

Best Practices for Reasonableness of Executive Compensation Analysis

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The U.S. Tax Court decision in *Clary Hood, Inc. v. Commissioner* provides important practical guidance to private companies and to private company owners—and to their legal, accounting, and compensation advisers—regarding the reasonableness of executive/shareholder compensation income tax deductions. In this decision, the Tax Court provides a fulsome discussion of its application of the so-called multifactor approach to reasonableness of executive compensation analysis. This judicial decision also provides important practical guidance to forensic accountants, financial analysts, valuation analysts, and other professionals who provide testifying expert services in reasonableness of executive compensation (and in other) federal taxation disputes.

INTRODUCTION

There are many reasons why valuation analysts, damages analysts, compensation consultants, and other professional advisers may be asked to analyze—and opine on—the reasonableness of the amount of compensation paid to the employees of a private company or institution.

Assessing the reasonableness of executive/shareholder compensation is a generally accepted due diligence procedure in the development of a private company business valuation prepared for many purposes. Valuation analysts typically “normalize” the private company’s historical results of operations for amounts paid to employee/owners that are in excess of what would be considered reasonable compensation for the actual services provided to the company by the employee/owner.

Assessing the reasonableness of executive compensation (including nonshareholder executives) is important for (1) a private company owned by an employee stock ownership plan (“ESOP”) or (2) a not-for-profit organization. Excessive executive compensation payments may be considered unfair to the ESOP participants and may decrease the fair market value of the ESOP-owned sponsor company.

Not-for-profit organizations (whether in the health care, education, research, or other industries) may not pay more than a fair market level of compensation to executives or professionals.

Assessing the reasonableness of executive/shareholder compensation is an important due diligence procedure when a noncontrolling shareholder is claiming to have suffered damages as the result of the actions of the company’s board of directors or the company’s controlling shareholder. Such a damages claim may relate to either (1) shareholder oppression and breach of fiduciary duty litigation or (2) dissenting shareholder appraisal rights litigation.

And, assessing the reasonableness of executive/shareholder compensation may be particularly important in income tax disputes between the closely held company and the Internal Revenue Service. In fact, private company owners and their legal and other tax advisers often look to income-tax-related judicial decisions for guidance related to reasonableness of compensation issues. The U.S. Tax Court recently provided such judicial guidance in the matter of *Clary Hood, Inc. v. Commissioner*.

CLARY HOOD, INC. v. COMMISSIONER OF INTERNAL REVENUE

The U.S. Tax Court matter *Clary Hood, Inc. v. Commissioner of Internal Revenue* involved a dispute between the Internal

Revenue Service (“the Service”) and a private C corporation taxpayer Clary Hood, Inc. (“CHI”) regarding the reasonableness of executive compensation paid to chief executive officer/shareholder Clary R. Hood (“Hood”). The Tax Court published its decision in T.C. Memo 2022-15 (“the *Hood* decision”).

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

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

SUMMARY OF THE HOOD DECISION

Upon audit, the Service determined deficiencies in, and Section 6662 accuracy-related penalties with respect to, the CHI federal income tax returns for the tax (fiscal) years ending May 31, 2015 and 2016 (collectively, the “tax years at issue”). Exhibit 1 summarizes the conclusion of the Service’s audit of CHI for fiscal years 2015 and 2016.

Although it is only a memorandum decision, the *Hood* decision presents a detailed description of the decision-making process followed by Tax Court Judge Greaves. The *Hood* decision provides a thorough discussion of the factors that the Tax Court considered in assessing the reasonableness of executive/shareholder compensa-

the so-called multifactor approach. And, the decision explains the court’s analysis of each factor within that multifactor approach.

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

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

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

THE HOOD DECISION FINDINGS OF FACT

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

Clary Hood as the Company Founder and CEO

Judge Greaves made the following important observation in the *Hood* decision: “To understand Clary Hood, Inc., one must first know Mr. Hood.”

Before the years at issue in this tax dispute, Hood had dedicated his entire career to the construction industry, specializing in the construction industry segments of land grading and excavation. Hood learned the industry as a boy from his father, J.E. Hood. J.E. Hood operated his own land grading business. Upon graduation from high school in 1967, Hood joined his father’s company in the land grading industry segment.

