. Hood made to the company, the corporation ultimately could not identify any drastic change in Mr. Hood’s duties to the corporation that would justify an abrupt 207 percent increase in his compensation, especially given that the amount far exceeded pay for comparable work in the industry. Salaries for non-shareholder employees had traditionally been set by Clary Hood, Inc. using unspecific, subjective factors such as the employee’s ability to get along with people and the amount of pride taken in an employee’s work. As a general practice, compensation levels at Clary Hood Inc. had no clear ties to corporate profitability.

Even though the corporation had more than sufficient cash on hand to pay a dividend, the court observed that Mr. Hood, as the controlling shareholder, chose to receive company profits in the form of increased salary and bonuses. Quoting from Mulcahy, Pauritsch, Salvador & Co., LTD v. Commissioner, the court observed that, “when a person provides both capital and services to an enterprise over an extended period, it is most reasonable to suppose that a reasonable return is being provided for both aspects of the investment, and that a characterization of all fruits of the enterprise as salary is not a true representation of what is happening.” The court found that at least some portion of Mr. Hood’s compensation consisted of a return on capital rather than a payment for services and computed those amounts on behalf of the taxpayer, resulting in a multi-million dollar tax and penalty assessment for Clary Hood, Inc.

**Reasonable compensation deduction allowed by the court**

While the tax court disallowed $2,029,836 of Clary Hood, Inc.’s compensation deduction for 2015 and $4,511,754 of the deduction for 2016, the amounts that were ultimately deemed deductible by the court were substantially higher than the original deduction amounts set forth by the IRS, as shown below:

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claimed on return</td>
<td>$5,711,105</td>
<td>$5,874,585</td>
</tr>
<tr>
<td>IRS allowed</td>
<td>$517,964</td>
<td>$700,792</td>
</tr>
<tr>
<td>Tax Court allowed</td>
<td>$3,681,269</td>
<td>$1,362,831</td>
</tr>
</tbody>
</table>

To set an amount for reasonable compensation in its ruling, the court relied heavily on comparable compensation data, as is frequently the case. To this end, Clary Hood Inc.—which has the burden of proof to support any tax deduction greater than that determined by the Commissioner—provided expert testimony from two sources. The first was the testimony of Mr. Samuel Kursh, who relied on a report co-authored by Mr. Kursh and Dr. Brett Margolin, both of BLDS, LLC, an economic consulting firm. To the detriment of Clary Hood, Inc.’s case, Mr. Kursh’s testimony revealed a lack of knowledge about the underlying data supporting his firm’s

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7 Mulcahy, Pauritsch, Salvador & Co., LTD v. Commissioner, 109 AFTR 2d 2012-2140 (7th Cir.).
report and the court also observed faulty underlying assumptions, including compensation comparisons with much larger corporations such as Caterpillar, Inc. Ultimately, the court gave little or no weight to Mr. Kursh’s testimony or the BLDS report.

The second expert testimony presented by Clary Hood, Inc. was that of Mr. Theodore Sharp of Korn Ferry, a management consulting firm. Like Mr. Kursh, Mr. Sharp also relied on a report prepared by his firm, and similar to the testimony provided by Mr. Kursh, Mr. Sharp displayed little knowledge about the data underlying the report. And as was the case with the BLDS report, the court similarly found that the assumptions behind the report were unsound. Therefore, the court also gave little or no weight to Mr. Sharp’s testimony or the Korn Ferry report.

In response, the IRS presented expert testimony by Mr. David Fuller of the Firm Value, Inc., a company which routinely renders advice on executive compensation. Mr. Fuller presented two opinions of a reasonable salary for Mr. Hood. The “primary” opinion concluded that reasonable compensation for Mr. Hood was $3,681,269 for 2015 and $1,314,500 for 2016. The alternative opinion, which used different assumptions, presented substantially lower amounts for reasonable compensation: $2,202,063 for 2015 and $1,314,500 for 2016. Of three reports, the court found Mr. Fuller’s testimony and report to be “the most credible and complete source of data, analysis and conclusions” and granted Clary Hood, Inc. a deduction based on Mr. Fuller’s primary opinion, which was the higher of the two.

