



# Current Federal Tax Developments

June 5, 2023

Kaplan Financial Education



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## This Week We Look At:

Fourth Circuit does not agree with view expressed by Seventh Circuit in *Menard, Inc.* that C corporation reasonable compensation only depends on a reasonable return to investors

Eleventh Circuit holds that “hobby loss” expenses under §183 are miscellaneous itemized deductions

Elderly attorney had reasonable cause for failure to file payroll tax returns and timely pay payroll tax liabilities

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria



- *Clay Hood, Inc. v. Commissioner*, Case No. 22-1573, CA4, May 31, 2023
- IRS looks to see if amounts treated as salary for a C corporation owner is really a disguised dividend
- Opposite bias as we see for S corporations
- In this case the salary program was created to deal with future changes (likely ownership)

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria

### Company History

Hood, Inc. was founded in 1980 as a subchapter C corporation, and during the period relevant to this appeal, Clary Hood and his wife, Gail Hood, each owned 50% of the company's stock. They were also the only members of its board of directors, and Mr. Hood served as the company's CEO. From 2000 to 2010, the company averaged approximately \$21 million in revenue, earning an average of less than \$1 million each year in net income before taxes. Seeking to increase revenue, Mr. Hood decided in 2011 to pivot the company away from retail-related projects to other commercial and industrial projects, and this decision proved to be especially astute. Revenues immediately increased, and by 2015, the company's revenue had grown to \$44 million and by 2016, to \$69 million. Net income before taxes also increased, as did cash and cash equivalents. The company also grew in size during this period, from approximately 80 employees in 2011 to approximately 150 employees in 2016.

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## **Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria**

### **Company History**

The Tax Court recognized the significance of Mr. Hood's various contributions, crediting mostly him with the success of Hood, Inc.

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria

### Compensation Planning

During the company's fiscal year ending May 31, 2015, in which the company realized significant growth, Hood, Inc.'s Chief Financial Officer ("CFO") began an assessment of Mr. Hood's past compensation, and he concluded that in prior years, Mr. Hood had been undercompensated. To determine how much to compensate Mr. Hood for the 2015 fiscal year and the years thereafter, the CFO sought the advice of the company's accountants at Elliott Davis Decosimo, LLC ("Elliott Davis"). The record is not clear to what extent Mr. Hood participated in this assessment. But, as the Tax Court noted, Mr. Hood later acknowledged "that he was aware that he needed to start making necessary preparations from an 'income tax' perspective in 'getting money out of the company in anticipation of 'a changing of the guard.'" After meeting with the company's accountants, Hood, Inc.'s CFO determined that Mr. Hood had been undercompensated since 2000 and that the total amount that would both remedy that past undercompensation and recognize Mr. Hood's service for the 2015 year was \$7.1 million.

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria

### Compensation Planning

The CFO thus suggested that Hood, Inc. pay Mr. Hood a \$5 million bonus in 2015, some portion of which was to remedy past undercompensation, with the balance of the undercompensation amount to be paid in "future years." The company's accountants gave their approval to this suggestion and concluded that the CFO's proposal was "reasonable." Accordingly, at the meeting of Hood, Inc.'s board of directors, Mr. and Mrs. Hood approved paying Mr. Hood a \$5 million bonus, in addition to Mr. Hood's \$168,559 salary. The minutes of that meeting explained that the bonus was approved in recognition of Mr. Hood's "many years of sacrificial work done on the Company's behalf."

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria

### Compensation Planning

The following year, after Hood, Inc. went through the same process as it did for determining the bonus for the 2015 fiscal year, Mr. and Mrs. Hood as board members again approved a bonus to Mr. Hood of \$5 million for the 2016 fiscal year, again in addition to Mr. Hood's salary, which in 2016 was \$196,500.

Despite substantial retained earnings and cash, however, Hood, Inc. did not consider paying any dividends to its two shareholders, i.e., Mr. and Mrs. Hood. *Indeed, the company had never paid any dividends.*

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria

### IRS Challenge and Battle of the Experts

The IRS's expert, David Fuller, agreed that Mr. Hood was undercompensated for the period of 2000 to 2012 but found that Hood, Inc. had started to remedy this condition beginning with its payment of approximately \$1.4 million in total compensation to Mr. Hood in 2013. Based on survey data of compensation paid to other similarly situated executives, the specific characteristics of Hood, Inc., and Mr. Hood's contributions, Fuller concluded in his report that Mr. Hood was undercompensated in total by approximately \$2.3 million as of May 31, 2014. Taking this undercompensation amount into account, as well as interest on that amount, Fuller concluded that the total reasonable compensation amounts for Mr. Hood would be \$3,681,269 for 2015 and \$1,362,831 for 2016, and that any amounts above those figures constituted excess or "unreasonable" compensation.

