EXHIBIT 5

H

United States District Court,
S.D. Iowa,
Central Division.
DAVID E. WATSON, P.C., Plaintiff,
v.
UNITED STATES of America, Defendant.

No. 4:08–cv–442.
May 27, 2010.

Background: Subchapter S-corporation, that had paid dividends to its sole shareholder, filed suit seeking refund of employment taxes when Internal Revenue Service (IRS) recharacterized the dividend distributions as wages. Plaintiff moved for summary judgment.

Holding: The District Court, Robert W. Pratt, Chief Judge, held that genuine issue of material fact as to whether dividend distributions were "remuneration for services performed," precluded summary judgment.

Motion denied.

West Headnotes

[1] Federal Civil Procedure 170A ⚿2462

170A Federal Civil Procedure
170AXVII Judgment
170AXVII(C) Summary Judgment
170AXVII(C)1 In General
170Ak2462 k. Purpose. Most Cited Cases

Role of summary judgment is to pierce boilerplate of pleadings and assay the parties' proof in order to determine whether trial is actually required.

[2] Internal Revenue 220 ⚿4374

220 Internal Revenue
220XIV Taxes on Specific Articles and Transactions
220XIV(D) Employment Taxes
220k4374 k. Taxes in general. Most Cited Cases

While an employer is required to pay Federal Insurance Contributions Act (FICA) tax on all wages paid to its employees, it is not obligated to pay FICA tax on other types of employee income, such as dividends. 26 U.S.C.A. §§ 3111(a), 3121(a).

[3] Internal Revenue 220 ⚿4374

220 Internal Revenue
220XIV Taxes on Specific Articles and Transactions
220XIV(D) Employment Taxes
220k4374 k. Taxes in general. Most Cited Cases

The characterization of funds disbursed by an S-corporation to its employees or shareholders, as "dividends" rather than "wages," turns on an analysis of whether the payments at issue were made as "remuneration for services performed." 26 U.S.C.A. § 3111(a).

[4] Internal Revenue 220 ⚿4374

220 Internal Revenue
220XIV Taxes on Specific Articles and Transactions
220XIV(D) Employment Taxes
220k4374 k. Taxes in general. Most Cited Cases

The determination of whether funds are "remuneration for services performed," so as to constitute "wages" for purposes of employment tax, must be made in view of all the evidence; intent of the parties is unquestionably a consideration in court's analysis. 26 U.S.C.A. § 3111(a).

[5] Federal Civil Procedure 170A ⚿2514

170A Federal Civil Procedure
170AXVII Judgment

170AXVII(C) Summary Judgment
170AXVII(C)2 Particular Cases
170Ak2514 k. Tax cases. Most Cited Cases

Genuine issue of material fact as to whether dividend distributions S-corporation made to its sole shareholder were "remuneration for services performed" so as to constitute "wages," subject to Federal Insurance Contributions Act (FICA) tax, precluded summary judgment in taxpayer's action against Internal Revenue Service (IRS) seeking refund of employment taxes. 26 U.S.C.A. §§ 3101, 3111(a).

***955** Jan Mohrfeld Kramer, Smith & Kramer PC, Ronald L. Mountsier, Schneider Stiles Serangeli & Mountsier PC, Des Moines, IA, for Plaintiff.

Miranda J. Bureau, Robert E. Fay, U.S. Dept. of Justice Civil Tax Division, Washington, DC, for Defendant.

ORDER

ROBERT W. PRATT, Chief Judge.

Before the Court is a Motion for Summary Judgment and Request for Oral Argument, filed March 10, 2010 by David E. Watson, P.C. ("Plaintiff" or "DEWPC"). Clerk's No. 13. The United States of America ("Defendant") filed a resistance to the Motion on April 5, 2010. Clerk's No. 14. Plaintiff filed a Reply on April 13, 2010. Clerk's No. 15. Despite Plaintiff's request, the Court does not believe oral arguments would substantially aid it in resolving the present Motion. The matter is, therefore, fully submitted.

I. FACTUAL AND PROCEDURAL BACKGROUND

The facts of this case are largely undisputed. David Watson ("Watson") graduated from the University of Iowa in 1982, with a bachelor's degree in business administration and a specialization in accounting. Def.'s Statement of Additional Facts (hereinafter "Def.'s Facts") ¶ 1. Watson became a Certified Public Accountant ("CPA") in 1983, and received a master's degree in taxation from Drake University in 1993. *Id.* ¶ 2. Between 1982 and 1992, Watson practiced accounting at Ernst & Young, where he specialized in partnership taxation. *Id.* ¶ 3. In 1992, after leaving Ernst & Young, Watson joined with Tom Larson ("Larson"), Jeff Bartling ("Bartling"), and Dale Eastman ("Eastman") to form an accounting firm named Larson, Watson, Bartling & Eastman ("LWBE").[FN1] *Id.* ¶ 5; Def.'s App. at 21. According to Watson, LWBE became profitable "within the first couple years." Def.'s Facts ¶ 7.

FN1. It appears that each partner owned a 25% share of LWBE. *See* Def.'s Facts ¶¶ 5–6.

On October 11, 1996, Watson incorporated DEWPC as an Iowa Professional Corporation ("PC"). Pl.'s Statement of Material Facts (hereinafter "Pl.'s Facts") ¶ 1. Larson, Bartling, and Eastman also formed PCs, and on October 11, 1996, each of the four partners replaced their individual ownership in LWBE with ownership by their respective PC. Def.'s Facts ¶¶ 8–9; Def.'s App. at 62–72. On the same date, LWBE, DEWPC, and Watson entered into an employment agreement whereby Watson became DEWPC's employee and agreed to provide his accounting services exclusively to LWBE. Def.'s Facts ¶¶ 12–13. By 1998, Paul Jeffer, PC, had replaced Dale Eastman, PC as a partner, causing LWBE to be reformed as Larson, Watson, Bartling, and Jeffer ("LWBJ"), though neither the work performed by the firm, nor the employment arrangement between the firm, DEWPC, and Watson, changed significantly. *Id.* ¶¶ 10–11.

As structured in 2002 and 2003, the years relevant to the present lawsuit, Watson provided accounting services exclusively to LWBJ and its clients as an employee of DEWPC. Pl.'s Facts ¶ 6; Def.'s Facts ¶ 14. Under the arrangement between Watson, DEWPC, and LWBJ, LWBJ provided professional liability insurance for Watson and had the authority to determine how much vacation Watson could take. Def.'s Facts ¶ 15. From 2002 to 2003,

and continuing to the present, LWBJ's website listed Watson, rather than DEWPC, as a partner, and Watson held himself out to the public as a specialist ***956** in partnership taxation, who spends "a significant amount of time structuring and restructuring businesses and real estate investments for tax purposes" and who "consistently designs tax-advantaged ownership structures using various combinations of entities." *Id.* ¶¶ 16–17.

Since its inception, DEWPC has elected to be taxed as an S Corporation, and Watson has been its sole shareholder, employee, director, and officer. Pl.'s Facts ¶¶ 3–4, 7; Def.'s Facts ¶¶ 18–19. As such, Watson had complete control over the flow of money through DEWPC. *See* Def.'s Facts ¶ 22; Pl.'s Response to Def.'s Facts (hereinafter "Pl.'s Response") ¶ 22. Watson is the only person to whom DEWPC distributed money in 2002 or 2003.[FN2] Def.'s Facts ¶ 20. DEWPC has only one checking account, and Watson is the only person authorized to sign checks on that account. *Id.* ¶ 23. At shareholder meetings Watson held with himself in 2000–2002, Watson authorized for himself a salary from DEWPC in the amount of $24,000.00 annually. *Id.* ¶ 25. In selecting $24,000.00 as his salary, Watson did no research other than to talk to Larson, Bartling and Jeffer to reach an agreement on what salary each would pay himself. *Id.* ¶ 27. In 2002 and 2003, DEWPC did, in fact, pay Watson $24,000.00 in funds designated as salary and paid federal employment taxes on that amount. *Id.* ¶ 24.

> FN2. Some of the money distributed to Watson by DEWPC was in the form of an interest-free loan to Watson in 2002. Def.'s Facts ¶ 21.

DEWPC's 2002 and 2003 income came exclusively in the form of distributions from LWBJ. Def.'s Facts ¶ 32. DEWPC apparently then passed the distributions on to Watson, though Watson admits that, on occasion, he may have taken distributions from LWBJ and placed them directly in his personal checking account without first placing the money in DEWPC's checking account. *Id.* ¶ 35. In 2002, in addition to his $24,000.00 salary, Watson received checks from DEWPC totaling $203,651.00. Pl.'s Response ¶ 28. Watson received these checks in twenty-four separate installments during 2002, and eighteen of the installments were for exactly $5,000.00. Def.'s Facts ¶ 29. DEWPC recorded $118,159.00 of the payments to Watson in 2002 as dividend distributions to Watson. Pl.'s Response ¶ 28. In 2003, in addition to his $24,000.00 salary, Watson received $221,577.00 in dividend payments from DEWPC. Def.'s Facts ¶ 30; Pl.'s Response ¶ 30.[FN3] In both years, Watson worked for DEWPC an average of 35 to 45 hours per week for about 46 weeks per year. Def.'s Facts ¶ 33; Pl.'s Response ¶ 33. Watson also admitted that for both years, his monthly living expenses exceeded the $2,000.00 in "salary" he was receiving from DEWPC. Def.'s Facts ¶ 36.

> FN3. According to the parties: "Due to a reduction in a 2002 loan from DEWPC to Watson, it is possible that the actual amount of money that flowed from LWBJ to DEWPC to Watson in 2003 was not $2[2] 1,577 but $1 [8]0,093. At his deposition, Watson could not say with certainty." Def.'s Facts ¶ 31; Pl.'s Response ¶ 31.

On or about February 5, 2007, the Internal Revenue Service ("IRS") assessed $48,519.30 in taxes, penalties, and interest against DEWPC for the eight calendar quarters of 2002 and 2003. Def.'s Facts ¶ 37. The IRS made these assessments after it determined that portions of the dividend distributions from DEWPC to Watson should be recharacterized as wages paid to Watson, subject to employment taxes under 26 U.S.C. § 3101 and § 3111. Pl.'s Facts ¶ 8. Specifically, the IRS contended that $130,730.05 of the dividend payments to Watson for 2002 should be recharacterized as wages subject to employment***957** taxes, and that $175,470.00 of the dividend payments to Watson for 2003 should be recharacterized as wages subject to employment taxes. Pl.'s Facts ¶¶ 9–10; Def.'s Response to Pl.'s

Facts (hereinafter "Def.'s Response") ¶¶ 9–10. Since the initial assessments were made, Defendant's expert witness, Igor Ostrovsky, has amended his opinion regarding how much of the dividend payments should be recharacterized as wages several times. *See* Pl.'s Facts ¶¶ 11–13. Currently, Defendant takes the position that $67,044.00 of the dividend distributions should be recharacterized as wages for each of 2002 and 2003. *Id.* ¶ 13. On April 11, 2007, DEWPC paid Defendant $4,063.93 toward the assessments.[FN4] Compl. ¶¶ 11–12; Def.'s Answer ¶¶ 11–12. On June 27, 2007, DEWPC filed a claim for a refund of its payment, but the claim was denied by the IRS on November 16, 2007. Compl. ¶¶ 13–14. DEWPC filed the present action on October 31, 2008, claiming that Defendant improperly recharacterized dividend payments to Watson as wages and incorrectly determined that DEWPC owed employment taxes on the improperly recharacterized funds. *See generally* Compl. Accordingly, Plaintiff requests that the Court order judgment in its favor in the amount of $4,063.93, plus interest, costs, and reasonable litigation expenses. *Id.*

> FN4. Plaintiff contends that the $4,063.93 was the additional tax, penalty, and interest for the calendar quarter ending December 31, 2002, but that the IRS erroneously applied the payment to the tax liability assessed for the first quarter of 2002. Compl. ¶¶ 11–12.