In 1980, Hood founded CHI with his wife, Gail. Together they served as the CHI sole shareholders and

Exhibit 1 Clary Hood, Inc. Internal Revenue Service Audit Summary of Results		
Fiscal Year	Income Tax Deficiency Concluded	Section 6662 Substantial Understatement Penalty
2015	\$1,581,202	\$316,240
2016	\$1,613,308	\$322,662

tion for this closely held C corporation. The decision explains the legal rationale for the court’s reliance on



sole members of the company board of directors. Hood exercised ultimate decision-making control over all of the CHI operations, from the company's founding up through the tax years at issue.

CHI Business History and Operations

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

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

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

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

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

projects. Ultimately, this risky management decision would prove very beneficial for CHI.

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

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

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

Exhibit 2
Clary Hood, Inc.
Summary of Results of Operations
Fiscal Years Ending May 31, 2000 through 2016

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

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

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

The CHI Management Structure

Hood used various management titles with CHI during the review period. However, during this time period, Hood's executive duties at CHI were generally the same: (1) oversight of the company's equipment fleet (procurement, use, maintenance, and disposition); (2) hiring, training, and supervision of mechanics; (3) supervision

and inspection of jobsites; (4) preparation, review, and approval of job fee estimates and budgets; (5) submission and negotiation of job bids; (6) setting employee salaries and bonuses; and (7) acquisition of bonding for grading projects.

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

Like Hood, Wesley joined his father's construction company right after graduation from high school. After several years of operating heavy equipment for the

grading company, Wesley became more involved in the CHI management. In the 2000s, Wesley became the CHI president and CEO. However, Wesley decided to leave CHI in 2011.

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

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

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

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

The Executive/Shareholder Compensation Amounts in Dispute

There was no written employment agreement in place between Hood and the company during the review period. The CHI board of directors, which was comprised solely of Clary and Gail Hood, set the amount of Hood's annual compensation, including bonuses. Although they

Exhibit 3 Clary Hood, Inc. Compensation Paid to Mr. Clary Hood Fiscal Years Ending May 31, 2000 through 2016

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

generally solicited and accepted the advice of the CHI independent accountants, Mr. and Mrs. Hood did not use any type of formula in setting Hood's compensation amounts during the review period—except during the tax years at issue. During the review period, Hood received from CHI the amounts presented in Exhibit 3. CHI reported these amounts as employee compensation deductions on its federal income tax returns.

Based on the CHI agreement with its bonding companies, Mr. and Mrs. Hood agreed to personally guarantee any claim the bonding companies may have had against CHI during the review period for amounts beyond the company's ability to pay (surety bond guaranties). Hood also agreed to personally guarantee payment of some of the CHI business loans, credit lines, and capital leases during the review period ("debt guaranties").

In addition, CHI lent money to—and extended credit to—Hood and to some of his other business ventures

during the review period. Before the tax years at issue in the dispute, CHI never compensated Hood (or Mrs. Hood) for the debt guaranties or for the surety bond guaranties.

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

Phillips, Hood, Greenway, and Stacy Stokes, a tax partner at Elliott Davis, discussed Hood's compensation situation during a fiscal year-end business meeting in May 2015. They all agreed that (1) Hood was undercompensated during the review period and (2) he deserved a catch up bonus in the amount of \$5 million pending a follow-up compensation analyses.

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

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

The compensation due spreadsheet also incorporated data from the Greenway-provided salary surveys. Following the May 2015 meeting, Stokes provided Phillips with additional research on the topic of reason-



able executive compensation. Stokes also modified the compensation due spreadsheet. Stokes added line items below the income statements, including a "Total Equity" figure and a "Return on Equity for the Year" calculation for each year during the review period.

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

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

In support of this catch-up bonus amount, the CHI board minutes described the following prior services rendered by Hood during the review period:

1. Navigating CHI through "the loss of a president and long-time vice president in 2011"
2. Deciding "to change direction of the [c]ompany away from 'big box' grading work to more industrial grading opportunities"
3. "Dealing [with] and reacting to the most severe recession faced by the [c]ompany in 2009-2011"
4. "Personally guaranteeing most or all of the [c]ompany debt, capital leases, and credit lines since inception"
5. Acting as the "[p]ersonal guarantor to the [c]ompany's bonding company since inception"
6. "Providing a steadying influence to both customers, vendors, and, most importantly, employees"
7. "Leading the [c]ompany by being prudent in seeking job opportunities and the purchasing of

equipment necessary to handle the [c]ompany's emergent work opportunities"

8. "Personally overseeing that equipment used by Clary Hood, Inc. on job sites met or exceeded expectations in the performance of the job"
9. "Managing and leading the [c]ompany over the most profitable four year run in its existence."