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## **Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria**

### **IRS Challenge and Battle of the Experts**

Hood, Inc. submitted two expert reports, but the Tax Court afforded them “little to no weight” based on the “dubious assumptions” underlying the reports and the lack of supporting calculations.

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria

### Original Tax Court Decision

In its thorough 64-page opinion, the Tax Court accepted Fuller’s calculations and thus found that the amounts deductible as reasonable compensation to Mr. Hood for his services were \$3,681,269 for 2015 and \$1,362,831 for 2016. The court did not impose a “substantial underpayment” penalty under 26 U.S.C. §6662 for 2015, finding, pursuant to 26 U.S.C. §6664, that the company had established a reasonable-cause defense to any penalty for that year because it reasonably relied on professional tax advice in good faith. But the court found that the company had not established the same defense for 2016, and therefore it sustained the imposition of a penalty for that tax year.

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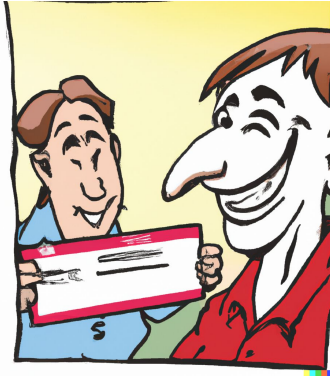
## **Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria**

### **Original Tax Court Decision**

The Tax Court entered its final decision on May 12, 2022, finding that Hood, Inc. was liable for a \$550,866 income tax deficiency for 2015 and a \$1,411,991 deficiency for 2016. It also imposed a penalty of \$282,398 for 2016.

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria



- *Clay Hood, Inc. v. Commissioner*, Case No. 22-1573, CA4, May 31, 2023
- Reasonable compensation under IRC §162(a) - payment must be for personal services actually rendered
- Regulations indicate to look at reasonableness "under all the circumstances"
- Taxpayer argued Court should use a single reasonable return test based on CA7 2009 decision in *Menard, Inc.*
- Court of Appeals rejects this view

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria

### CA4 Analysis - Consider More Than Return

While it might be reasonable to consider the Seventh Circuit's independent investor test along with other factors relevant to the totality of the circumstances, we conclude that solely using that test to establish a presumption of reasonableness, as Hood, Inc. urges, would be too narrow in light of the regulatory demand that we consider "what is reasonable under all the circumstances." 26 C.F.R. § 1.162-7(b)(3). For instance, under the independent investor test, an executive's compensation could be presumed to be reasonable even if it exceeded the amount that was genuinely compensation "for personal services actually rendered," 26 U.S.C. §162(a)(1), and that "would ordinarily be paid for like services by like enterprises under like circumstances," 26 C.F.R. § 1.162-7(b)(3). By contrast, the multifactor test allows for consideration of the numerous other relevant factors. Accordingly, we conclude that it is the appropriate test to apply and that the Tax Court did not err in applying it here.

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria



- *Clay Hood, Inc. v. Commissioner*, Case No. 22-1573, CA4, May 31, 2023
- Found Tax Court properly applied other factors
  - No dividend had ever been paid
  - No structured system for owner compensation
  - Compensation not in line with comparable executives - amount allowed was in the 99th percentile

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## Fourth Circuit - Reasonable Compensation for a C Corporation Not to Be Tested by Single Criteria



- *Clay Hood, Inc. v. Commissioner*, Case No. 22-1573, CA4, May 31, 2023
  - But found the Tax Court improperly found penalty relief only applied for one year
  - CA4 allowed relief for both years based on reliance on qualified professional advice
  - For taxpayer, seems to have put too much reliance on a single opinion that *might* have required taking statements with a grain of salt

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions



- *Gregory v. Commissioner*, Case No. 22-10707, CA11, May 30, 2023
  - Taxpayer was not challenging finding that yacht activity was covered by IRC §183 (activity not engaged in for a profit)
  - Generally under §183(b) deductions that would otherwise be allowed under §162 if there was a profit motive only allowed to the extent of gross income
  - But what type of deduction is it?