II. STANDARD FOR SUMMARY JUDGMENT

[1] Summary judgment has a special place in civil litigation. The device "has proven its usefulness as a means of avoiding full-dress trials in unwinnable cases, thereby freeing courts to utilize scarce judicial resources in more beneficial ways." *Mesnick v. Gen. Elec. Co.*, 950 F.2d 816, 822 (1st Cir.1991). In operation, the role of summary judgment is to pierce the boilerplate of the pleadings and assay the parties' proof in order to determine whether trial is actually required. *See id.; see also Garside v. Osco Drug, Inc.*, 895 F.2d 46, 50 (1st Cir.1990). "[S]ummary judgment is an extreme remedy, and one which is not to be granted unless the movant has established his right to a judgment with such clarity as to leave no room for controversy and that the other party is not entitled to recover under any discernible circumstances." *Robert Johnson Grain Co. v. Chem. Interchange Co.*, 541 F.2d 207, 209 (8th Cir.1976) (citing *Windsor v. Bethesda Gen. Hosp.*, 523 F.2d 891, 893 n. 5 (8th Cir.1975)). The purpose of the rule is not " 'to cut litigants off from their right of trial by jury if they really have issues to try,' " *Poller v. Columbia Broad. Sys., Inc.*, 368 U.S. 464, 467, 82 S.Ct. 486, 7 L.Ed.2d 458 (1962) (quoting *Sartor v. Ark. Natural Gas Corp.*, 321 U.S. 620, 627, 64 S.Ct. 724, 88 L.Ed. 967 (1944)), but to avoid "useless, expensive and time-consuming trials where there is actually no genuine, factual issue remaining to be tried." *Anderson v. Viking Pump Div., Houdaille Indus., Inc.*, 545 F.2d 1127, 1129 (8th Cir.1976) (citing *Lyons v. Board of Educ.*, 523 F.2d 340, 347 (8th Cir.1975)).

The plain language of Federal Rule of Civil Procedure 56(c) mandates the entry of summary judgment, after adequate time for discovery and upon motion, against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial. *See Celotex Corp. v. Catrett*, 477 U.S. 317, 322, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). The precise standard ***958** for granting summary judgment is well-established and oft-repeated: summary judgment is properly granted when the record, viewed in the light most favorable to the nonmoving party and giving that party the benefit of all reasonable inferences, shows that there is no genuine issue of material fact, and the moving party is entitled to judgment as a matter of law. *See* Fed.R.Civ.P. 56(c) ; *Harlston v. McDonnell Douglas Corp.*, 37 F.3d 379, 382 (8th Cir.1994). A court does not weigh the evidence nor make credibility determinations, rather it only determines whether there are any disputed issues and, if so, whether those issues are

both genuine and material. *See Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 252, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986); *Wilson v. Myers,* 823 F.2d 253, 256 (8th Cir.1987) ("Summary judgment is not designed to weed out dubious claims, but to eliminate those claims with no basis in material fact.").

Plaintiff bears the burden of proof in this case. It is the unusual case where the party shouldering the burden of proof prevails on a summary judgment motion. *See Turner v. Ferguson,* 149 F.3d 821, 824 (8th Cir.1998) ("Summary judgments in favor of parties who have the burden of proof are rare, and rightly so."). The moving party bears the initial burden of demonstrating the absence of a genuine issue of material fact based on the pleadings, depositions, answers to interrogatories, admissions on file, and affidavits, if any. *See Celotex Corp.,* 477 U.S. at 323, 106 S.Ct. 2548; *Anderson,* 477 U.S. at 248, 106 S.Ct. 2505. Once the moving party has carried its burden, the nonmoving party must go beyond the pleadings and, by affidavits or by the depositions, answers to interrogatories, and admissions on file, designate specific facts showing that there is genuine issue for trial. *See* Fed.R.Civ.P. 56(c), (e); *Celotex Corp.,* 477 U.S. at 322–23, 106 S.Ct. 2548; *Anderson,* 477 U.S. at 257, 106 S.Ct. 2505. "[T]he mere existence of *some* alleged factual dispute between the parties will not defeat a motion for summary judgment; the requirement is that there be no *genuine* issue of *material* fact." *Anderson,* 477 U.S. at 247–48, 106 S.Ct. 2505 (emphasis in original). An issue is "genuine," if the evidence is sufficient to persuade a reasonable jury to return a verdict for the nonmoving party. *See id.* at 248, 106 S.Ct. 2505. "As to materiality, the substantive law will identify which facts are material.... Factual disputes that are irrelevant or unnecessary will not be counted." *Id.*

III. LAW AND ANALYSIS

[2] The Federal Insurance Contributions Act ("FICA") imposes "on every employer an excise tax, with respect to having individuals in his employ, equal to [a certain] percentage[ ] of the wages paid by him with respect to employment." 26 U.S.C. § 3111(a). The term "wages" is defined broadly by FICA as "all remuneration for employment." [FN5] 26 U.S.C. § 3121(a). Thus, an employer, such as DEWPC, is required to pay FICA tax on all wages paid to its employees. *See HB & R, Inc. v. United States,* 229 F.3d 688, 690 (8th Cir.2000). An employer is not, however, obligated to pay FICA tax on "other types of employee income, such as dividends." *Id.* The parties are in agreement that Watson was an employee of DEWPC. *See* Pl.'s Facts ¶ 4 ("During the years 2002 and 2003, Watson was employed by [DEWPC], and was its only employee."). The parties are further in agreement that if the funds paid to Watson are properly characterized as dividends, ***959** DEWPC need not pay FICA taxes on them, but that if the funds are properly recharacterized as wages, DEWPC would be required to pay FICA tax.

> FN5. The definition of "wages" contains numerous exceptions, none of which are applicable in the present case. *See* 26 U.S.C. § 3121(a)(1)-(23).

In its Motion for Summary Judgment, DEWPC contends that it "clearly intended to pay [Watson] compensation of $24,000 per year, and that amounts distributed to Mr. Watson in excess of that amount are properly classified as dividends and/or loans." Pl.'s Br. at ii. DEWPC argues that "the United States does not have the authority to require that [DEWPC] pay any sort of minimum salary to [Watson] before it can pay dividends to [Watson], and that the United States' ability to assess additional employment taxes is limited to taxing payments which were intended to be compensatory in nature." *Id.* at ii-iii. In short, Plaintiff argues that it is the intent of DEWPC that controls whether funds paid to Watson are categorized as wages or as dividends. *Id.* at 3–4. According to Plaintiff, DEWPC's intent to pay Watson a salary of only $24,000 is clearly evidenced by the Minutes of the Combined Meeting of the Shareholders and Direct-

ors of DEWPC during the relevant time frame, which all evidence the fact that DEWPC intended to pay Watson $24,000.00 annually as salary, and intended to pay dividends "in the amount of available cash on hand after payment of compensation and other expenses of the corporation." Pl.'s App. at 17–20, 29–32. Plaintiff cites *Electric & Neon, Inc. v. Commissioner of Internal Revenue,* 56 T.C. 1324 (1971), *Paula Construction Co. v. Commissioner of Internal Revenue,* 58 T.C. 1055 (1972), and *Pediatric Surgical Associates, P.C. v. Commissioner of Internal Revenue,* T.C. Memo 2001–81 (Apr. 2, 2001), in support of its position.

In *Electric & Neon,* the owners of a C corporation took loans from the corporation on a regular basis to pay ordinary expenses, but rarely or irregularly paid back such loans. 56 T.C. at 1327. The IRS determined that the un-repaid loans should be considered dividend income. *Id.* at 1330. The owners sought to have the loans declared compensation for services rendered so that the corporation could deduct the funds as expenses. *Id.* at 1340. The Tax Court found that the owners could deduct the amount of compensation paid out, "so long as such payments (1) do not exceed the reasonable compensation for the services actually rendered, and (2) are actually intended to be paid purely for the services." *Id.* The IRS did not object to the first prong of the test, and conceded that if the loan payments were deemed compensation, they would not exceed the reasonable compensation for services actually rendered by the owners to the corporation. *Id.* The IRS did, however, object to the second prong of the test, urging that the owners never *intended* for the loans to be compensation. *Id.* Noting that "[i]t is settled law that such intent must be shown as a condition precedent to the allowability of a deduction to the corporation," the Tax Court determined that the fact that funds were intended as loans undermined the owners' assertion that the funds were intended as compensation. *Id.* at 1340–41 ("[Owners'] testimony that the withdrawals were intended to be loans does, in fact, tend to negate his alternative argument that compensation was intended.").

The following year, the Tax Court reaffirmed in *Paula* that "it is now settled law that only if payment is made with the intent to compensate is it deductible as compensation." 58 T.C. at 1058. In *Paula,* an S corporation tried to argue that certain dividends paid to its stockholders were actually compensation for services rendered. *Id.* In refusing to recharacterize the dividends as wages, the Tax Court ignored the fact that the stockholders were not compensated for substantial services, ***960** finding that, aside from that fact, nothing in the record "indicates that compensation was either paid or intended to be paid" and that "[n]one of the evidence indicates that at the time those payments were made they were intended to be compensation for services performed." *Id.* at 1057–60.

Finally, in *Pediatric Surgical Associates, P.C.,* a C corporation deducted certain funds paid to shareholder surgeons as compensation. T.C. Memo 2001–81. The IRS "disallowed a portion of such deductions on the ground that a portion of the amounts paid to the shareholder surgeons was dividend rather than officers' compensation." *Id.* Stating that the burden was on the corporation to prove its intent to pay compensation, the court affirmed the recharacterization, finding that the "compensation" paid to the shareholder surgeons "exceed[ed] reasonable allowances for services actually rendered by them." *Id.*

Plaintiff would have the Court read these three decisions as standing for the proposition that DEWPC's stated subjective intent as to the purpose of its distributions to Watson controls the classification of the funds as either dividends or wages. The Court finds Plaintiff's citation to *Electric & Neon, Paula,* and *Pediatric Surgical Associates, P.C.* inapposite, however, because in each case, the *taxpayer* was attempting to recharacterize funds, whereas in the present case, it is the Government that is attempting to recharacterize the funds. One author addressed this distinction in the 1993 edition of the Akron Tax Journal:

The courts and the Service seem to have adopted

> a double standard. In the context of taxpayer attempts at recharacterization, "intent" has dominated the decisions. But the courts have found intent irrelevant where the Service is arguing for recharacterization. This outcome may be justified to the extent the taxpayer is distorting the actual character of payments received from the corporation for tax advantage.

Harrington, Kirsten, *Employment Taxes: What Can the Small Businessman Do?* 10 Akron Tax J. 61, 69 (1993). Indeed, the incentive for S corporations to distort the actual character of payments to its shareholders/employees to obtain a tax advantage was recently articulated by Judge Richard A. Posner:

> The distinction between accounting profits, losses, assets, and liabilities, on the one hand and cash flow on the other is especially important when one is dealing with either a firm undergoing reorganization in bankruptcy or a small privately held firm; in the latter case, in order to avoid double taxation (corporate income tax plus personal income tax on dividends), the company might try to make its profits disappear into officers' salaries. *See Menard, Inc. v. Commissioner,* 560 F.3d 620, 621 (7th Cir.2009). The owners of a Subchapter S corporation, however, have the oppositive incentive—to alchemize salary into earnings. A corporation has to pay employment taxes, such as state unemployment insurance tax and social security tax, on the salaries it pays. A Subchapter S corporation can avoid paying them by recharacterizing salary as a distribution of corporation income.

Constr. & Design Co. v. United States Citizenship & Immigration Servs., 563 F.3d 593, 595–96 (7th Cir.2009).

Plaintiff's position that its own intent controls the characterization of funds paid to Watson is further undermined by relevant IRS Revenue Rulings and by case law that is more in line with the facts of this case than *Electric & Neon, Paula,* or *Pediatric Surgical Associates, P.C.* In a 1974 ***961** Revenue Ruling, two sole shareholders of a corporation sought advice on whether they would incur liability for employment taxes on facts similar to the present case. Rev. Rul. 74–44 (1974). The shareholders "performed services for the corporation. However, to avoid the payment of Federal employment taxes, they drew no salary from the corporation but arranged for the corporation to pay them 'dividends' [in an amount equal to] the amount they would have otherwise received as reasonable compensation for services performed." *Id.* The IRS stated that the dividends "were reasonable compensation for services" performed by the shareholders "rather than a distribution of the corporation's earnings and profits." *Id.* Accordingly, the dividends would properly be characterized as "wages" for which "liability was incurred for the taxes imposed by [FICA and other federal employment taxes]." *Id.* This conclusion comports with an earlier Revenue Ruling stating:

> Neither the election by the corporation as to the manner in which it will be taxed for Federal income tax purposes nor the consent thereto by the stockholder-officers has any effect in determining whether they are employees or whether payments made to them are 'wages' for Federal employment tax purposes.
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> Rev. Rul. 73–361 (1973).