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

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

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

NOTICE OF DEFICIENCY AND FILING OF THE TAX COURT PETITION

Following an audit of the CHI federal income tax returns, the Service issued a notice of deficiency for the tax years at issue. The notice of deficiency concluded that portions of Hood's compensation paid for the tax years at issue exceeded reasonable compensation amounts under

Section 162(a)(1). The Service disallowed the deduction for these alleged excess (greater than reasonable amount) compensation payments.

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

The Service's notice also included accuracy-related penalties under Section 6662 for underpayments due to the substantial understatement of income tax of \$316,240 and \$322,662 for the 2015 and the 2016 tax years, respectively.

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

THE TAX COURT'S OPINION

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

Burden of Proof

Not surprisingly, the Tax Court concluded that (1) the Service's determinations set forth in its notice of deficiency are generally presumed to be correct and (2) the

taxpayer (in this case, CHI) bears the burden of proving that the determinations are in error. Specifically, the *Hood* decision mentions *Cozart Packing Co. v. Commissioner*,¹ which applies this presumption to a reasonable compensation determination. Citing *INDOPCO, Inc. v. Commissioner*,² the *Hood* decision states the rule that the taxpayer bears the burden of proving entitlement to any deduction claimed.

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

Exhibit 4
Clary Hood, Inc.
Compensation (Other than Bonuses) Paid to Senior Executives
Fiscal Years Ending May 31, 2000 through 2016

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

REASONABLENESS OF EXECUTIVE/ SHAREHOLDER COMPENSATION TAX DEDUCTIONS

Tax Deduction Requirements under Section 162(a)

CHI, a C corporation, is subject to federal income tax on its taxable income, which is its gross income less allowable deductions. Under Section 162, a corporation may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Such expenses include a reasonable allowance for salaries or other compensation; for example, bonuses or for personal services actually rendered. Whether the compensation payments are reasonable and purely for services is a question of fact to be determined based on all the facts and circumstances of each particular case. In its discussion of the facts and circumstances criteria, the memorandum decision cited *Martens v. Commissioner*³ and *American Savings Bank v. Commissioner*.⁴

Since it was an issue in the *Hood* matter, it is noteworthy that an employer may deduct compensation paid to an employee in a year although the employee may have performed the services in a prior year. To support this proposition, the *Hood* decision cited *Lucas v. Ox Fibre Brush Co.*⁵ and *R.J. Nicoll Co. v. Commissioner*.⁶ However, the employer has to show that (1) the employee was not sufficiently compensated in the prior year and (2) the current year's compensation was in fact paid to compensate for that underpayment. To support this proposition, the *Hood* decision cited *Estate of Wallace v. Commissioner*.⁷

The *Hood* decision specifically stated:

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

In this regard, the *Hood* decision cited *Richlands Medical Association v. Commissioner*⁸ and *Estate of Wallace v. Commissioner*.⁹

The Multifactor Approach to Assessing the Reasonableness of Compensation

The Tax Court recognized that the U.S. Court of Appeals for the Fourth Circuit, the appeals court to which an appeal of the *Hood* matter would be made, requires consideration of multiple factors in determining reasonable compensation (the so-called multifactor approach). These multiple factors include the following:

Exhibit 5
Clary Hood, Inc.
Bonus Amounts Paid to Senior Executives
Fiscal Years Ending May 31, 2013 through 2016

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

the employee's qualifications; the nature, extent, and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; and the salary policy of the taxpayer as to all employees. In its discussion of this multifactor approach, the *Hood* decision cited *Richlands Medical Association v. Commissioner*.¹⁰

In the context of a private corporation with a limited number of officers, additional reasonableness of compensation factors to consider may include (1) the amount of compensation paid to the particular employee in the previous years (as considered in *Mayson Manufacturing Company v. Commissioner*¹¹) and (2) any personal guaranties of debts or other obligations of the corporation (as considered in *E.J. Harrison & Sons, Inc. v. Commissioner*¹²).

In the application of the multifactor approach, no single factor is considered to be decisive. Instead, the trial court may consider and weigh the totality of the factors and circumstances when making its decision (as in *Martens v. Commissioner*¹³). In doing so, the trial court may find certain factors less relevant or helpful than other factors when considering the factors necessary to reach a reasonableness of compensation conclusion (as in *Medina v. Commissioner*¹⁴).