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions



- *Gregory v. Commissioner*, Case No. 22-10707, CA11, May 30, 2023
  - General rules for determining how exclusion or deduction is reported
    - IRC §61 defines gross income broadly
    - IRC §62 lists deductions allowed in arriving at adjusted gross income (“above the line”)
    - IRC §67 lists itemized deductions that aren’t miscellaneous, with all others being miscellaneous deductions subject to limitations (including now §67(g) denial)

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions



- *Gregory v. Commissioner*, Case No. 22-10707, CA11, May 30, 2023
  - IRC §183(b) doesn't explicitly state what type of deduction it is
  - CA11 notes that no Court of Appeals has previously looked at this issue

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions

### CA11 Analysis - Law Provides Unambiguous Answer (Not a Good One for Taxpayer)

The language of the relevant statutory provisions settles this question. See *Mamani v. Berzain*, 825 F.3d 1304, 1309 (11th Cir. 2016). We presume that the Internal Revenue Code “says . . . what it means and means . . . what it says.” See *Conn. Nat’l Bank v. Germain*, 503 U.S. 249, 254 (1992). We therefore begin our statutory interpretation with the words of the statutes themselves. *Harris v. Garner*, 216 F.3d 970, 972 (11th Cir. 2000) (en banc). Still, “[s]tatutory provisions are not written in isolation.” *In re Shek*, 947 F.3d 770, 776 (11th Cir. 2020). A provision’s meaning must consider both the “particular statutory language at issue” and “the language and design of the statute as a whole.” *Id.* at 777 (quoting *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291 (1988)).

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions

### CA11 Analysis - Law Provides Unambiguous Answer (Not a Good One for Taxpayer)

Three provisions of Section 183 are relevant. First, Section 183(a) prohibits all hobby loss deductions except for those allowable in Section 183(b). I.R.C. §183(a) (stating that, if an “activity engaged in by an individual or an S Corporation” is “not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section”).

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions

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Three provisions of Section 183 are relevant. First, Section 183(a) prohibits all hobby loss deductions except for those allowable in Section 183(b). I.R.C. §183(a) (stating that, if an “activity engaged in by an individual or an S Corporation” is “not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section”). Second, Section 183(b)(1) grants activities not engaged in for profit (e.g., hobbies) the same deductions “allowable under this chapter . . . without regard to whether or not such activity is engaged in for profit.” Id. §183(b)(1). Third, and this is the disputed provision, Section 183(b)(2) allows “a deduction equal to the amount of deductions . . . allowable under this chapter . . . only if such activity were engaged in for profit.” Id. §183(b)(2). But the amount of this deduction cannot exceed the difference between the hobby’s gross income and the deductions allowed under Section 183(b)(1). See id. Thus, the law caps a Section 183(b)(2) deduction at the amount of the hobby’s “gross income” minus the deductions claimed under Section 183(b)(1).[

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions

### CA11 Analysis - Law Provides Unambiguous Answer (Not a Good One for Taxpayer)

Second, Section 183(b)(1) grants activities not engaged in for profit (e.g., hobbies) the same deductions "allowable under this chapter . . . *without regard to whether or not such activity is engaged in for profit.*" Id. §183(b)(1).

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions

### CA11 Analysis - Law Provides Unambiguous Answer (Not a Good One for Taxpayer)

Third, and this is the disputed provision, Section 183(b)(2) allows “a deduction equal to the amount of deductions . . . allowable under this chapter . . . only if such activity were engaged in for profit.” Id. §183(b)(2). But the amount of this deduction cannot exceed the difference between the hobby’s gross income and the deductions allowed under Section 183(b)(1). See *id.* Thus, the law caps a Section 183(b)(2) deduction at the amount of the hobby’s “gross income” minus the deductions claimed under Section 183(b)(1).

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions

### CA11 Analysis - Law Provides Unambiguous Answer (Not a Good One for Taxpayer)

Section 183 does not expressly answer these questions. In this respect, Section 183(b)(2) resembles many other Code provisions that identify an allowable deduction but do not account for that deduction's placement above or below the line. ...

Because the text of Section 183 does not tell us how to treat the hobby loss deduction it provides, we must turn to other provisions of the Code to answer that question. See *Hagans v. Comm'r of Soc. Sec.*, 694 F.3d 287, 296 (3d Cir. 2012) ("When a statute is 'complex and contains many interrelated provisions,' it may be 'impossible to attach a plain meaning to provisions in isolation.'" (quoting *Cleary ex rel. Cleary v. Waldman*, 167 F.3d 801, 807 (3d Cir. 1999))). Those provisions are Section 62, Section 63, and Section 67. As explained below, those provisions establish that Section 183(b)(2) deductions are below-the-line and must exceed two percent of a taxpayer's adjusted gross income before they become deductible.