In *Joseph Radtke, S.C. v. United States,* a district court determined that certain funds designated as dividends were actually compensation for which an S Corporation owed employment taxes. 712 F.Supp. 143 (E.D.Wis.1989). Radtke, a Wisconsin attorney, had created an S corporation to provide legal services in Milwaukee. *Id.* at 144. Radtke was the firm's sole director, shareholder, and full-time employee, but he took no salary, receiving instead $18,225 in dividend payments from the corporation in 1982. *Id.* Since Radtke received the funds as dividends, rather than as wages, the corporation did not pay employment taxes on them. *Id.* The IRS recharacterized the funds as wages and assessed FICA and other employment taxes on them, along

with penalties and interest. *Id.* at 145. In concluding that the funds were properly recharacterized as wages rather than dividends, the district court stated:

> I am not moved by the Radtke corporation's connected argument that "dividends" cannot be "wages." Courts reviewing tax questions are obligated to look at the substance, not the form, of the transactions at issue. *Frank Lyon Co. v. United States,* 435 U.S. 561, 573, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978). Transactions between a closely held corporation and its principals, who may have multiple relationships with the corporation, are subject to particularly careful scrutiny. *Tulia Feedlot, Inc. v. United States,* 513 F.2d 800, 805 (5th Cir.1975). Whether dividends represent a distribution of profits or instead are compensation for employment is a matter to be determined in view of all the evidence. *Cf. Logan Lumber Co. v. Commissioner,* 365 F.2d 846, 851 (5th Cir.1966) (examining whether dividends were paid in guise of salaries).
>
> In the circumstances of this case-where the corporation's only director had the corporation pay himself, the only significant employee, *no* salary for substantial services-I believe that Mr. Radtke's "dividends" were in fact "wages" subject to FICA and FUTA taxation. His "dividends" functioned as remuneration for employment....
>
> An employer should not be permitted to evade FICA and FUTA by characterizing *all* of an employee's remuneration as something other than "wages." *Cf.* ***962** *Greenlee v. United States,* [661 F.Supp. 642] 87–1 U.S.T.C. ¶ 9306 (corporation's interest-free loans to sole shareholder constituted "wages" for FICA and FUTA where loans were made at shareholder's discretion and he performed substantial services for corporation). This is simply the flip side of those instances in which corporations attempt to disguise profit distributions as salaries for whatever tax benefits that may produce.

Id. at 146. Radtke appealed the district court's decision to the Seventh Circuit, which framed the issue as, "whether, based on the statutes and unusual facts involved, the payments at issue were made to Mr. Radtke as remuneration for services performed." *Joseph Radtke, S.C. v. United States,* 895 F.2d 1196, 1197 (7th Cir.1990). "As the district judge determined, these payments were clearly remuneration for services performed by Radtke and therefore fall within the statutory and regulatory definitions of wages." *Id.*

Relying on *Radtke* and the Revenue Rulings cited *supra,* the Ninth Circuit has also determined, in a case remarkably similar to the one at bar, that payments designated as dividends can properly be recharacterized by the IRS as wages subject to federal employment taxes. *See Spicer Accounting, Inc. v. United States,* 918 F.2d 90 (9th Cir.1990). Spicer, a licensed public accountant, was the president, treasurer, and director of an S Corporation, Spicer Accounting, Inc. *Id.* at 91. Spicer and his wife were the only stockholders in the corporation, and Spicer performed substantial services for the corporation. *Id.* at 91–92. Spicer had an arrangement with the corporation whereby he would "donate his services to the corporation" and "withdraw earnings in the form of dividends." *Id.* at 91. For tax years 1981 and 1982, the IRS recharacterized dividend payments to Spicer by the corporation as wages, and assessed taxes, penalties, and interest against the corporation for unpaid employment taxes. *Id.* The Ninth Circuit affirmed the characterization of payments to Spicer as wages, emphasizing that it is the substance rather than the form of the transaction that matters, and noting that "salary arrangements between closely held corporations and its shareholders warrant close scrutiny." *Id.* at 92. Citing to *Radtke,* the *Spicer* court found that, "regardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments are for remunerations for services rendered." *Id.* at 93. According, "Mr. Spicer's intention of receiving the payments as dividends has no bearing on the tax treat-

ment of these wages." *Id.*

Other courts have reached conclusions like those in *Radtke* and *Spicer*. For instance, in *Veterinary Surgical Consultants v. Commissioner of Internal Revenue*, the United States Tax Court rejected a petitioner's argument that amounts paid to its sole shareholder were distributions of corporate net income rather than wages. 117 T.C. 141, 145 (2001).

> Dr. Sadanaga performed substantial services on behalf of petitioner [the S corporation]. The characterization of the payment to Dr. Sadanaga as a distribution of petitioner's net income is but a subterfuge for reality; the payment constituted remuneration for services performed by Dr. Sadanaga on behalf of petitioner. An employer cannot avoid Federal employment taxes by characterizing compensation paid to its sole director and shareholder as distributions of the corporation's net income, rather than wages. Regardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments represent remunerations for services rendered.

***963** *Id.* at 145–46. Likewise, in *JD & Associates, Ltd. v. United States*, Jeffrey Dahl, the sole shareholder, officer, and director of the plaintiff S corporation, received an annual salary of $19,000.00 in 1997 and $30,000.00 for each of 1998 and 1999. No. 3:04–cv–59, at 4 (D.N.D. May 19, 2006) (available in Def.'s App. at 146–56). Dahl also received dividends of $47,000.00 for 1997, $50,000.00 for 1998, and $50,000.00 for 1999. *Id.* at 5. As in the present case, the IRS determined that Dahl's salary was unreasonably low, and assessed employment taxes, interest, and penalties against the corporation after recharacterizing portions of the dividend payments as wages to Dahl. *Id.* at 1. Applying an Eighth Circuit test to determine whether Dahl's compensation was reasonable,[FN6] the district court concluded it was not and upheld the tax assessments against the corporation. *Id.* at 9–11.

FN6. The test employed was that from *Charles Schneider & Co., Inc. v. Commissioner of Internal Revenue*, wherein the Court stated:

> Several factors to be considered in determining reasonableness of compensation have been mentioned by the courts. Such factors include 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 the gross income and the 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; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.
>
> 500 F.2d 148, 152 (8th Cir.1974).

[3][4] After careful review of the relevant authorities, the Court agrees with Defendant that DEWPC's self-proclaimed intent to pay Watson $24,000.00 in salary does not limit the United States' ability to recharacterize dividends paid to Watson as wages, even though DEWPC properly documented its claimed intent in its corporate records. Rather, the characterization of funds disbursed by an S corporation to its employees or shareholders turns on an analysis of whether the "payments at issue were made ... as remuneration for services performed." *Radtke*, 895 F.2d at 1197. This approach conforms with well settled jurisprudence holding that tax consequences are governed by the economic realities of a transaction, not by the form of the transaction or labels given it by the parties. *See, e.g., Boulware v. United States*, 552 U.S. 421, 430, 128 S.Ct. 1168, 170 L.Ed.2d 34 (2008) ("The colorful behavior described in the al-

legations requires a reminder that tax classifications like 'dividend' and 'return of capital' turn on 'the objective economic realities of a transaction rather than ... the particular form the parties employed.' ") (quoting (*Frank Lyon,* 435 U.S. at 573, 98 S.Ct. 1291);) *Pinson v. Commissioner of Internal Revenue,* T.C. Memo 2000–208 (July 6, 2000) ("As a general rule, the substance of a transaction controls tax treatment.") (citing *Gregory v. Helvering,* 293 U.S. 465, 469–70, 55 S.Ct. 266, 79 L.Ed. 596 (1935)); *True v. United States,* 190 F.3d 1165, 1173–74 (10th Cir.1999) (stating that "substance over form" is a "fundamental tax principle [that] operates to prevent the 'true nature of a transaction from being disguised by mere formalisms, which exist solely to alter tax liabilities' ") (quoting *Commissioner v. Court Holding Co.,* 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981 (1945)); *Leisure Dynamics, Inc. v. Commissioner of Internal Revenue,* 494 F.2d 1340, 1345 (8th Cir.1974) ("For tax purposes, we must concern ourselves with actualities rather than the refinements of title; our concern is with the substance, not form."). This is not to say that intent ***964** is insignificant to the analysis. Indeed, a determination of whether funds are "remuneration for services performed," must be made "in view of all the evidence," and intent is unquestionably a consideration in such an analysis.[FN7] *Radtke,* 712 F.Supp. at 145.

FN7. The United States has repeatedly affirmed that it recharacterized dividend payments to Watson as wages based on its determination that Watson's "salary" was unreasonably low under the facts and circumstances of the case. The United States has also admitted that it does not have any authority to require DEWPC to pay Watson a minimum salary. Plaintiff would have the Court construe these admissions as evidence supporting Plaintiff's claim that the "United States is simply trying to do indirectly exactly that which it concedes it cannot do directly—require that a corporation pay a minimum amount of compensation or remuneration to a shareholder employee before paying a dividend to that employee." Pl.'s Reply at 2. The Court rejects Plaintiff's proposed construction. Whether Watson's salary was "reasonable" is unquestionably a relevant consideration in determining whether DEWPC's dividend payments to Watson were actually "remuneration for employment." *See, e.g., Construction & Design Co.,* 563 F.3d at 595–96 ("To limit the ability of shareholder-employees to minimize their salaries and thus the company's employment taxes, the government requires that they be paid reasonable salaries.") (quoting Michael Schlesinger, *Practical Guide to S Corporations* ¶ 102.9, pp. 5–6; ¶ 1302. 10, p. 461 (4th ed. 2007)).

[5] Regardless, however, whether intent is the sole factor in determining whether funds are "remuneration for services performed," or merely one factor to be considered in the totality of the circumstances, the Court would deny Plaintiff's request for summary judgment on the facts of this case. This is because, contrary to Plaintiff's assertion that DEWPC "clearly documented its intent to pay $24,000 in salary to Watson," consideration of evidence other than corporate documentation[FN8] gives rise to an equally reasonable inference that DEWPC structured Watson's salary and dividend payments in an effort to avoid federal employment taxes, with full knowledge that dividends paid to Watson were actually "remuneration for services performed." *See Hunt v. Cromartie,* 526 U.S. 541, 554, 119 S.Ct. 1545, 143 L.Ed.2d 731 (1999) ("Summary judgment in favor of the party with the burden of persuasion, however, is inappropriate when the evidence is susceptible of different interpretations or inferences by the trier of fact."). Indeed, intent often must be inferred from the totality of the circumstances, as one would hardly expect a corporate entity to thoroughly document an actual intent to avoid federal employment taxes by disguising remuneration as dividends. *See, e.g., Tool*

Producers, Inc. v. Commissioner of Internal Revenue, No. 95–2056, 1996 WL 515344, at *3 (6th Cir. Sept. 10, 1996) ("In determining the intent behind a corporate distribution, we have held that a court should 'look not to mere labels or to the self-serving declarations of the parties, but to more reliable criteria of the circumstances surrounding the transaction.' " (quoting *Jaques v. Commissioner of Internal Revenue,* 935 F.2d 104, 107 (6th Cir.1991)); *Electric & Neon,* 56 T.C. at 1340) (finding that a corporation may deduct the amount of compensation that it pays so long as it "actually intended" to pay the relevant funds as compensation, but noting that "whether such intent has been shown is, of course, a factual question ***965** to be decided on the basis of the particular facts and circumstances of the case"); *Paula,* 58 T.C. at 1058–59 ("It is now settled law that only if payment is made with the intent to compensate is it deductible as compensation. Whether such intent has been demonstrated is a factual question to be decided on the basis of the particular facts and circumstances of the case." (internal citations omitted)).[FN9]

FN8. For example, the Government has presented undisputed evidence that, amongst other things: Watson was the sole shareholder, employee, director, and officer of DEWPC; Watson had sole check writing authority for DEWPC; Watson determined his own salary; all of DEWPC's income came solely from LWBJ; Watson took interest free loans from DEWPC; and DEWPC paid out dividends totaling approximately 7–8 times Watson's salary for the years in question.

FN9. Plaintiff makes the following additional argument regarding intent in this case:

> The United States cannot dispute [that it never considered intent]. It has candidly admitted that it didn't even consider intent in making the reclassification, but instead looked solely at the 'fair value' of services provided by Watson to [DEWPC]. The sole focus of the United States in this case is on the reasonableness of the compensation. The United States has not considered intent, has not alleged intent, and has no evidence as to intent. On this record, [DEWPC] is clearly entitled to summary judgment in its favor.

Id. at 5–6. In making this assertion, Plaintiff references the testimony of the United States' Designee, Daniel Olson, who testified that, in reaching a conclusion that Watson's salary was set unreasonably low, "We didn't look to intent. We looked to the fair value of the services provided by the shareholder employee to determine the amounts that were subject to Social Security Tax." Pl.'s App. at 52 ("Q. So basically, the sole basis for the adjustment is the fact that you believe his salary was unreasonably low? A. Yes."). Plaintiff further argues in its Reply Brief that "the United States should not be allowed to belatedly question DEWPC's and Watson's intent and assert a basis for the assessment that was not properly disclosed to DEWPC during discovery." Pl.'s Reply at 6.