The Independent Investor Test

Some federal courts have applied the so-called independent investor test to analyze the reasonableness of private company executive/shareholder compensation. Some of the judicial decisions that applied the independent investor test include (1) *Metro Leasing & Development Corporation v. Commissioner*¹⁵ (noting that the independent investor test is one of several factors that may be considered in analyzing the reasonableness of executive/

shareholder compensation); (2) *Haffner's Service Stations, Inc. v. Commissioner*¹⁶ (rejecting the independent investor test as the only test and instead applying a multifactor approach with consideration of the taxpayer company's profit and return on equity); and (3) *Exacto Spring Corp. v. Commissioner*¹⁷ (relying primarily on the independent investors test).

Under this independent investor test of reasonable executive/shareholder compensation, the court typically considers, "whether an inactive, independent investor would be willing to compensate the employee as he was compensated" (see *Elliotts, Inc. v. Commissioner*¹⁸).

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

In addition, the *Hood* decision noted that the Tax Court generally applies the multifactor approach unless a case is appealable to a Court of Appeals which has expressly applied the independent investor test. See, for example, (1) *Pepsi-Cola Bottling Co. of Salina v. Commissioner*¹⁹ (noting that it is "well settled" that the Tax Court should consider the multifactor approach in reasonable compensation cases); (2) *Beiner, Inc. v. Commissioner*²⁰ (refusing to apply the independent investor test exclusively by finding comparative industry salaries the most relevant factor in that case; and (3) *Metro Leasing & Development Corporation v. Commissioner*²¹ (concluding that it was not "appropriate to rely solely on the independent investor test to reach our findings and/or holding").

Therefore, in the *Hood* matter, the Tax Court concluded that it should apply the multifactor approach to determine the reasonableness of the CHI compensation paid to Hood (1) based on the precedent of the Tax Court and, more importantly, (2) based on the precedent of the Court of Appeals for the Fourth Circuit (see *Golsen v. Commissioner*²²).

THE TAX COURT ANALYSIS OF HOOD'S COMPENSATION

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

It is not the responsibility of either the Tax Court or the Service to substitute its business judgment for that

of the CHI board as to the setting of the appropriate amount of an employee's compensation. However, it is the responsibility of the Tax Court to examine the extent to which that compensation may be deducted from federal income tax purposes. That is because, as even CHI management recognized, limits do exist as to what may be reasonably deducted as compensation expense.

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

Hood's Background and Qualifications

An employee's superior qualifications for his or her position may justify high compensation. With over 50 years of relevant work experience, Hood had substantial knowledge and experience in both managing and performance grading and excavation work. In addition, Hood had developed an excellent reputation in his market. The court recognized that Hood's reputation allowed CHI to compete for, and win, subcontracting jobs.

The Nature, Extent, and Scope of Hood's Work

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

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

The Size and Complexity of the CHI Business Operations

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

During the review period, CHI experienced exceptional growth in terms of both employees and revenue. The CHI workforce increased from approximately 80 to 150 employees. And, the CHI annual revenue increased

from as low as \$9 million in 2003 to over \$68 million by 2016. The *Hood* decision noted, “Even if we were to assume that land excavation and grading does not require substantial scientific or technical knowledge, petitioner’s work is more complex than that of a general construction company.”

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

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

Comparison of Hood’s Compensation to the CHI Income

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

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

The Prevailing Economic Conditions

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

In the instant case, the CHI annual revenue increased from approximately \$16 million to over \$68 million during the review period. Greenway, a CPA with extensive experience in the construction industry, offered testi-

mony at the *Hood* trial that the CHI success, at least in the post-Walmart era, was due to factors other than general economic conditions.

At trial, Greenway testified that CHI was his most profitable construction client between 20013 and 2016. Even the Service’s testifying expert offered confirmation of this view. The Service’s testifying expert placed the CHI performance in the upper quartile of its industry peers for the post-Walmart era. During that time period, CHI attained its most profitable jobs through Hood’s direct involvement.

At trial, Hood testified that the CHI poorest performance years were predominantly attributable to years of national economic contractions. At trial, Hood testified that many of the CHI competitors went out of business during these economic downturns. Hood, on the other hand, took active measures as CEO to ensure the CHI survival during such economic downturn periods. Those measures included (1) selling equipment; (2) reducing employee compensation, including Hood’s own compensation; and (3) conserving financial resources.