Penalties

As noted, the court waived substantial underpayment penalties for 2015 but not for 2016, finding that the taxpayer acted with reasonable cause and in good faith regarding the 2015 return. During that year, Clary Hood, Inc. had sought advice on Mr. Hood’s compensation from its outside accounting firm, Elliot Davis, including having had discussions with an audit partner who was head of the firm’s construction practice and with a tax partner having over twenty years of experience as a CPA and who had guided at least twenty other clients on similar compensation issues. The court determined that Clary Hood, Inc. provided necessary and accurate information about Mr. Hood’s compensation to its outside accountants and found that the accountants carried out a reasonably critical analysis of the data provided. The court ruled that Clary Hood, Inc. relied in good faith on the judgment of their independent accounting advisors.

In contrast with 2015, Clary Hood, Inc. could provide no evidence of similar consultations for the 2016 tax year, other than preparation of an updated compensation spreadsheet by Clary Hood, Inc. personnel. Alternatively, Clary Hood, Inc. argued for exemption from penalty by claiming substantial authority for their position, citing the aforementioned independent investor approach supported by two decisions in the U.S. Court of Appeals for the Seventh Circuit. However, the tax court noted that only the Seventh Circuit has rejected the multi-factor
approach and that this case, if appealed, would go to the U.S. Court of Appeals for the Fourth Circuit. Thus, the tax court upheld the IRS’s substantial underpayment penalty for 2016.

**Conclusion**

This case demonstrates that while there may be a great deal of leeway in what is considered reasonable executive compensation under Treasury regulations, there are also limits. In *Clary Hood, Inc. v. Commissioner*, the tax court stressed having sound, well-documented support for drastic increases in executive compensation. Compensation needs to be factually supported by comparables that are truly comparable, and these computations should be subject to ongoing review by advisors who are knowledgeable about both compensation issues as well as the taxpayer’s particular circumstances.
Credit for Caring Act of 2021

H.R. 3321 (117th Congress)

By: Dale Loepp, CPA, Tam Nguyen, and MST Students in BUS 223A Tax Research, Spring 2022

On May 18, 2021, Congresswoman Linda Sánchez (D-CA) introduced the Credit for Caring Act of 2021 (H.R. 3321, 117th Congress), to create a nonrefundable credit to eligible caregivers (Section 25E, Working Family Caregivers). This credit is equal to 30 percent of qualified expenses incurred by the eligible caregiver that exceeds $2,000. The credit shall not exceed $5,000 and will be adjusted for inflation for tax years after 2021. Caregiving is a selfless duty people provide for others and this credit is meant to assist especially during a difficult time the COVID-19 pandemic created. Per sponsor Congresswoman Sánchez: “Especially during this pandemic, caregivers have been asked to juggle working from home and caring for a loved one, all while managing the financial responsibility associated with caregiving. The Credit for Caring Act will help alleviate some of that burden by providing a tax credit for services such as home care and adult day care.”¹

In the bill, an eligible caregiver must meet two requirements.

1. Pay or incur qualified expenses during the taxable year to provide care for a qualified care recipient.

2. Have earned income (as defined) in the same taxable year in excess of $7,500.

A qualified care recipient must either be the spouse of the eligible caregiver or a family member as defined by Section 152(d)(2). Prior to claiming this credit, the recipient must be certified by a licensed health care practitioner as someone needing long term care for at least 180 consecutive days in the tax year.

The following section analyzes H.R. 3321, Credit for Caring Act of 2021, using the twelve principles set out in the AICPA’s Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.²

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### Application of the Principles of Good Tax Policy