Given the Court's conclusion that intent is determined from the totality of the circumstances, and that intent is but one factor to be considered in characterizing corporate distributions to Watson as either dividends or wages, the Court finds Plaintiff's arguments in this regard to be utterly without merit for several reasons. First, the arguments fail because they turn on Plaintiff's now-rejected position that DEWPC's subjective intent solely controls how funds paid to Watson should be characterized. Second, Plaintiff's contention that Defendant did

not consider intent at all is belied by Olson's testimony stating that Defendant "believed that the primary reason for setting the salary at $24,000 was to minimize Social Security tax." Def.'s App. at 4. Finally, Defendant specifically denied Plaintiff's contention in its Statement of Material Facts that it "did not look to the intent" of DEWPC. *See* Pl.'s Facts ¶ 20. Indeed, the Court fully agrees with Defendant's further reply in support of its denial: "Simply because the United States did not *base its adjustment* on intent, that does not mean the United States did not *consider or examine* Watson's intent prior to making its adjustment, it just reached a different conclusion about intent than DEWPC would have the Court reach." Def.'s Response to Facts ¶ 20.

IV. CONCLUSION

In support of its Motion for Summary Judgment, Plaintiff points the Court to the following oft-cited statement of Judge Learned Hand:

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

See Pl.'s Reply Br. at 5 n. 2 (quoting *Commissioner of Internal Revenue v. Newman,* 159 F.2d 848, 850–51 (2d Cir.1947) (L. Hand, J., dissenting)). While the Court agrees fully with Judge Learned Hand, it would remind Plaintiff of Justice Oliver Wendell Holmes' succinct, yet equally eloquent statement in *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue:* "Taxes are what we pay for civilized society." 275 U.S. 87, 100, 48 S.Ct. 100, 72 L.Ed. 177 (1927) ***966** (Holmes, J., dissenting). Indeed, "the greatness of our nation is in no small part due to the willingness of our citizens to honestly and fairly participate in our tax collection system." *Manley v. Commissioner of Internal Revenue,* T.C. Memo 1983–558 (Sept. 12, 1983). Thus, while Plaintiff is free to structure its financial affairs in such a way as to avoid paying "more [taxes] than the law demands," Plaintiff is not free to structure its financial affairs in a way that avoids paying those taxes demanded by the law. In this case, the law demands that Plaintiff pay employment taxes on "all remuneration for employment," and there is clearly a genuine issue of material fact as to whether the funds paid to Watson, in actuality, qualify as such. Accordingly, for the reasons stated herein, Plaintiff's Motion for Summary Judgment (Clerk's No. 13) is DENIED.

IT IS SO ORDERED.

S.D.Iowa,2010.
David E. Watson, P.C. v. U.S.
714 F.Supp.2d 954, 105 A.F.T.R.2d 2010-2624, 2010-1 USTC P 50,444

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United States District Court,
S.D. Iowa,
Central Division.
DAVID E. WATSON, P.C., Plaintiff,
v.
UNITED STATES of America, Defendant.

No. 4:08–cv–442.
Dec. 23, 2010.

Background: Taxpayer brought action against United States seeking refund of taxes paid, interest, and fines.

Holding: The District Court, Robert W. Pratt, Chief Judge, held that evidence supported government's recharacterization of dividend and loan payments distributed by S corporation to its sole shareholder and employee, as wages.

Ordered accordingly.

West Headnotes

[1] Internal Revenue 220 ⚿3899.1

220 Internal Revenue
220V Income Taxes
220V(O) Small Business Corporations (Subchapter S Corporations)
220k3899 Distributions to Stockholders
220k3899.1 k. In general. Most Cited Cases

The characterization of funds disbursed by an S corporation to its employees or shareholders turns on an analysis of whether the payments at issue were made as remuneration for services performed, rather than on the stated intent of the corporation in characterizing the disbursements as wages or dividends.

[2] Internal Revenue 220 ⚿3071

220 Internal Revenue
220V Income Taxes
220V(A) In General
220k3071 k. Substance or form of transaction. Most Cited Cases

Tax consequences are governed by the economic realities of a transaction, not by the form of the transaction or labels given it by the parties.

[3] Internal Revenue 220 ⚿3899.1

220 Internal Revenue
220V Income Taxes
220V(O) Small Business Corporations (Subchapter S Corporations)
220k3899 Distributions to Stockholders
220k3899.1 k. In general. Most Cited Cases

In considering whether funds disbursed by an S corporation are remuneration for services performed, in addition to intent, other relevant considerations include, but are not limited to: (1) the employee's qualifications; (2) the nature, extent and scope of the employee's work; (3) the size and complexities of the business; (4) a comparison of salaries paid with the gross income and the net income; (5) the prevailing general economic conditions; (6) comparison of salaries with distributions to stockholders; (7) the prevailing rates of compensation for comparable positions in comparable concerns; (8) the salary policy of the taxpayer as to all employees; and (9) in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

[4] Internal Revenue 220 ⚿3899.1

220 Internal Revenue
220V Income Taxes
220V(O) Small Business Corporations (Subchapter S Corporations)
220k3899 Distributions to Stockholders
220k3899.1 k. In general. Most Cited

Cases

Evidence supported government's recharacterization of dividend and loan payments distributed by S corporation to its sole shareholder and employee, as wages; employee was an exceedingly qualified accountant, with over 20 years experience, in a reputable firm that grossed over $2 million in each of the applicable tax years, and his wages of $24,000 per year were incongruent with financial position of the firm, when compared to the $200,000 in distributions he received per year, and the salary that could reasonably be expected to be earned by persons with experience similar to employee's.

***878** Ronald L. Mountsier, Schneider Stiles Serangeli & Mountsier PC, Des Moines, IA, for Plaintiff.

Michael R. Pahl, U.S. Dept. of Justice Tax Division, Washington, DC, for Defendant.

ORDER ON BENCH TRIAL

ROBERT W. PRATT, Chief Judge.

On or about February 5, 2007, the United States of America ("Defendant" or "Government") recharacterized dividend and loan payments from David E. Watson, P.C. ("DEWPC" or "Plaintiff") to its sole shareholder and employee, David E. Watson ("Watson"), as wages. Compl. (Clerk's No. 1) ¶ 10. In light of this recharacterization, Defendant assessed additional employment taxes, interest and penalties against Plaintiff for each of the eight calendar quarters in 2002 and 2003. *Id.* DEWPC paid the fourth quarter 2002 assessment of $4,063.93 on or about April 14, 2007 and filed a claim for refund of that amount on or about June 27, 2007. *Id.* ¶¶ 12–13. Defendant denied Plaintiff's request for a refund on or about November 16, 2007. *Id.* ¶ 14.

Plaintiff filed the above-captioned action on October 31, 2008, contending that the assessments against it were illegal, and requesting a refund of the amount paid. *Id.* ¶ 3. Defendant filed an Answer and Counterclaim on February 12, 2009 (Clerk's No. 6), resisting Plaintiff's request for refund, and requesting Judgment against Plaintiff in the amount of $44,457.39 for additional assessments, penalties, and interest for the seven additional quarters in 2002 and 2003 for which Plaintiff did not make payment. The Court held a bench trial in the case on August 27, 2010. Clerk's No. 29. On September 27, 2010, the parties submitted proposed findings of fact and conclusions of law. Clerk's Nos. 33–34. The matter is fully submitted.

***879** I. CONSIDERATIONS ON REVIEW

Federal Rule of Civil Procedure 52(a) requires that in all cases tried without a jury or with an advisory jury, "the court shall find the facts specially and state separately its conclusions of law thereon." In determining the credibility of the witnesses and the weight to be accorded their testimony, the Court has taken into consideration: the character of the witnesses, their demeanor on the stand, their interest, if any, in the result of the trial, their relation to or feeling toward the parties to the trial, the probability or improbability of their statements as well as all the other facts and circumstances given in evidence. *Clark v. United States,* 391 F.2d 57, 60 (8th Cir.1968). With these considerations in mind, the Court finds facts and makes conclusions of law as articulated herein.

II. FINDINGS OF FACT

A. *Stipulated Facts*

The parties have stipulated to many of facts in this case. *See* Stip. Facts in Final Pretrial Order at 2–5 (Clerk's No. 19). Pursuant to the parties' stipulation, the Court finds the following facts in this case:

• David Watson ("Watson") graduated from the University of Iowa in 1982, with a bachelor's degree in business administration and a specialization in accounting. Stip. Fact ¶ L.

• Watson became a Certified Public Accountant ("CPA") in 1983, and received a master's degree in taxation from Drake University in 1993. *Id.* ¶ M.

• Between 1982 and 1992, Watson practiced accounting at two different accounting firms, one of which was Ernst & Young, where he began specializing in partnership taxation. *Id.* ¶ N.

• After leaving Ernst & Young, Watson became a 25% shareholder in an accounting firm called Larson, Watson, Bartling & Eastman ("LWBE"). *Id.* ¶ O.

• The remaining 75% of LWBE was owned by Tom Larson, Jeff Bartling, and Dale Eastman. Stip. Facts. ¶ P.

• On October 11, 1996, Watson incorporated DEWPC, an Iowa Professional Corporation. *Id.* ¶¶ A, Q.

• DEWPC is a validly organized and existing corporation, properly recognized as a separate entity for federal tax purposes. *Id.* ¶ B.

• Watson, at the times relevant to this action, and at all times generally, is the only individual who is or has ever been an officer, shareholder, director, or employee of DEWPC. *Id.* ¶¶ C, E, U, V.

• Watson's employment with DEWPC was, at all relevant times, governed by the terms and conditions of an Employment Agreement. *Id.* ¶ D.

• DEWPC has elected to be taxed as an S Corporation since the time of its inception. *Id.* ¶ I.

• After incorporating DEWPC in 1996, Watson caused DEWPC to become a 25% shareholder in LWBE, replacing Watson's own, individual shareholder status in DEWPC. *Id.* ¶ Q.

• The other partners in LWBE undertook similar action, such that LWBE became owned by DEWPC, Thomas E. Larson, P.C., Jeffrey T. Bartling, P.C., and Dale A. Eastman, P.C., rather than by Watson, Larson, Bartling, and Eastman individually. *Id.* ¶ R.

• By 1998, Paul Juffer, P.C. had become a partner and Dale A. Eastman, P.C. had ceased being a partner, such that LWBE changed its name to Larson, Watson, Bartling, & Juffer, LLP ("LWBJ"). *Id.* ¶ S. DEWPC remained a partner in LWBJ after the name change. *Id.* ¶ G.

• Watson is not personally a partner or employee of LWBJ; rather, he provides ***880** accounting services to LWBJ and its clients as an employee of DEWPC. *Id.* ¶¶ H, J, K.

• In the relevant years, 2002 and 2003, Watson could not practice accounting other than through LWBJ.[FN1] *Id.* ¶ F.

> FN1. The accounting work that Watson performed did not change significantly after LWBE became LWBJ. Stip. Facts. ¶ T.

• In 2002 and 2003, Watson received $24,000 designated as salary from DEWPC and paid employment taxes on that amount. *Id.* ¶ W.

• DEWPC's 2002 and 2003 cash income came exclusively in the form of distributions from LWBJ. *Id.* ¶ AA.

• Watson is the only person to whom DEWPC distributed money in 2002 or 2003. *Id.* ¶ X.

• There is no tax statute, regulation, or other rule that requires DEWPC to pay any minimum salary to Watson. *Id.* ¶ Y.

• There is no minimum amount of compensation that DEWPC was required to pay to Watson before it could declare and pay a dividend to Watson. *Id.* ¶ Z.

• On or about April 14, 2007, the United States received a payment of $4,063.93 from DEWPC, representing additional tax and related penalty and interest assessments made against DEWPC by the United States for the calendar quarter ending December 31, 2002. *Id.* ¶¶ BB, EE.

• Though DEWPC designated that the payment of

$4,063.93 be applied to the tax liability for the fourth quarter of 2002, the IRS erroneously applied the payment to the first quarter of 2002. *Id.* ¶¶ CC–DD.

• The parties agree that the erroneous application of Plaintiff's tax payment to the first quarter of 2002, rather than the fourth quarter of 2002, does not operate to deprive this Court of subject-matter jurisdiction. *Id.* ¶¶ FF–GG.

B. *Additional Findings of Fact*

Though the facts to follow were not stipulated to by the parties, the Court finds that they have been amply proven or established by evidence and testimony at trial.

1. *David Watson.*

• DEWPC regularly held shareholder meetings, at which Watson (DEWPC's only shareholder, employee, and officer) was the only participant. *See* Exs. 5–9, 18–19.

• Watson testified that, when LWBE first started, he received zero salary due to the start-up nature of the company. Tr. at 18–19.[FN2]

FN2. References to the transcript are to the unedited RealTime Transcript provided to the Court by the reporter.