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions



- *Gregory v. Commissioner*, Case No. 22-10707, CA11, May 30, 2023
  - Taxpayer claims §183(b) does define -
    - They say it is a framework and the deduction is still a §162 one
    - Majority finds the reference to §162 merely serves to calculate a deduction only allowed under §183(b)

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions



- *Gregory v. Commissioner*, Case No. 22-10707, CA11, May 30, 2023
  - Alternatively, they argue that it reduces gross income (so it is netted at IRC §61)
  - Majority ground that they are confusing above the line deductions (which reduce gross income) with gross income

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions



- *Gregory v. Commissioner*, Case No. 22-10707, CA11, May 30, 2023
  - Concurring opinion arrived at same result, but in a different fashion
    - Found that since §183(b) didn't provide the answer else, had to look outside the IRC (no reason given for why extra information couldn't be in IRC)
    - Found that TCJA conference report listed §183 deductions as miscellaneous, showing Congressional intent

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## Hobby Loss Deductions Are Miscellaneous Itemized Deductions



- *Gregory v. Commissioner*, Case No. 22-10707, CA11, May 30, 2023
  - Concurring opinion arrived at same result, but in a different fashion
    - Personally don't like this logic - by this logic Sections 62 and 67 are irrelevant
    - Virtually no IRC provision granting a deduction states where to deduction it-rather relies on §§62 and 67
    - Also, the years in question predate TCJA - so why would a TCJA report be relevant?

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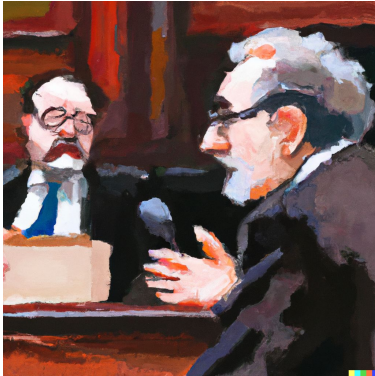
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## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports



- *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023
  - Elderly attorney was attempting to shut down his law firm
  - Had numerous problems with his own illnesses and infirmities and caring for his terminally ill spouse
  - Had another attorney handling most client work and assistant handling administrative issues, including payroll tax compliance and payment issues

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## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports

Petitioner, 92 years old at the time of this Opinion, was a sole proprietor who operated a law practice during the periods in issue and had done so for approximately 60 years. He did not timely file returns or timely pay his employment tax liabilities for the periods ending September 30, 2017, through June 30, 2019. During this time petitioner was 87 to 88 years old and was closing his solo law practice because of his declining health and advanced age.

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## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports

A Navy veteran, petitioner had long been determined disabled because of hearing loss and a back injury that had worsened with time. He was nearly deaf and had significant balance difficulties. Petitioner also suffered from joint disease in his knees and hips (which were in poor condition and needed replacing), atrial fibrillation, hypertension, and cardiopulmonary disease. As he took the steps necessary to close his law practice, petitioner's assistant of more than 25 years helped him in his daily business operations while another attorney substantially worked petitioner's cases. In addition, he relied on a part-time aide for his daily living activities, including grocery shopping, errands, laundry, cooking, and cleaning. During this time, petitioner also cared for his dying wife of 55 years.

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## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports

An attorney, petitioner had an ethical obligation to his remaining clients. He could not simply close his practice and walk away. Although petitioner's law practice continued to operate, it was not he who did the bulk of the work. Petitioner's assistant and another attorney kept the law practice operating until it closed.

Petitioner's assistant handled his bookkeeping and payroll. *Another of petitioner's assistant's duties was to communicate with petitioner's tax preparer and handle petitioner's employment taxes on petitioner's behalf.*

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## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports

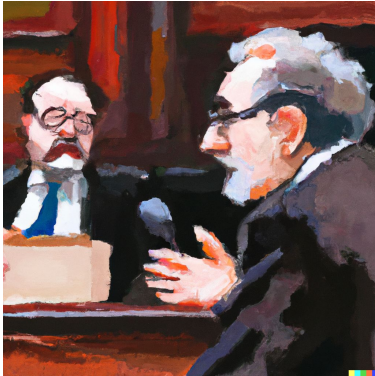
However, the assistant, privy to the law practice's declining income and fearful of losing her job, did not perform the duties assigned to her in relation to petitioner's employment taxes.