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Does the proposal satisfy the criteria? (explain)</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity and Fairness</strong> –</td>
<td>Vertical Equity: Vertical equity is satisfied when taxpayers with higher income pay more tax than taxpayers with lower income. H.R. 3321 contains a phase-out provision that prevents high-income taxpayers from claiming the credit (proposed Section 25E(f)). The credit will phase out if modified adjusted gross income (MAGI) on a joint return exceeds $150,000, or $75,000 on non-joint returns. Such a phase-out rule promotes vertical equity. This means that high-income taxpayers are ineligible for this credit, which means high-income taxpayers pay more taxes. This proposal meets the principle of vertical equity. Horizontal equity: Taxpayers with similar abilities to pay should pay the same amount of tax. The horizontal equity principle is met since taxpayers at the same level of income are limited to a credit of $5,000. This limit prevents taxpayers in higher tax brackets from taking larger tax breaks than taxpayers from lower tax brackets, as this is a proportional tax.</td>
<td>+</td>
</tr>
<tr>
<td>Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer’s income for different income levels of taxpayers.</td>
<td>H.R. 3321 does not meet the principle of certainty. There is a possibility that certain expenses would qualify for a credit under this bill while simultaneously qualifying for a credit under the Child and Dependent Care Credit in terms of human assistance. At that point the taxpayer must determine which expenses go where which could cause some confusion. Or the taxpayer would accidently claim the expenses on both credits leading to an overstatement of credits they actually qualify for.</td>
<td>-</td>
</tr>
<tr>
<td><strong>Certainty</strong> – Does the rule clearly specify when the tax is owed and how the amount is determined? Are taxpayers likely to have confidence that they have applied the rule correctly.</td>
<td>The principle of convenience of payment is satisfied. The bill would generate a credit that eligible caregivers would receive when filing their tax return, just like any similar tax credit. Once the credit is claimed on the return, the taxpayer would instantly receive the credit to reduce the amount of taxes due on their return. However, this credit serves to provide financial relief to qualifying taxpayers, but that relief won’t be realized until the return is filed rather than monthly when it might provide greater assistance to the taxpayer.</td>
<td>+/-</td>
</tr>
<tr>
<td><strong>Convenience of payment</strong> – Does the rule result in tax being paid at a time that is convenient for the payor?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| **Effective Tax Administration** – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers? | This act creates more administrative work for both taxpayers and the government and does not meet the principle of effective tax administration. Maintaining records of qualified expenses, obtaining certification from a licensed health care practitioner to certify a qualified care recipient, completing the tax form to claim the credit, and having revenue officers review the tax return are all part of the additional compliance requirements imposed by H.R. 3321 for both the government and taxpayers. If qualified expenses reach $2,000, the proposed Section 25E provides a credit equal to 30% of such expenses; however, as previously stated, the credit is phased out. Calculation and income limitation impose additional administrative costs on the government and taxpayers, which appears to violate the policy of effective tax administration.

There will be additional work for the IRS to provide guidance, possibly a new tax form and create and pursue appropriate examination techniques. |
| **Information Security** – Will taxpayer information be protected from both unintended and improper disclosure? | This bill meets the principle of information security by not requiring personally identifiable information to be submitted. The only requirement that would need to be entered is the total amount of expenses spent on caregiving on the tax return. No information is given out to a third party to where privacy is in danger. |
| **Simplicity** - Can taxpayers understand the rule and comply with it correctly and in a cost-efficient manner? | H.R. 3321 addresses the principle of simplicity through minimally complex rules for when the tax credit is computed and allowable and when it becomes phased out. The types of qualified expenditures are clearly outlined so that those types of costs are understandable by the average taxpayer. It further provides for simplicity by requiring a minimal amount of recordkeeping by the taxpayer.

Eligible taxpayers may have other tax credits and there may be some confusion on the sequencing of them all. Also, because this is not a refundable credit and there is no carryforward for any credit unusable in the year generated, there is some complexity in how to claim it along with other credits. |
| **Neutrality** – Is the rule unlikely to change taxpayer behavior? | H.R. 3321 seems unlikely to either encourage or discourage people from expending necessary effort or funds to care for |
a family member. The effect on taxpayer behavior should be minimal. Therefore, this bill meets the principle of neutrality.