• At the October 6, 1997 shareholder meeting, DEWPC authorized an annual salary for Watson of $12,000 for 1998. Ex. 8. DEWPC also approved payment to Watson of "dividends in the amount of available cash on hand after payment of compensation and other expenses of the corporation." *Id.*

• Watson testified that the partners agreed to a $12,000 annual salary for each in 1998 because "we had determined as a group that, as a minimum, we should have enough cash flow on hand in any given period to pay $1,000 a month to each partner, whether it was good times or bad." Tr. at 28.

• At the October 2, 2000 shareholder meeting, DEWPC authorized an annual salary for Watson of $24,000 for 2001. Ex. 19. DEWPC also approved payment to Watson of "dividends in the amount of ***881** available cash on hand after payment of compensation and other expenses of the corporation." *Id.*

• DEWPC approved the same salary and dividend arrangement with respect to Watson ($24,000 salary plus dividends) at its October 1, 2001, October 7, 2002, and October 6, 2003 shareholder meetings. Exs. 5–7.

• Watson testified at trial that the reason his compensation was set at $24,000 for the years 2002 and 2003 was because the partners of LWBJ "got together and discussed what we felt that we could pay on a regular and continuous basis regardless of the seasonability of our business." Tr. at 24. Watson further testified that the partners agreed that "regardless of whether it's a good economy or bad economy ... we felt that we'd grown to the point that, for each of the partners, that we could pay $2,000 a month for sure and then we'd have that cash available." *Id.* at 24–25.

• Watson testified that his salary for the last several years (post-dating the tax years at issue in this case) has been $48,000, again because the partners of LWBJ agreed that the business' cash flow was sufficient to pay a "minimum of $4,000 per month whether it was good times or bad." Tr. at 28.

• LWBJ maintained a "co-employer" relationship with Merit Resources, whereby twice a month, LWBJ submits funds to Merit Resources, and Merit Resources sends out payroll checks after accounting for relevant deductions. *Id.* at 28–29. Hence, Watson's paychecks and W–2s are issued by Merit Resources. *Id.* at 29.

• The gross revenues of LWBJ for 2002 were $2,349,556, and the gross revenues for LWBJ for 2003 were $2,949.739. Exs. 12–13; Tr. at 30.

• Watson's gross billings to clients were approxim-

ately $197,682.21 in 2002, and $200,380.36 in 2003. Exs. 14–15; Tr. at 31.

• Watson testified that LWBJ has approximately 30 employees, and that approximately 26–27 of those employees bill time to clients. Tr. at 33.

• Watson further testified that the partners of LWBJ incur substantially more of the expenses of the firm than any other employees, due to larger officers, more travel, and greater educational costs. *Id.* at 32–33.

• Watson testified that there are adverse effects of setting his salary at $24,000 annually for the relevant years, including lesser 401(k) contributions and matching, and lower Social Security contributions. *Id.* at 34–35.

• Watson testified that when he set his salary at $24,000, he was not concerned that he was doing any thing improper with regard to the payment of employment taxes because: 1) the salary was set for a business purpose; and 2) because the partners were "vaguely familiar" with case law where S corporation and C corporation distributions were recharacterized, but did not believe such case law was applicable to LWBJ because of differing fact patterns. *Id.* at 35–37.

• Watson, through DEWPC, received profit distributions from LWBJ totaling $203,651 for 2002. Ex. 21 at 19–20; Tr. at 41–42. Specifically, Watson received profit distributions of $36,151 during the first quarter of 2002; $55,000 during the second quarter of 2002; $26,500 during the third quarter of 2002; and $86,000 during the fourth quarter of 2002. Ex. 21 at 20; Tr. at 46–49.

• Watson, through DEWPC, received profit distributions from LWBJ totaling approximately $175,470, with payments totaling***882** $43,867.50 in each of the four quarters of 2003. Ex. 32.

• Watson is an experienced and successful Certified Public Accountant, and has advertised on the internet as having "significant experience in the taxation of S corporations." Tr. at 59–61.

• Watson has taught in Drake University's MBA program and keeps up on developments in the tax law. *Id.* at 64.

• Watson is aware of IRS Circular 230, which provides that return preparers cannot take a position on a tax return unless there is a realistic possibility of the position being sustained on its merits. *Id.* at 65.

• LWBJ routinely advises S corporations on taxation issues. *Id.* at 63.

• Payment of a lower wage results in the payee owing less employment ("FICA") taxes. *Id.* at 63–64.

• Watson has no documents reflecting conversations with other members of LWBJ regarding setting salaries, and no other members of LWBJ testified on the matter at trial. *Id.* at 66–67.

• Watson and the other partners of LWBJ did not "research the tax issues" when they put the structure of LWBJ together. *Id.* at 69.

• Watson testified that he and the other LWBJ partners did not raise their salaries to $48,000 in 2007 as a result of being audited on August 25, 2006, and did not consider factors identified in case law as relevant to setting salaries due to the different factual settings in the case law. *Id.* at 75–76.

• Watson testified that when setting his salary, he did not look at what comparable business paid for similar services. *Id.* at 80.

• Watson maintained at trial that the IRS has no authority whatsoever to reclassify dividends as wages in a situation where $12,000 or $5,000 in wages were paid, but agreed that a salary of a penny could be reclassified. *Id.* at 80–81.

• Watson was not surprised to discover that he was paying himself less salary than that typically made by a recent college graduate in accounting. *Id.* at

84.

• Watson testified that he would not hire himself out to someone else for $24,000 per year without having ownership in the business. *Id.* at 84.

• Watson testified that he is aware that the IRS has taken a public position that S Corporation employees must be paid reasonable compensation, but does not believe that there is statutory authority to support the IRS's position that wages must be reasonable. *Id.* at 88–90.

2. *Igor Ostrovsky.*

• Igor Ostrovsky is a general engineer [FN3] for the IRS, who offered testimony at trial regarding the fair market value of Watson's accounting services in 2002 and 2003. Tr. at 93.

> FN3. Ostrovsky testified that a general engineer for the IRS serves acts as a consultant on audits, and assists revenue agents in the valuation of businesses, depreciation, tangible and intangible assets, and reasonable compensation, amongst other things. Tr. at 95.

• Ostrovsky holds bachelor of science degrees in electrical engineering and mathematics and a Masters of Business Administration with concentration in finance, all from the University of Minnesota. *Id.* at 95.

• Ostrovsky has acted as an expert for the IRS in evaluating the reasonableness of taxpayer compensation on an estimated 20–30 cases. *Id.* at 95–96.

• Ostrovsky has made presentations regarding issues of reasonable compensation***883** in his role as an engineer with the IRS. *Id.* at 98.

• Ostrovsky has testified three times in court on issues of reasonable compensation. *Id.* at 99.

• Ostrovsky is a member of the National Association of Certified Valuation Analysts. *Id.* at 101.

• Ostrovsky testified that he did not share his expert report with anyone at the IRS and that no one at the IRS attempted to influence his testimony in any way. *Id.* at 101.

• Ostrovsky is competent to render an expert opinion regarding the fair market value of Watson's accounting services, and is qualified as an independent expert in the field of compensation, specializing in the fair market value of S corporations and other corporate entities, based on his experience training, and education. *Id.* at 105.

• Ostrovsky's expert opinion is that for the years 2002 and 2003, the fair market value of Watson's accounting services to DEWPC and LWBJ were $91,044 per year. *Id.* at 106.

• In reaching his opinion, Ostrovsky evaluated the financial performance of both Watson and LWBJ. *Id.* at 109.

• Relying on the Risk Management Association ("RMA") annual statement studies Ostrovsky opined that DEWPC was "significantly more profitable than comparably sized firms, accounting firms, and they were as much as ten times more profitable than comparable firms," and that LWBJ was "at least three times more profitable than comparably sized firms in the[ ] accounting field." *Id.* at 110.

• Ostrovsky also found that the Leo Troy Almanac of Business and Industrial Financial Ratios, which contains tax return data on all C and S corporations, supports a conclusion that DEWPC was "considerably more profitable than its peers" and that LWBJ "was at least twice as profitable as [its] peers." *Id.* at 112.

• Ostrovsky additionally looked at information relating to compensation for accountants in rendering his expert opinion. *Id.* at 112.

• Relying on a survey published by the University of Iowa regarding starting salaries for new accounting graduates, Ostrovsky opined that Watson's salary of $24,000 was lower than: 1) the median re-

ported starting salary for new graduates in 2002 ($40,000); 2) the median reported starting salary for new graduates in 2003 (just under $40,000); and 3) the minimum reported offer for an accounting graduate in 2002 ($26,000). *Id.* at 113, 131.

• Using compensation data from Robert Half International, a placement agency for individuals in accounting and finance, Ostrovsky determined that compensation for individuals in positions subordinate to that of Watson was significantly higher than the compensation Watson claimed in 2002 and 2003. *Id.* at 114. In reaching this conclusion, Ostrovsky deemed Watson, an individual with approximately 20 years of accounting experience as akin to a director/manager, defined by the Half survey as a person with 11–plus years of experience. *Id.* Persons in positions of lesser experience to that of the director/manager position had a range of compensation in 2002 from between the "middle sixties to almost $90,000." *Id.* Ostrovsky made adjustments to account for region and education. *Id.* at 114–15.

• Ostrovsky also relied on the portion of the Management of an Accounting Practice ("MAP") survey, conducted by the American Institute of Certified Public Accountants, relevant specifically to the ***884** Iowa Society of CPAs. Tr. at 116. The MAP survey indicated that an average "owner" (defined as both an investor in and an employee of a firm) in a firm the size of LWBJ would receive approximate $176,000 annually, reflecting both compensation and return on investment. *Id.* at 117–18. A director (defined as solely an employee with no investment interest) would realize approximately $70,000 compensation annually. *Id.* at 118.

• To properly determine a comparable salary for Watson, free of "return on investment," Ostrovsky evaluated billing rates for owners and directors and found that owners billed at a rate approximately 33% higher than did a director. *Id.* at 119. Accordingly, Ostrovsky increased the director's estimated compensation by 33% to obtain an estimated comparable salary for someone in Watson's position of approximately $93,000. *Id.* at 119–20. Ostrovsky then reduced this amount to $91,044 to account for certain untaxable fringe benefits. *Id.* at 120.

• Ostrovsky believes his estimate, providing that reasonable compensation for Watson would have been approximately $91,044 for each of 2002 and 2003, to be an "extremely conservative determination." *Id.* at 120.

• Ostrovsky concedes that part of the reason LWBJ appears more profitable than its comparators is because it pays lower salaries. *Id.* at 129–30. Ostrovsky did not evaluate how LWBJ or DEWPC's profitability would look *after* the recharacterization of dividends as wages. *Id.*

• Ostrovsky's opinion changed over time as he became aware of more facts regarding Watson's engagement with DEWPC and LWBJ following Watson's deposition, and as he identified some errors in his initial calculations. *Id.* at 133–37.

• Ostrovsky's opinion is based on analyzing Watson as a de facto partner in LWBJ, not based on his status in relation to the smaller DEWPC. *Id.* at 151.

• Ostrovsky's opinion of the fair market value of Watson's services was based on an average billing rate, rather than on Watson's actual billing rate. *Id.* at 158.

3. *Daniel Olson.*

• Daniel Olson testified via deposition designations.

• Olson testified that the amount of compensation properly paid to Watson would be determined the same regardless of whether DEWPC had S or C corporation status. Dep. at 6.

• Olson testified that the United States does not take the position that any special rules are applicable to DEWPC or to Watson, or that there is any tax, statute, regulation, or other rule that would require DEWPC to pay Watson any minimum amount of compensation. *Id.* at 6.

• Olson testified that the sole basis for Defendant's

position that portions of the 2002 and 2003 dividend payments to Watson should be recharacterized as wages is Defendant's belief that DEWPC paid Watson an unreasonably low salary. *Id.* at 7, 36.

• Olson testified that the Defendant does not contend that DEWPC failed to properly authorize loans or dividend payments to Watson. *Id.* at 8.

• Olson testified that the Defendant does not contend that there is any minimum amount of compensation that DEWPC must pay Watson before it can pay him dividends; rather, Defendant contends only that FICA taxes be paid on the fair value of services provided by Watson to DEWPC. *Id.* at 14–15.

• Olson testified that the Defendant believes the primary reason for setting Watson's salary at $24,000 was to minimize Social Security tax. *Id.* at 24.

***885** • Olson testified that, in reaching its determination, the Defendant "didn't look to intent. We looked to the fair value of the services provided by the shareholder employee to determine the amounts that were subject to Social Security tax." *Id.* at 25.

• Olson testified that setting Watson's salary low could have had a negative impact on his later entitlement to Social Security benefits. *Id.* at 25–26.