Petitioner was not aware that his assistant had shirked her duties. Upon learning of the unfiled returns and unpaid taxes, petitioner promptly filed the returns and paid the taxes. He did not pay the additions to tax but requested that the IRS abate them. The IRS granted petitioner partial abatement of section 6651(a)(2) failure to pay penalties.

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## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports



- *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023
  - Penalties under §6651(a)(1) and (2) can be waived if taxpayer can establish the failure
    - Was due to reasonable cause and
    - Not due to willful neglect
  - IRM Sections 20.1.1.3.2.2.1 (11-25-2011) applies to claims of reasonable cause due to death, serious illness, or unavoidable absence

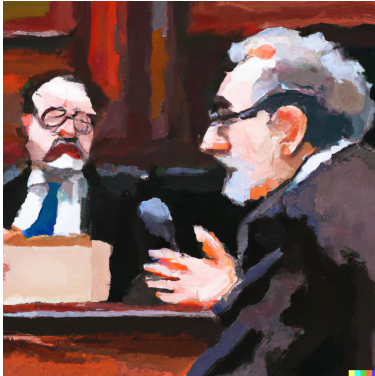
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## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports



- *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023
- IRS denied most relief. Key factors in this case that normally are seen as either not being reasonable cause or showing willful neglect were:
  - Ability to continue business as normal
  - Failure to properly supervise party put in charge of filing
  - And simply attempting to delegate filing duty

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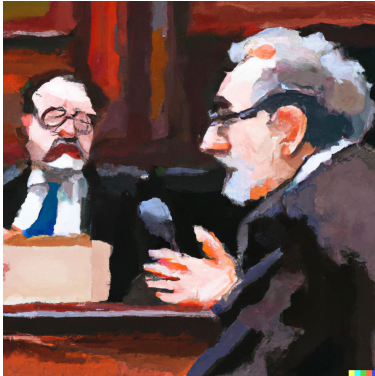
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  - Failure to properly supervise party put in charge of filing
  - And simply attempting to delegate filing duty

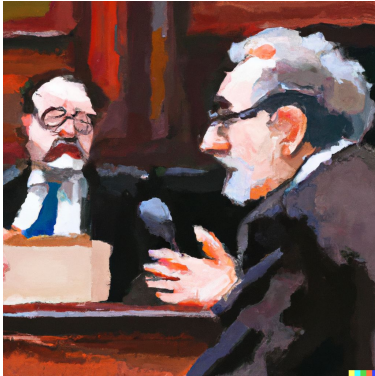
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## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports



- *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023
- Tax Court found the specific circumstances explained those issues
  - Wasn't really doing work at the business - only open due to ethical obligations
  - Used same system to handle payroll taxes as he had for 60 years
  - Did not supervise mainly due to his infirmities and challenges

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## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports

Notwithstanding petitioner's many difficulties due to his failing health and advanced age, petitioner was diligent in exercising ordinary business care and prudence. He had systems in place to ensure tax compliance. Petitioner's systems had not previously failed him in his approximately 60 years of solo law practice. It was reasonable, and not willfully neglectful, for petitioner to trust his systems' continued reliability. Further, it was not petitioner's reliance on his assistant but his inability to adequately supervise her (due to his failing health and advanced age) that caused his failure to file. Petitioner acted quickly to file the outstanding returns upon discovering he was out of compliance. Had he been able to supervise his assistant properly, petitioner would have ensured that the returns were filed.

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/court-finds-reasonable-cause-for-ailing-attorney%E2%80%99s-failure-to-pay/7gtf0>



## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports

*Given all the facts and circumstances, petitioner was diligent in exercising ordinary business care and prudence in providing for payment of his tax liabilities but was nevertheless unable to pay timely because of his poor health and advanced age. As previously discussed, petitioner had effective systems in place that failed him in his final years of law practice only because he was unable to supervise his assistant properly.*

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/court-finds-reasonable-cause-for-ailing-attorney%E2%80%99s-failure-to-pay/7gtf0>





## Reasonable Cause Found for Elderly Attorney's Late Filing and Payment of Payroll Tax Reports



- *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023
  - Don't expect this result in most cases unless your taxpayer faces the myriad of problems that faced this attorney
  - But it does remind us to argue for why the taxpayer's case is different from those that the IRS will attempt to rely upon

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