<p>| Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy? | H.R.3321 aims to alleviate financial strains on eligible caregivers by providing a 30% credit for qualified expenses incurred. The permitted credit will reduce the government’s tax revenue, but the greater tax benefits are unlikely to provide working family caregivers with a competitive edge, given that they are already facing substantial financial challenges because they are sacrificing work hours to provide care to their family members. The credit is likely to increase the buying power of eligible taxpayers and ease the financial strain on family caregivers, which will stimulate economic growth. This nonrefundable credit also incentivizes caregivers to work since they must have more than $7,500 of earned income to qualify. Another possibility is that companies that compete in the assistive care industry could potentially create new equipment or devices that caregivers would purchase knowing they will receive a credit to offset the cost. Considering these factors, this act would meet the principle of economic growth and efficiency. |
| Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others? | Visibility to the taxpayer may be hampered by the fact that Child and Dependent Care Credit is somewhat similar in nature (although certainly more expansive in coverage). It may be difficult to clearly publicize the fact that an additional new credit exists with some potential overlap with other credits. Therefore, this bill does not meet the principle of transparency and visibility. |
| Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low? | Because expenditure eligibility is defined quite broadly in the bill, possibilities exist for non-compliance. For example, it might be difficult for a taxpayer to determine whether a home modification is truly for the care of the qualified care recipient or whether it was undertaken for other reasons, or even multiple reasons. Similar credits now require additional due diligence on the part of tax preparers. The IRS would need to decide whether the Credit for Caring Act would require the same sort of due diligence (although credits currently covered by Section 6695(g) are refundable credits). Tax preparers may need additional guidance as to appropriate documentation for this credit. |
| Accountability to taxpayers – Will taxpayers know the | H.R. 3321 addresses the principle of accountability by having it clearly be a credit for eligible caregivers providing care to qualified care recipients. Looking after people are unable to |</p>
<table>
<thead>
<tr>
<th>purpose of the rule,  why needed and whether alternatives were considered? Can lawmakers support a rationale for the rule?</th>
<th>do so themselves is a costly endeavor. This proposal will ease the burden for taxpayers willing to assume this responsibility. For all of the currently eligible caregivers, this will enable them to do continue providing service to their loved ones.</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Appropriate government revenues</em> – Will the government be able to determine how much tax revenue will likely be collected and when?</td>
<td>This bill meets the principle of appropriate government revenues by setting a limit of up to $5,000 tax credit for 30% of expenses from long-term care expenses that surpass $2,000 in the taxable year. The amounts are clearly stated so that it would make it easier for the government to come up with a reasonable estimate of the amounts to be collected. Also, it is reasonable to assume the tax credit would be reliable for taxpayers since it is realistic to meet the criteria. The qualified expenses for the tax credit are clearly stated and provides excellent categories to distinguish the different types.</td>
</tr>
</tbody>
</table>

Based on this analysis, the Credit for Caring Act of 2021 has a positive rating for the principles of equity and fairness, convenience of payment, information security, simplicity, neutrality, economic growth and efficiency, accountability to taxpayers, and appropriate government revenues. Several key principles including certainty, effective tax administration, transparency and visibility, and minimum tax gap.

Suggestions for improvement:

1. Consider expanding the Child and Dependent Care Credit to include these proposed provisions under that credit. This would improve the ability of the proposal to meet the principle of transparency and visibility.

2. Provide more guidance on what is eligible as an expenditure that can be taken for this credit to ensure the correct expenses are considered for the credit. This will improve the ability of the proposal to meet the principle of minimum tax gap.
New Foreign Tax Credit Regulations

By: Dale Loepp, CPA, MST Student

On December 28, 2021 the U.S. Department of the Treasury released final regulations on the foreign tax credit. Even though these regulations generally followed the proposed regulations issued in 2020, important changes related to the creditability of foreign taxes, accompanied by a new attribution requirement, have significantly shifted the economic landscape for multinational U.S. corporations and individuals who pay foreign taxes.

An explanation of these regulations was presented at a one-hour webinar on February 4, 2022 by Caroline Chen, Associate Professor in San Jose State’s Lucas College and Graduate School of Business. Professor Chen provided an informative overview on both the general nature of the foreign tax credit along with many of the old and new issues at play. This seminar, which followed a quick “lunch and learn” format, was attended by a wide variety of participants, ranging from practitioners and MST students who were generally unfamiliar with the foreign tax credit, to those with a great deal of experience on the subject.