III. LEGAL CONCLUSIONS

The Federal Insurance Contributions Act ("FICA") imposes "on every employer an excise tax, with respect to having individuals in his employ, equal to [a certain] percentage[ ] of the wages paid by him with respect to employment." 26 U.S.C. § 3111(a). The term "wages" is defined broadly by FICA as "all remuneration for employment." [FN4] 26 U.S.C. § 3121(a). Thus, an employer, such as DEWPC, is required to pay FICA tax on all wages paid to its employees. *See HB & R, Inc. v. United States,* 229 F.3d 688, 690 (8th Cir.2000). An employer is not, however, obligated to pay FICA tax on "other types of employee income, such as dividends." *Id.* There is no dispute in this case that Watson was an employee of DEWPC. There is, likewise, no dispute that if the funds paid to Watson are properly characterized as dividends, DEWPC need not pay FICA taxes on them, but that if the funds are properly recharacterized as wages, DEWPC would be required to pay FICA tax.

> FN4. The definition of "wages" contains numerous exceptions, none of which are applicable in the present case. *See* 26 U.S.C. § 3121(a)(1)-(23).

The IRS assessments against DEWPC are "entitled to a legal presumption of correctness." *United States v. Fior D'Italia, Inc.,* 536 U.S. 238, 242, 122 S.Ct. 2117, 153 L.Ed.2d 280 (2002). Thus, DEWPC bears the burden to prove by a preponderance of the evidence that the IRS tax assessments are incorrect, as well as to prove what the correct assessments should be. *See Armstrong v. United States,* 366 F.3d 622, 625–26 (8th Cir.2004) (citing *IA 80 Group, Inc. v. United States,* 347 F.3d 1067, 1071 (8th Cir.2003)); *Mattingly v. United States,* 924 F.2d 785, 787 (8th Cir.1991). DEWPC additionally bears the burden of proving that the wages paid to Watson were reasonable. *RTS Inv. Corp. v. C.I.R.,* 877 F.2d 647, 650 (8th Cir.1989) ("The determination of what is reasonable compensation is a question of fact.... The burden of proving reasonableness of compensation is on the taxpayer."). The fact that the United States is defending this suit using a different methodology than the one it used in making its initial assessment against DEWPC is of little import, and does not change the Court's analysis. *See Blansett v. United States,* 283 F.2d 474, 478 (8th Cir.1960) ("[A] deficiency assessment may be sustained upon any legal ground supporting it, even though the Commissioner did not rely thereon when the assessment was made. If the assessment is right on any theory it must be sustained.") (citing *Helvering v. Gowran,* 302 U.S. 238, 58 S.Ct. 154, 82 L.Ed. 224 (1937)).

DEWPC contends that it unquestionably inten-

ded to pay Watson compensation of $24,000 per year, and that amounts distributed to Watson in excess of that amount are properly classified as dividends and/or loans. DEWPC points out that the United States has stipulated that it does not have the authority to require DEWPC to pay Watson any particular minimum salary before it can pay dividends to Watson. According to DEWPC, the United States' ability to assess additional employment ***886** taxes is limited to taxing payments which were intended to be compensatory in nature. Thus, DEWPC maintains, as it did at summary judgment, that it is the intent of DEWPC that controls whether funds paid to Watson are categorized as wages or as dividends. DEWPC claims its intent is evidenced by Watson's testimony and trial evidence showing that DEWPC opted to pay Watson $24,000 annually for "legitimate business reasons, and not for the purposes of reducing [DEWPC's] employment tax liability, and therefore, [DEWPC] and Watson's classification of the distributions to Watson in excess of $24,000.00 per year as dividends should not be ignored." Pl.'s Proposed Findings of Fact & Conclusions of Law (hereinafter Pl.'s Br.) at 6.

As it did at summary judgment, DEWPC cites *Electric & Neon, Inc. v. Commissioner of Internal Revenue,* 56 T.C. 1324 (1971), *Paula Construction Co. v. Commissioner of Internal Revenue,* 58 T.C. 1055 (1972), and *Pediatric Surgical Associates, P.C. v. Commissioner of Internal Revenue,* T.C. Memo 2001–81 (Apr. 2, 2001), in support of its position. After evaluating each of those cases in its summary judgment order (Clerk's No. 17),[FN5] the Court determined that the cases were inapposite, because in each of those cases, "the *taxpayer* was attempting to recharacterize funds, whereas in the present case, it is the Government that is attempting to recharacterize the funds." Clerk's No. 17 at 10–11. The Court noted that the distinction was discussed in the 1993 edition of the *Akron Tax Journal:*

> "The courts and the Service seem to have adopted a double standard. In the context of taxpayer attempts at recharacterization, "intent" has dominated the decisions. But the courts have found intent irrelevant where the Service is arguing for recharacterization. This outcome may be justified to the extent the taxpayer is distorting the actual character of payments received from the corporation for tax advantage."

Id. at 18 (quoting Harrington, Kirsten, *Employment Taxes: What Can the Small Businessman Do?* 10 Akron Tax J. 61, 69 (1993)). The Court further stated that the incentive for S corporations to distort the actual character of payments to its shareholders/employees to obtain a tax advantage had been recently articulated by Judge Richard A. Posner:

> "The distinction between accounting profits, losses, assets, and liabilities, on the one hand and cash flow on the other is especially important when one is dealing with either a firm undergoing reorganization in bankruptcy or a small privately held firm; in the latter case, in order to avoid double taxation (corporate income tax plus personal income tax on dividends), the company might try to make its profits disappear into officers' salaries. *See Menard, Inc. v. Commissioner,* 560 F.3d 620, 621 (7th Cir.2009). The owners of a Subchapter S corporation, however, have the oppositive incentive-to alchemize salary into earnings. A corporation has to pay employment taxes, such as state unemployment insurance tax and social security tax, on the salaries it pays. A

FN5. The Court incorporates by reference both the undisputed facts and the legal analysis in its May 27, 2010, 714 F.Supp.2d 954 (S.D.Iowa 2010), ruling on summary judgment. *See* Clerk's No. 17. Given that the issues at the bench trial are virtually identical to those raised at summary judgment, this Order will quote extensively from the May 27, 2010 summary judgment order, though not always with direct citation thereto.

> Subchapter S corporation can avoid paying them by recharacterizing salary as a distribution of corporation income."
>
> ***887** *Id.* at 11 (quoting *Constr. & Design Co. v. United States Citizenship & Immigration Servs.*, 563 F.3d 593, 595–96 (7th Cir.2009)).

The Court reaffirms the analysis it undertook in evaluating DEWPC's motion for summary judgment. DEWPC's assertion that its own intent controls the characterization of funds paid to Watson is only minimally supported by the case law it cites, and is undermined by relevant IRS rulings and case law that are more in line with the facts of this case than *Electric & Neon, Paula,* or *Pediatric Surgical Associates, P.C.* First, in a 1974 Revenue Ruling, two sole shareholders of a corporation sought advice on whether they would incur liability for employment taxes on facts similar to the present case. Rev.Rul. 74–44 (1974). The shareholders "performed services for the corporation. However, to avoid the payment of Federal employment taxes, they drew no salary from the corporation but arranged for the corporation to pay them 'dividends' [in an amount equal to] the amount they would have otherwise received as reasonable compensation for services performed." *Id.* The IRS stated that the dividends "were reasonable compensation for services" performed by the shareholders "rather than a distribution of the corporation's earnings and profits." *Id.* Accordingly, the dividends would properly be characterized as "wages" for which "liability was incurred for the taxes imposed by [FICA and other federal employment taxes]." *Id.* This conclusion comports with an earlier Revenue Ruling stating:

> Neither the election by the corporation as to the manner in which it will be taxed for Federal income tax purposes nor the consent thereto by the stockholder-officers has any effect in determining whether they are employees or whether payments made to them are 'wages' for Federal employment tax purposes.
>
> Rev.Rul. 73–361 (1973).

Of the relevant case law, the Court finds *Joseph Radtke, S.C. v. United States* and *Spicer Accounting, Inc. v. United States* particularly persuasive. In *Joseph Radtke, S.C.,* the district court determined that certain funds designated as dividends were actually compensation for which an S corporation owed employment taxes. 712 F.Supp. 143 (E.D.Wis.1989). Radtke, a Wisconsin attorney, had created an S corporation to provide legal services in Milwaukee. *Id.* at 144. Radtke was the firm's sole director, shareholder, and full-time employee, but he took no salary, receiving instead $18,225 in dividend payments from the corporation in 1982. *Id.* Since Radtke received the funds as dividends, rather than as wages, the corporation did not pay employment taxes on them. *Id.* The IRS recharacterized the funds as wages and assessed FICA and other employment taxes on them, along with penalties and interest. *Id.* at 145. In concluding that the funds were properly recharacterized as wages rather than dividends, the district court stated:

> I am not moved by the Radtke corporation's connected argument that "dividends" cannot be "wages." Courts reviewing tax questions are obligated to look at the substance, not the form, of the transactions at issue. *Frank Lyon Co. v. United States,* 435 U.S. 561, 573, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978). Transactions between a closely held corporation and its principals, who may have multiple relationships with the corporation, are subject to particularly careful scrutiny. *Tulia Feedlot, Inc. v. United States,* 513 F.2d 800, 805 (5th Cir.1975). Whether dividends represent a distribution of profits or instead are compensation for employment is a matter***888** to be determined in view of all the evidence. *Cf. Logan Lumber Co. v. Commissioner,* 365 F.2d 846, 851 (5th Cir.1966) (examining whether dividends were paid in guise of salaries).
>
> In the circumstances of this case—where the corporation's only director had the corporation pay himself, the only significant employee, *no* salary

> for substantial services—I believe that Mr. Radtke's "dividends" were in fact "wages" subject to FICA and FUTA taxation. His "dividends" functioned as remuneration for employment....
>
> An employer should not be permitted to evade FICA and FUTA by characterizing *all* of an employee's remuneration as something other than "wages." *Cf. Greenlee v. United States,* 87–1 U.S.T.C. ¶ 9306[, 661 F.Supp. 642] (corporation's interest-free loans to sole shareholder constituted "wages" for FICA and FUTA where loans were made at shareholder's discretion and he performed substantial services for corporation). This is simply the flip side of those instances in which corporations attempt to disguise profit distributions as salaries for whatever tax benefits that may produce.

Id. at 146. Radtke appealed the district court's decision to the Seventh Circuit, which framed the issue as, "whether, based on the statutes and unusual facts involved, the payments at issue were made to Mr. Radtke as remuneration for services performed." *Joseph Radtke, S.C. v. United States,* 895 F.2d 1196, 1197 (7th Cir.1990). "As the district judge determined, these payments were clearly remuneration for services performed by Radtke and therefore fall within the statutory and regulatory definitions of wages." *Id.*

Relying on *Radtke* and the Revenue Rulings cited *supra,* the Ninth Circuit also determined, in a case remarkably similar to the one at bar, that payments designated as dividends can properly be recharacterized by the IRS as wages subject to federal employment taxes. *See Spicer Accounting, Inc. v. United States,* 918 F.2d 90 (9th Cir.1990). Spicer, a licensed public accountant, was the president, treasurer, and director of an S Corporation, Spicer Accounting, Inc. *Id.* at 91. Spicer and his wife were the only stockholders in the corporation, and Spicer performed substantial services for the corporation. *Id.* at 91–92. Spicer had an arrangement with the corporation whereby he would "donate his services to the corporation" and "withdraw earnings in the form of dividends." *Id.* at 91. For tax years 1981 and 1982, the IRS recharacterized dividend payments to Spicer by the corporation as wages, and assessed taxes, penalties, and interest against the corporation for unpaid employment taxes. *Id.* The Ninth Circuit affirmed the characterization of payments to Spicer as wages, emphasizing that it is the substance rather than the form of the transaction that matters, and noting that "salary arrangements between closely held corporations and its shareholders warrant close scrutiny." *Id.* at 92. Citing to *Radtke,* the *Spicer* court found that, "regardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments are for remunerations for services rendered." *Id.* at 93. According, "Mr. Spicer's intention of receiving the payments as dividends has no bearing on the tax treatment of these wages." *Id.*

Other courts have reached conclusions similar to those in *Radtke* and *Spicer.* For instance, in *Veterinary Surgical Consultants v. Commissioner of Internal Revenue,* the United States Tax Court rejected a petitioner's argument that amounts paid to its sole shareholder were distributions***889** of corporate net income rather than wages. 117 T.C. 141, 145 (2001).

> Dr. Sadanaga performed substantial services on behalf of petitioner [the S corporation]. The characterization of the payment to Dr. Sadanaga as a distribution of petitioner's net income is but a subterfuge for reality; the payment constituted remuneration for services performed by Dr. Sadanaga on behalf of petitioner. An employer cannot avoid Federal employment taxes by characterizing compensation paid to its sole director and shareholder as distributions of the corporation's net income, rather than wages. Regardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments represent remunerations for services rendered.