Comparison of Hood’s Compensation with Distributions to Stockholders

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

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

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

Prevailing Compensation Rates for Comparable Positions at Comparable Concerns

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

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

The Samuel Kursh Expert Testimony

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

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

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

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

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

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

The Theodore Sharp Expert Testimony

At trial, CHI also offered the expert testimony of Theodore Sharp, a senior partner at the management

consulting firm Korn Ferry. Sharp is a member of the Korn Ferry Executive Pay and Governance group and specializes in compensation-relation issues, including executive compensation benchmarking. At trial, Sharp testified that he reviewed and agreed with his written expert report ("the Korn Ferry report"), but Sharp acknowledged that he had not written it.

The Korn Ferry report consisted of approximately one dozen PowerPoint slides in bullet-point format.

The Tax Court had the following observation regarding this expert's work: "As with the BLDS report, supporting calculations used to reach key findings and conclusions were conspicuously absent from the report and underlying data sources were not adequately disclosed."

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

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

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

The David Fuller Expert Testimony

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

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

The Fuller report placed CHI in annual quartiles in a given year based on the company's performance against the RMA data. Then, the Fuller report examined

officer compensation as a percentage of revenue within the respective annual performance quartile. As part of his analysis, Fuller observed compensation data for executive/shareholders in the construction industry from the survey service PAS. And, Fuller also applied the multifactor approach.

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

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

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

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

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

Accordingly, the Tax Court concluded, "Therefore, while such benchmark data may not be as statistically exacting as petitioner would like, petitioner did not provide satisfactory countervailing evidence through its expert witness that would credibly support a greater allowable amount. In this absence, we are left looking

to Mr. Fuller's report as the most credible and complete source of data, analyses, and conclusions in the record regarding what similar companies might be willing to pay Mr. Hood on petitioner's facts."

DID HOOD PROVIDE EXTRAORDINARY OR UNIQUE SERVICES?

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

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

THE CHI SALARY POLICY AS TO ALL OTHER EMPLOYEES

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

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

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

CHI had no agreement in place with Hood regarding his compensation. Instead, Hood's compensation during the review period was set by him along with his wife in

their roles as the CHI board of directors. Therefore, the court examined the specific circumstances surrounding the setting of Hood's compensation in the tax years at issue.

THE 2015 COMPENSATION AMOUNT

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

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

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

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

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

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

THE 2016 COMPENSATION AMOUNT

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

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

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

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

ANALYSIS OF HOOD'S PRIOR COMPENSATION AMOUNTS

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

Hood's total compensation increased over 300 percent in the CHI 2015 fiscal year, its most profitable year to date. Nonetheless, there was no corresponding

increase in Hood's duties or responsibilities in that year. According to the CHI corporate minutes, the stated justification for this increase is that Hood was undercompensated in prior years. In the Hood decision, the Tax Court addressed this issue as follows: "While we do not disagree that Mr. Hood was undercompensated in certain years of the review period, this does not entitle petitioner to carte blanche in deducting Mr. Hood's backpay bonus amount."

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

HOOD'S PERSONAL GUARANTY OF THE CHI DEBTS AND BONDING OBLIGATIONS

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

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

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

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

THE HOOD DECISION REASONABLE COMPENSATION CONCLUSION

Considering the totality of the factors discussed above, the Tax Court concluded that CHI did not adequately

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

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

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

THE SECTION 6662 PENALTIES

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

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

WITH REASONABLE CAUSE AND IN GOOD FAITH EXCEPTION

According to Section 6664(c)(1), the substantial understatement penalty does not apply with respect to any portion of an underpayment to which a taxpayer acted "with reasonable cause and in good faith." According to Regulation 1.6664-4(b)(1), whether a taxpayer acted with reasonable cause and in good faith is decided on a case-

by-case basis, taking into account all pertinent facts and circumstances.

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

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

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

THE 2015 PENALTY AMOUNT AND A COMPETENT PROFESSIONAL WITH SUFFICIENT EXPERTISE

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

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

Accordingly, the Tax Court concluded that the CHI advisers were adequately qualified to counsel the company on the issue of Hood's compensation and its tax implications.