Generally speaking, the foreign tax credit under Section 901 of the Internal Revenue Code is a dollar-for-dollar credit granted for certain taxes paid to a foreign country. Professor Chen laid out the basic requirements: the tax must be truly imposed, the tax must be paid or accrued, and the tax’s character must be that of a net income tax or a type of tax that is “in lieu of an income tax.” These requirements that seem relatively simple on the surface already raise complex issues, particularly when determining whether a foreign tax, which may be structured under a system of taxation that is quite different from our own, is sufficiently similar to the U.S. system to be deemed an income tax or a tax in lieu of an income tax. To complicate matters further, the specific tests for creditability of foreign taxes as set out in the old proposed regulations have now been supplemented by a controversial new attribution test which will more closely focus on the issue of nexus between the taxpayer’s business activities and the country levying the tax. Of course, not all foreign systems of taxation have nexus requirements that are sufficiently equivalent to the U.S. system that a foreign tax credit will be allowed. For example, although the foreign law need not conform to U.S. law in all respects, the applicable foreign sourcing rules must now at least be “reasonably similar” to U.S. sourcing rules. According to Professor Chen, these new requirements actually represent a significant shift in the foreign tax environment, noting that taxes which were creditable under the proposed regulations will now likely be disallowed under the new final regulations.

Ultimately, Professor Chen also believes that the new regulations will require tax preparers and tax advisors to gain a much deeper understanding of how any relevant foreign system of taxation actually functions—a task that will require greater collaboration with other professionals such as foreign lawyers, accountants, and translators. Tax treaties will be examined in more detail and may ultimately need to be revamped to accommodate prevailing views as to what constitutes a foreign tax in lieu of an income tax.
Although the brevity of the presentation limited the depth of what could be covered during the seminar, Professor Chen demonstrated that this format can provide a very valuable update both for those who would like to learn more about aspects of international taxation and those who must continue to deal with its impact on behalf of their employers or clients. Ultimately, Professor Chen clearly demonstrated that the foreign tax credit was already a complex area of practice, and one that has now been made even more complex and uncertain by new regulations.

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November 18, 2022 at noon PT

§1031 Webinar with MST Adjunct Zach Nolan, JD, LLM
Fun Tax Facts

By: Sheetal Partani, EA, MST

Hat tax

Beginning in 1784, the British government levied a tax on men’s hats. The rationale behind the tax was that the number of hats owned would be relative to the owner’s wealth and that if you are poor, you would own fewer hats or perhaps no hat. In addition to the number of hats, wealthy people would more likely own more expensive hats.

This tax was partially funded through a mandatory retailers’ license costing £2 in London and five shillings elsewhere.1 The tax paid by the purchaser was dependent on the cost of the hat; the greater the cost of the hat, the higher the tax. Men’s hats were required to have a revenue stamp located inside the lining of the hat to demonstrate that the tax had been paid. Hefty fines could be levied for those who failed to pay the hat tax2 and the death penalty could be imposed on the owners of the hats if they used fabricated revenue stamps. This tax was repealed in 1811.

Shoe toll

In 1901 in Curaçao, The Queen Emma Bridge3 was built to connect two parts of the city of Willemstad. The government decided to charge a toll, but only for those wearing shoes at the time of crossing the bridge: two cents per person for those wearing shoes and no toll for those crossing barefoot. The idea behind the tax was to target people who owned luxury goods (shoes) and to create a progressive tax. However, this attempt to target the rich backfired. To avoid the tax, some people who owned shoes started crossing the bridge barefoot. However, the poor were at times too proud to admit that they could not afford the toll and often borrowed shoes to cross the bridge. The tax was ultimately repealed.

Other interesting tax facts

• The Rolling Stones, Rod Stewart, and David Bowie chose to go into exile rather than pay the United Kingdom 95 percent of their earnings in tax during the 1960s and 1970s.4

• In the United States, March 1 was initially the deadline for paying income taxes. In 1919 the date was moved to March 15 and in 1955 the date was moved again to the current date of April 15. The reason behind these changes was likely that the government needed more time to process the tax returns as the number of tax filers increased during this time period.