Id. at 145–46. Likewise, in *JD & Associates, Ltd. v. United States,* Jeffrey Dahl, the sole share-

holder, officer, and director of the plaintiff S corporation, received an annual salary of $19,000.00 in 1997 and $30,000.00 for each of 1998 and 1999. No. 3:04–cv–59, at 4 (D.N.D. May 19, 2006) (available in Def.'s App. to Summ. J. at 146–56 (Clerk's No. 14.3)). Dahl also received dividends of $47,000 for 1997, $50,000 for 1998, and $50,000 for 1999. *Id.* at 5. As in the present case, the IRS determined that Dahl's salary was unreasonably low, and assessed employment taxes, interest, and penalties against the corporation after recharacterizing portions of the dividend payments as wages to Dahl. *Id.* at 1. Applying an Eighth Circuit test to determine whether Dahl's compensation was reasonable, the district court concluded it was not and upheld the tax assessments against the corporation. *Id.* at 9–11.

[1][2][3] Upon review of the law, the Court holds that the characterization of funds disbursed by an S corporation to its employees or shareholders turns on an analysis of whether the "payments at issue were made ... as remuneration for services performed." *Radtke,* 895 F.2d at 1197. This approach conforms with well settled jurisprudence holding that tax consequences are governed by the economic realities of a transaction, not by the form of the transaction or labels given it by the parties. *See, e.g., Boulware v. United States,* 552 U.S. 421, 430, 128 S.Ct. 1168, 170 L.Ed.2d 34 (2008) ("The colorful behavior described in the allegations requires a reminder that tax classifications like 'dividend' and 'return of capital' turn on 'the objective economic realities of a transaction rather than ... the particular form the parties employed.' ") (quoting *Frank Lyon,* 435 U.S. at 573, 98 S.Ct. 1291); *Pinson v. Comm'r of Internal Revenue,* T.C. Memo 2000–208 (July 6, 2000) ("As a general rule, the substance of a transaction controls tax treatment." (citing *Gregory v. Helvering,* 293 U.S. 465, 469–70, 55 S.Ct. 266, 79 L.Ed. 596 (1935)); *True v. United States,* 190 F.3d 1165, 1173–74 (10th Cir.1999) (stating that "substance over form" is a "fundamental tax principle [that] operates to prevent the 'true nature of a transaction from being disguised by mere formalisms, which exist solely to alter tax liabilities' " (quoting *Comm'r v. Court Holding Co.,* 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981 (1945)); *Leisure Dynamics, Inc. v. Comm'r of Internal Revenue,* 494 F.2d 1340, 1345 (8th Cir.1974) ("For tax purposes, we must concern ourselves with actualities rather than the refinements of title; our concern is with the substance, not form."). Thus, a determination of whether funds are "remuneration for services performed," must be made "in view of all the evidence." *Radtke,* 712 F.Supp. at 145. While intent is unquestionably a consideration in the analysis, it is by no means the only one. Other relevant considerations include, but are ***890** not limited to: 1) the employee's qualifications; 2) the nature, extent and scope of the employee's work; 3) the size and complexities of the business; 4) a comparison of salaries paid with the gross income and the net income; 5) the prevailing general economic conditions; 6) comparison of salaries with distributions to stockholders; 7) the prevailing rates of compensation for comparable positions in comparable concerns; 8) the salary policy of the taxpayer as to all employees; and 9) in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years. *See Charles Schneider & Co., Inc. v. Comm'r of Internal Revenue,* 500 F.2d 148, 151 (8th Cir.1974) (identifying factors to be considered in determining the "reasonableness of compensation").

After considering the trial testimony, and all exhibits and evidence in this case, the Court finds Watson's assertion that DEWPC "intended" to pay Watson a mere $24,000 in compensation for the tax years 2002 and 2003 to be less than credible. Indeed, the Court is convinced upon the entire record that substantial portions of the distributions from LWBJ to DEWPC, and in turn to Watson were, in fact, "remuneration for services performed." Watson is an exceedingly qualified accountant, with both bachelor's and advanced degrees and with approximately 20 years experience in accounting and taxation. He worked approximately 35 to 45 hours

per week as one of the primary earners in a reputable and well-established firm, which had earnings well in excess of comparable firms, with over $2 million in gross revenues for 2002 and nearly $3 million in gross revenues for 2003. Tr. at 30, 68, 78; Exs. 12–13. A reasonable person in Watson's role within LWBJ would unquestionably be expected to earn far more than a $24,000 salary for his services. As such, the $24,000 salary Watson opted to pay himself as DEWPC's sole shareholder, officer, and employee, is incongruent with the financial position of LWBJ and in light of Watson's experience and contributions to LWBJ, and when compared to the approximately $200,000 in distributions DEWPC received in each of 2002 and 2003. Moreover, the $24,000 salary is low when compared to salaries that could reasonably be expected to be earned by persons with experience similar to that of Watson, and holding a position such as Watson held in a firm comparable to LWBJ. Indeed, upon evaluation of all of the facts and circumstances in this case, the Court is convinced that DEWPC structured Watson's salary and dividend payments in an effort to avoid federal employment taxes, with full knowledge that dividends paid to Watson were actually "remuneration for services performed." *See, e.g., Tool Producers, Inc. v. Comm'r of Internal Revenue,* No. 95–2056, 1996 WL 515344, at *3 (6th Cir. Sept. 10, 1996) ("In determining the intent behind a corporate distribution, we have held that a court should 'look not to mere labels or to the self-serving declarations of the parties, but to more reliable criteria of the circumstances surrounding the transaction.' ") (quoting *Jaques v. Comm'r of Internal Revenue,* 935 F.2d 104, 107 (6th Cir.1991)); *Electric & Neon,* 56 T.C. at 1340 (finding that a corporation may deduct the amount of compensation that it pays so long as it "actually intended" to pay the relevant funds as compensation, but noting that "whether such intent has been shown is, of course, a factual question to be decided on the basis of the particular facts and circumstances of the case"); *Paula,* 58 T.C. at 1058–59 ("It is now settled law that only if payment is made with the intent to compensate is it deductible as compensation. Whether such intent has been demonstrated is a factual question to be decided***891** on the basis of the particular facts and circumstances of the case." (internal citations omitted)).

The Court further finds the testimony of Igor Ostrovsky to be abundantly reasonable and credible. Ostrovsky's calculations, though they changed somewhat over time due to his receipt of additional information, are amply supported in their methodology and reach a well-reasoned conclusion as to what constitutes a "reasonable" salary for Watson under the facts and circumstances of this case. Accordingly, the Court adopts Ostrovsky's calculations and finds that, for each of the years 2002 and 2003, the reasonable amount of Watson's "remuneration for services performed" was $91,044. This amount is $67,044 more than the $24,000 annual salary paid by DEWPC to Watson, and DEWPC, accordingly, is obligated to pay the appropriate FICA taxes, interest, and penalties on the recharacterized amounts.

[4] Having established that DEWPC owes FICA taxes, penalties and interest on an additional $67,044 for each of the tax years 2002 and 2003, there remains one additional issue. Specifically, since taxes are imposed on a quarterly, rather than on an annual, basis, there still exists the question of whether the $67,044 should be imposed as wages ratably throughout each of the two years. DEWPC argues that, based on the Government's initial assessments, the amount of compensation would all be taxable only in the first two quarters of each tax year, with the remainder of funds paid to Watson comprising distributions only in the third and fourth quarters. According to Plaintiff's calculations, this would result in DEWPC only owing employment taxes, interest and penalties for recharacterized wages in the first two quarter of each tax year, meaning that DEWPC should succeed on its claim for a refund for the fourth quarter of 2002. The Court disagrees. An evaluation of the record demonstrates that Watson was paid his allotted

$24,000 salary in equal installments throughout the course of each tax year, with payments occurring in each of the four quarters of 2002 and 2003. The designated "distribution" payments were also made in installments throughout the year, with payments occurring in each of the four quarters of 2002 and 2003. Plaintiff offers no legal support for the proposition it would now have the Court adopt, i.e., that Watson received all his remuneration for services rendered in the first two quarters of each tax year. Indeed, had Watson's "salary" been set at $91,044 to begin with, he undoubtedly would have received such salary in ratable installments throughout each year, as virtually all salaried employees do. Accordingly, the Court finds that, unless the parties agree otherwise, the additional $67,044 in compensation should be applied ratably throughout each of the two years, with $16,761 in additional compensation attributed to each of the eight quarters of 2002 and 2003.

IV. CONCLUSION

For the reasons stated herein, the Court concludes that Plaintiff's $24,000 salary in 2002 and 2003 was unreasonable. The Government's recharacterization of $67,044 in dividend payments to Watson for each of the tax years 2002 and 2003 is amply supported by the evidence, as an annual salary of $91,044 for Watson is reasonable on the specific facts and circumstances of this case. Accordingly, DEWPC fails on its claim for refund of all taxes paid for the fourth quarter of 2002,[FN6] and the United ***892** States has prevailed on its counterclaim that DEWPC owes additional employment taxes, penalties and interest on a $91,044 salary for Watson for 2002 and 2003. The parties shall submit a joint proposed judgment, with final calculations of employment taxes, interest and penalties owed, based on the Court's findings of facts and conclusions of law within thirty days of the date of this Order.

FN6. The Court notes that, depending on the final tax calculations, DEWPC may be entitled to a *partial* refund of tax payments made for the fourth quarter of 2002. This is because the Government initially recharacterized more of the dividends as wages, and the assessments were issued on these higher amounts. Ultimately, however, since DEWPC will owe additional sums for the other seven quarters of 2002 and 2003, any potential refund would be offset by additional amounts owed.

IT IS SO ORDERED.

S.D.Iowa,2010.
David E. Watson, P.C. v. U.S.
757 F.Supp.2d 877, 107 A.F.T.R.2d 2011-311, 2011-1 USTC P 50,443

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EXHIBIT 6

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NORTH DAKOTA
SOUTHEASTERN DIVISION

JD & Associates, Ltd.,	)	
Plaintiff,	)	**FINDINGS OF FACT AND CONCLUSIONS OF LAW**
vs.	)	
	)	Case No. 3:04-cv-59
United States of America,	)	
Defendant.	)	

FINDINGS OF FACT

Background

1. The current action concerns employment taxes, with concomitant interest and penalties, assessed against JD & Associates, Inc. (hereafter "JDA") on the salary it paid to Jeffrey Dahl, its sole shareholder, officer, and director, for twelve quarters.

2. On May 11th, 2004, JDA brought this action seeking a refund of $2,861.44 which it paid during the first quarter of 1997 (doc. #1).

3. The United States filed an answer and counterclaim on July 29, 2004, wherein it resisted Plaintiff's suit and further sought $22,385.92 for additional tax assessments (doc. #5). The assessments were based on the theory that JDA paid unreasonably low wages to Dahl while simultaneously paying out large dividends to its sole shareholder, who was Dahl. These figures were derived from all quarters from 1997 through 1999, excepting the first quarter of 1997 which had already been paid. They are broken down as follows:

Period	Additional FICA withholding tax	Failure to deposit penalty	Assessed interest
Second quarter 1997	$1,637.72	$163.77	$785.93
Third quarter 1997	$1,637.72	$163.79	$730.95
Fourth quarter 1997	$1,637.72	$163.77	$678.24
First quarter 1998	$1,287.95	$128.80	$495.33
Second quarter 1998	$1,287.95	$128.80	$459.73
Third quarter 1998	$1,287.95	$128.80	$424.83
Fourth quarter 1998	$1,287.95	$128.80	$392.07
First quarter 1999	$1,360.94	$136.09	$392.04
Second quarter 1999	$1,361.08	$136.11	$357.07
Third quarter 1999	$1,360.94	$136.09	$320.60
Fourth quarter 1999	$1,361.08	$136.11	$289.20

4. The additional assessments are based on an IRS audit that concluded that a reasonable salary for Dahl would be substantially higher than the ones submitted to the IRS. The additional taxation is based on the following assessment:

Year	Amount reported as compensation	IRS determination of fair compensation	Additional amount subject to tax
1997	$19,000	$61,817	$42,817
1998	$30,000	$63,672	$33,072
1999	$30,000	$65,582	$35,582

5. Dahl exhausted his administrative remedies with the Internal Revenue Service before initiating litigation.

Dahl and JD & Associates, Ltd.

6. Jeffrey Dahl is an accountant in Fargo, ND and the principal of JDA.

7. Dahl is 44 years old. He was born and raised on a farm near Felton, Minnesota and graduated from high school in Glydon, Minnesota.