DID THE TAXPAYER PROVIDE NECESSARY AND ACCURATE INFORMATION?

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

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

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

DID THE TAXPAYER ACTUALLY RELY ON THE ADVISER'S JUDGMENT?

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

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

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

on CHI data and incorporated input that Phillips previously received from Greenway.

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

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

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

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

THE 2016 PENALTY AMOUNT AND RELIANCE ON PROFESSIONAL ADVICE

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

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

The Tax Court particularly noted this lack of evidence when considering that (1) in awarding Hood the 2015 bonus amount, the record did not reflect that the CHI board still believed that Hood remained entitled to

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

THE SUBSTANTIAL AUTHORITY DEFENSE

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

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

CHI claimed that its tax return position for each tax year at issue, including the 2016 bonus amount, was based on the independent investor test. CHI claimed that two judicial decisions by the U.S. Court of Appeals for the Seventh Circuit, *Menard, Inc. v. Commissioner*²³ and *Exacto Spring Corp. v. Commissioner*²⁴ “provide clear cut substantial authority” for the company’s use of this reasonableness of compensation test for the tax years at issue.

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

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

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

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

SUMMARY AND CONCLUSION

The U.S. Tax Court case *Clary Hood, Inc. v. Commissioner* involves a closely held C corporation’s dispute

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

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

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

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

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

Notes:

1. *Cozart Packing Co. v. Commissioner*, T.C. Memo. 1972-175, aff'd, 475 F.2d 1339 (4th Cir. 1973).
2. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).
3. *Martens v. Commissioner*, 934 F.2d 319, 1991 WL 87160, at *8 (4th Cir. 1991), aff'g per curiam T.C. Memo. 1990-42.
4. *Am. Sav. Bank v. Commissioner*, 56 T.C. 828, 843 (197).

5. *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 119 (1930), aff'g *Ox Fibre Brush Co. v. Blair*, 32 F.2d 42 (4th Cir. 1929, rev'g 8 B.T.A. 422 (1927)).
6. *R.J. Nicoll Co. v. Commissioner*, 59 T.C. 37, 50 (1972).
7. *Estate of Wallace v. Commissioner*, 95 T.C. 525, 553-554, aff'd 965 F.2d 1038 (11th Cir. 1992).
8. *Richlands Med. Ass'n v. Commissioner*, 953 F.2d 639, 1992 WL 14603, at *2 (4th Cir. 1992), aff'g per curiam T.C. Memo. 1990-660.
9. *Estate of Wallace v. Commissioner*, 95 T.C. at 556.
10. *Richlands Med. Ass'n v. Commissioner*, 1992 WL 14603, at *2.
11. *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115, 119 (6th Cir. 1949), rev'g and remanding a Tax Court Memorandum Opinion dated November 16, 1948).
12. *E.J. Harrison & Sons, Inc. v. Commissioner*, T.C. Memo. 2003-239, 2003 WL 21921049, at *14-*16, aff'd in part, rev'd in part, and remanded on another issue, 138 F. App'x 994 (9th Cir. 2005).
13. *Martens v. Commissioner*, 1991 WL 87160, at *9.
14. *Medina v. Commissioner*, T.C. Memo. 1983-253.
15. *Metro Leasing & Dev. Corp. v. Commissioner*, 326 F.3d 1, 3-4 (1st Cir. 2003), aff'g T.C. Memo. 2001-119, 2001 WL 530694 and 119 T.C. 8 (2002).
16. *Haffner's Serv. Stations, Inc. v. Commissioner*, 326 F.3d 1-3 (1st Cir. 2003), aff'g T.C. Memo. 2002-38.
17. *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 838 (7th Cir. 1999).
18. *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245 (9th Cir. 1983), rev'g T.C. Memo. 1980-282.
19. *Pepsi-Cola Bottling Co. of Salina v. Commissioner*, 61 T.C. 564, 567 (1974), aff'd, 528 F.2d 176, 179 (10th Cir. 1975).
20. *Beiner, Inc. v. Commissioner*, T.C. Memo. 2004-219, 2004 WL 2164888.
21. *Metro Leasing & Dev. Corp. v. Commissioner*, 2001 WL 530694.
22. *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), aff'd 445 F.2d 985 (10th Cir. 1971).
23. *Menard, Inc. v. Commissioner*, 560 F.3d 620 (7th Cir. 2009), rev'g T.C. Memo. 2004-207.
24. *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833.

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