• Joseph Nunan, who was the IRS Commissioner from 1944 to 1947, was sent to prison for tax evasion in 1954. Nunan was arrested for evading over $90,000 in taxes and failing to report $1,800 of winnings from a wager that Harry Truman would win against Thomas Dewey in the 1948 presidential election.

---

Required: The amount of gross income from a contribution to and earnings from a qualified-defined contribution plan.

The following Year 1 annual report was received by Clark from the qualified-defined contribution plan provided by Clark’s employer:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>$12,700</td>
</tr>
<tr>
<td>Employer contribution</td>
<td>600</td>
</tr>
<tr>
<td>Plan earnings</td>
<td>250</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$13,500</td>
</tr>
</tbody>
</table>

What income must be included in Clark’s gross income for Year 1?

A. $0
B. $250
C. $600
D. $850

Explanation

1. **Choice “A” is correct.** Employer contributions to qualified retirement plans are not included in income until distributed. Earnings from the plan also are not taxed until distribution. Clark’s report includes an employer contribution and earnings but no distribution; therefore, there is no income inclusion for Year 1.

2. Choice “B” is incorrect. The $250 of earnings from Clark’s qualified plan will not be taxed until distributed.

3. Choice “C” is incorrect. Clark’s employer’s $600 contribution to the qualified retirement plan will not be included in income until distributed.
4. Choice “D” is incorrect. Neither the employer’s $600 contribution to, nor the $250 of earnings from, the qualified retirement plan were distributed; therefore, they are not included in income.
Study Unit 7.2  
Source: CPA 21 REG-30

Required: The amount of deductible investment interest expense.

Jefferson’s investment income consisted of $2,000 in interest from a U.S. Treasury bond and $1,000 interest from a municipal bond. Jefferson also paid $4,000 in investment interest expense. Assuming that Jefferson itemizes, what amount can Jefferson deduct for investment interest expense?

A. $1,000  
B. $2,000  
C. $3,000  
D. $4,000

Explanation

1. Choice “B” is correct. Investment interest expense is only deductible to the extent of net investment income. Taxable investment income does not include tax-exempt municipal bond interest. Because the $2,000 U.S. Treasury bond interest income is the only taxable investment income, only $2,000 of the investment interest expense may be deducted in the current year.

2. Choice “A” is incorrect. Because the interest from the municipal bond is not taxable, deduction of investment interest expense is not permitted.

3. Choice “C” is incorrect. Investment interest expense is deductible only to the extent of net investment taxable income.

4. Choice “D” is incorrect. The full $4,000 investment interest expense is not deductible.
Study Unit 12.2  
Source: CPA 21 REG-35

Required: The true statement regarding the corporations’ eligibility to file a consolidated return.

The following information relates to three corporations: Mauve, Teal, and Fuchsia.

<table>
<thead>
<tr>
<th>Stockholders</th>
<th>Mauve</th>
<th>Teal</th>
<th>Fuchsia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adams</td>
<td>10%</td>
<td>18%</td>
<td>22%</td>
</tr>
<tr>
<td>Jefferson</td>
<td>40%</td>
<td>22%</td>
<td>0%</td>
</tr>
<tr>
<td>Washington</td>
<td>50%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Brook</td>
<td>0%</td>
<td>33%</td>
<td>70%</td>
</tr>
<tr>
<td>Smith</td>
<td>0%</td>
<td>27%</td>
<td>8%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

None of the corporations has made a subchapter S election. Which of the following statements about the corporations is true?

A. All three corporations must file a consolidated return.

B. All three corporations can elect to file a consolidated return.

C. Two of the three corporations can elect to file a consolidated return.

D. None of the corporations can file a consolidated return.

Explanation

1. **Choice “D” is correct.** A single federal income tax return may be filed by two or more includible corporations that are members of an affiliated group. Includible corporations are all corporations except the following:

   1. Tax-exempt corporations
   2. S corporations
   3. FSCs (foreign sales corporations)
   4. Insurance corporations
   5. REITs (real estate investment trusts)
   6. Regulated investment companies
   7. DISCs (domestic international sales corporations)

An affiliated group includes each corporation in a chain of corporations under the following conditions:

1. The other group members must directly own stock in the corporation that represents both
a. 80% or more of total voting power and
b. 80% or more of total value outstanding.

2. A parent corporation must directly own stock as outlined in 1. above (80% voting and value) of at least one includible corporation.

Thus, since the 80% criteria has not been met, a consolidated return is not filed.

2. Choice “A” is incorrect. The three corporations are not required to file a consolidated return. In addition, none of the corporations are affiliated.

3. Choice “B” is incorrect. The three corporations do not meet the affiliated criteria to elect to file a consolidated return.

4. Choice “C” is incorrect. None of the corporations are affiliated with each other, and a consolidated return is not filed.
Study Unit 14.2
Source: CPA 20 REG-38

Required: The shareholder’s basis in the S corporation.

Mark and Mary formed MM, Inc., as an S corporation. Each contributed $50,000 in exchange for five shares of corporate stock. In addition, MM obtained a $60,000 loan from a local bank that was still outstanding at the end of the year. In MM’s first year of operation, it reported a loss of $20,000 and did not make any distributions to the shareholders. What is Mark’s basis in his MM shares at the beginning of the second year?

A. $40,000
B. $50,000
C. $70,000
D. $100,000

Explanation

1. Choice “A” is correct. If a shareholder purchases stock, the shareholder’s original basis in the stock is its cost. Third-party loans to an S corporation do not increase the shareholder’s basis until payments are made on the loan. In this case, the original basis in the stock is $50,000 for each shareholder. Each shareholder’s share of the loss is $10,000 ($20,000 × 50% ownership). Therefore, Mark’s basis in the S corporation’s shares at the beginning of the second year is $40,000 ($50,000 basis in shares – $10,000 share of loss).

2. Choice “B” is incorrect. The amount of $50,000 is the basis each shareholder contributed to the S corporation. It does not take into the account the reported loss during the first year of operations.

3. Choice “C” is incorrect. Third-party loans to an S corporation do not increase the shareholder’s basis until payments are made on the loan.

4. Choice “D” is incorrect. The amount of $100,000 is the total initial basis in the corporate stock, not just Mark’s basis. Each individual shareholder’s basis in the S corporation is the shareholder’s cost of the stock, adjusted for the shareholder’s pro rata share of the corporation’s losses.
Study Unit 16.3  
Source: CPA 21 REG-33

**Required:** The partner’s basis in assets post liquidating distribution.

A partner receives the following as part of a liquidating distribution:

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$12,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Accounts receivable (A/R)</td>
<td>0</td>
<td>4,000</td>
</tr>
<tr>
<td>Land</td>
<td>8,000</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$20,000</strong></td>
<td><strong>$19,000</strong></td>
</tr>
</tbody>
</table>

The partner’s basis in the partnership immediately prior to the distribution is $25,000. What is the partner’s basis in the A/R and the land immediately after the liquidating distribution?

A. A/R: $4,000, land: $3,000.
B. A/R: $0, land: $13,000.
C. A/R: $13,000, land: $0.
D. A/R: $0, land: $8,000.

**Explanation**

1. **Choice “B” is correct.** The basis of properties distributed by a partnership in a liquidating distribution to a partner is the adjusted basis of the partner’s interest in the partnership less any money received in the same distribution. The basis of distributed property is allocated first to inventory items and unrealized receivables up to the amount of the partnership’s adjusted basis in these items, then to other property to the extent of each distributed property’s adjusted basis to the partnership. The distributee’s basis in (noncash) property received in a distribution in liquidation is any excess of his or her AB in the partnership interest immediately before distribution over any amount of money received.

   Partner’s basis in partnership $25,000  
   Less: Cash received (12,000)  
   **Adjusted basis** $13,000  
   Less: Basis in A/R (0)  
   Basis in land $13,000

2. Choice “A” is incorrect. The partner’s basis is not the FMV of the A/R and land.
3. Choice “C” is incorrect. The basis of distributed property is allocated first to inventory items and unrealized receivables up to the amount of the partnership’s adjusted basis in these items, then to other property to the extent of each distributed property’s adjusted basis to the partnership.

4. Choice “D” is incorrect. The partner’s basis in the land is greater than $8,000.
Acknowledgement

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