8. Dahl attended Mayville State University and Moorhead State University (now Minnesota State University, Moorhead) and received a college degree from the latter in the subject of accounting.

9. Dahl is a Certified Public Accountant (CPA). After graduation, he worked for Ernst & Young in Minneapolis, then later Charles Bailly in Fargo, and Aerial Contractors in Fargo. At Ernst & Young and Charles Bailly, Dahl was an auditor. While at Aerial Contractors, Dahl provided services as a bookkeeper and prepared financial statements.

10. Dahl began preparing tax returns for others as a volunteer while in college. He began preparing them professionally in 1990 for the 1989 tax year.

11. JDA is an accounting firm formed by Dahl in 1993. It is located in Fargo, ND.

12. JDA is registered as a subchapter S corporation for federal tax purposes. S corporations are referred to as passthrough entities because the items of income and expense are not taxed at the corporate level, but are passed through to each shareholder in his or her pro rata share. The individual shareholder then reports the income and expenses on his or her individual tax return.

13. Dahl is the sole owner of JDA.

14. JDA's net worth does not exceed $2 million.

15. JDA performs tax services, bookkeeping, and review of financial statements for its customers. Roughly 40% of its services are tax-related.

16. Other than Dahl, JDA had two employees in 1997 and three employees in 1998 and 1999.

17. Dahl has been the sole shareholder, officer, and director of JDA since its inception. He serves as JDA's president, vice-president, secretary, and treasurer.

18. At JDA, Dahl prepares tax returns, performs bookkeeping services, and reviews

financial statements and related fieldwork.

19. Dahl is responsible for all of JDA's personnel hiring and retention decisions.

20. Dahl pays all of JDA's bills, and is the only person authorized to write checks for JDA.

21. Dahl maintains the books and records of JDA, including financial books, corporate minutes, and tax returns.

22. Dahl is responsible for the overall management responsibilities at JDA, including the assignment of work to other employees.

23. Dahl performs the majority of review of other employee's work.

24. Dahl is responsible for JDA's marketing.

25. From 1996 to 1999, JDA saw a steady increase in the amount it billed its customers. In 1996, JDA billed $9,000 more than the previous year, in 1997 JDA billed $53,830 more than it did in 1996, in 1998 JDA billed $8,000 more than 1997, and in 1999, JDA billed $41,000 more than it did in 1998.

26. The gross receipts for JDA during the 1997 year were $182,158, with an ordinary income of $76,221, the gross receipts for 1998 were $232,721, with an ordinary income of $83,667, and the gross receipts for 1999 were $235,830, with an ordinary income of $77,320.

27. Dahl's annual salary for 1997 was $19,000, $30,000 for 1998, and $30,000 for 1999.

28. The compensation in 1997 for one JDA employee was $22,091, the compensation for the other JDA employee was $21,332. Neither employee was identified during testimony. In 1998, Employee Linda Meyer earned $23,266, Jason Luther earned $20,738, and Doreen Filler worked part of the year for $10,847 (a prorated amount of $22,000). In 1999, Linda Meyer earned $27,448, Jason Luther earned $24,614, and Doreen Filler was paid $25,313.

29. JDA paid dividends to Dahl as its sole shareholder at the end of each year. The

dividends were tied to the profitability of JDA and not to any work performed by Dahl.

30. In January 1998, JDA authorized a dividend from 1997's earnings that totaled $94 per share, for a total of $47,000 paid to Dahl. In January 1999, JDA authorized a dividend from 1998's earnings that equaled $100 a share, for a total of $50,000 paid to Dahl. In January 2000, JDA approved a dividend payment of $100 a share, for a total of $50,000 paid to Dahl.

31. Rather than being paid as a lump sum, these payments received the amount as advances throughout the year. Dahl then offset these advances against the dividend once announced.

32. Dahl considered these advances as one factor in determining the size of the yearly dividend JDA paid to him.

33. The United States offered expert testimony on whether Dahl's compensation was reasonable in comparison to other similarly situated businesses through Igor Ostrovsky, a valuation engineer with the IRS and a Accredited Valuation Analyst.

34. Mr. Ostrovsky based his opinions on a national survey of financial rations published by Risk Management Associates ("RMA"). He used the date in the RDA for accounting firms with assets less than $1,000,000.

35. The RDA compares an officer's salary to the firm's profitability, and does not compare the salary of other officers. Therefore, in determining the reasonableness of his compensation, Dahl's raw salary was not compared to the raw salaries of accounting executives in New York, Chicago, or Los Angeles.

36. In 1997, JDA had an after-tax profit of 43% of its net sales. In 1998, the profit equaled 38% of net sales. In 1999, this amount was 37%. Accounting firms in the RMA averaged profit before tax of 14.1% for 1997, 11.3% for 1998, and 7.7% for 1999.

37. JDA was thus significantly more profitable than other accounting firms during this time

period, being 208% more profitable than its peers in 1997, 233% more in 1998, and 374% more in 1999.

38. Dahl's salary as a percentage of net sales was 10% for 1997, 13% for 1998, and 13% for 1999. The RMA average officer compensation as determined from the upper quartile, by contrast, was 18.1% in 1997, a 266% greater amount than Dahl's salary in relative terms. In 1998, the average officer compensation was 25.7% and in 1999 it was 33.8%, both of which represent a 166% greater amount than Dahl's compensation in relative terms.

39. When JDA's officer compensation is normalized by applying the same percentage as the average upper quartile in the RMA, his salary becomes $69,584 for 1997, $79,823 for 1998, and $79,711 for 1999.

40. Mr. Ostrovsky used two other sources besides the RMA, Leo Troy's Almanac of Financial Ratios as well as data from Job Service of North Dakota. Both of these sources, however, would have produced a larger net income for Dahl than the RMA.

Deferred Compensation Agreement

41. In November of 1996, Dahl became involved with his family's farming operation. Dahl began providing services for the farm at the request of his father to order to ensure the farm stayed withing the Dahl family.

42. In 1997, Dahl's father announced his intention to retire from farming. In response, Dahl formed Dahl Farming, Inc. in order to operate his father's farm. Dahl's role in Dahl Farming was primarily administrative and bookkeeping functions. Dahl performed these services as an employee of JDA, and billed Dahl Farming for the services.

43. At the time Dahl performed the above services for Dahl Farming on behalf of JDA, the farm entity did not have much capital, having used all of its available capital and credit for

operations. Dahl, as bookkeeper to Dahl Farming, Inc. was aware of such.

44. Dahl stated that the farm performed poorly financially during the winters of 1997 and 1998.

45. Because Dahl Farming could not immediately pay its bills to JDA, and quite possibly may never had been able to pay its bills, JDA and Dahl Farming entered into a deferred compensation agreement wherein Dahl would receive 40% of any amount that Dahl Farming eventually paid to JDA.

46. The compensation agreement was structured so that Dahl had no right to payments made by Dahl Farming until they were received. Further, he would lose his rights to such payments if he ever left JDA.

47. Dahl did not include the deferred compensation on his Forms W-2 filed with the IRS until he received actual payment of the deferred compensation. Dahl thus assigned no value to the amounts "earned" in those years until he actually received payment.

CONCLUSIONS OF LAW

Burden of Proof

1. The Plaintiff bears the burden of demonstrating that the IRS assessments were incorrect and also what the correct assessments should be. See, e.g., IA 80 Group, Inc. v. United States, 347 F.3d 1067, 1071 (8th Cir. 2003) (citing United States v. Pfister, 205 F.2d 538, 542 (8th Cir. 1953)). Plaintiff also bears the burden in demonstrating that the compensation paid was reasonable. RTS Investment Corp. v. Commissioner, 877 F.2d 647, 650 (8th Cir. 1989)

2. The United States has defended the suit using a different methodology than it used in its initial assessment of tax liability. The government is free to use divergent methodology if it

supports the original assessment. Even erroneous assessments will be upheld if valid under a different theory. Blansett v. United States, 283 F.2d 474, 478 (8th Cir. 1960).

3. The United States' use of a different methodology than it used in its original assessment does not shift the burden from the Defendant to the United States. Blansett, 283 F.2d at 478; King v. United States, 641 F.2d 253, 258-59 (5th Cir. 1981); See generally Spangler v. Commissioner, 278 F.2d 665 (4th Cir. 1960); Sidney v. Commissioner, 273 F.2d 928 (2d Cir. 1960).

Reasonableness of Compensation

4. The Eighth Circuit, has set forth several factors for the Court to consider in determining the reasonableness of compensation with no single factor being dispositive.

5. The reasonableness test encompasses nine factors, some of which may be inapplicable or unsuitable given the particular context of the case. These factors are (1) employee qualifications; (2) the nature, extent, and scope of the employee's work; (3) the size and complexity of the business; (4) prevailing general economic conditions; (5) the employee's compensation as a percentage of gross and net income; (6) the employee-shareholder's compensation compared with distributions to shareholders; (7) the employee-shareholder's compensation compared with that paid to non-shareholder-employees or paid in prior years; (8) prevailing rates of compensation for comparable positions in comparable concerns; and (9) comparison of compensation paid to a particular shareholder-employee in previous years where the corporation where the corporation has a limited number of officers. Charles Schneider & Co. v. Commissioner, 500 F.2d 148, 182 (8th Cir. 1974).

6. No evidence was introduced by either party as to the prevailing economic conditions during the years 1997 through 1999, rendering an accurate appraisal of the fourth factor difficult.

7. The above test is adequately reflected in Trucks, Inc. v. United States, 588 F. Supp 638

(D. Neb. 1984). There, the court utilized the above factors, grouping them into three broader categories for ease in analysis and discussion. These categories were (1) performance of the employee, (2) salary comparisons, and (3) company conditions. This Court shall proceed in the same manner. It is worthy to note that the facts relevant to each particular category do not exist in isolation, but are intertwined, and often complementary.

8. In examining the first category, this Court concludes that Dahl's performance as head of JDA was exemplary. His firm boasted profits far in excess of the profits generated by comparable accounting firms. A reasonable director or chief executive officer who was hired and retained pursuant to arms length negotiation would expect to be compensated to a degree that matched his or her performance. Here, Dahl's compensation is not congruent to his performance.

9. A comparison of salaries also reveals that Dahl's salary was unreasonable. Dahl was compensated slightly above of that of his employees. Further, he received no raise from 1998 to 1999 despite his firm's success and despite the fact that all other employees saw a pay increase over the previous year. This factor weighs against a finding of reasonableness.

10. The conditions of the company would dictate greater pay to its chief executive. Certainly, JDA was a small enterprise. The company required little in terms of reinvestment. These facts contribute to generally low overhead which would, in turn, free up capital for employee compensation. Further, the firm saw continuous growth in every subsequent year. Certainly, the profitability of the firm would allow for a salary higher than that which Dahl received.

11. In applying the Eighth Circuit's multi factored test for reasonableness of compensation, broadly grouped into the three categories articulated by the court in Trucks, the compensation paid to Dahl was not reasonable.

Reasonableness of IRS' Assessment and Methodology

12. The figures $69,584 for 1997, $79,823 for 1998, and $79,711 for 1999, which are the amounts assessed by the IRS, are reasonable salaries for the years 1997 to 1999, respectively. These figures are larger than those on which the assessments in the counterclaim are based. Therefore, the figures in the counterclaim, on which the assessments are based, are likewise reasonable.

13. The upper quartile of the RMA is the appropriate comparison as Dahl would be expected to command a relatively higher compensation given JDA's extremely high profitability under his direction.

14. The Fargo Wage and Benefit Survey of the Job Service of North Dakota ("Survey") is not as accurate as the RMA as the Survey does not contain data as to average compensation for officers in accounting firms. Instead, the Survey only contains data for accountants and chief executive officers as separate and distinct entries.

Deferred Compensation Agreement

15. Income paid to Dahl from Dahl Farming via the deferred compensation agreement does not bring Dahl's salary to reasonable levels for the 1997 through 1999 period.

16. The Court must analyze the reasonableness of Dahl's salary through factors "existing at the date where the contract for services was made, not those existing at the date when the contract is questioned." Schneider v. Commissioner, 500 F.2d 148, 152 (8th Cir. 1974); Treas. Reg. § 1.162-7(a).

17. Dahl did not include the deferred compensation on his Forms W-2 filed with the IRS until he received actual payment of the deferred compensation, therefore Dahl did not assign value to the amounts "earned" in those years at the time his services were rendered.

18. The accounting services rendered to Dahl farming pursuant to the deferred compensation agreement were too speculative be considered the product of arms length negotiation. There existed no definite payment date, and the questionable vitality of Dahl Farming made nonpayment a very real possibility. Moreover, Dahl had no absolute right to the payments, as he would lose them if he terminated his employment with JDA before such payments were received.

19. Given the risk and lack of timeliness inherent in the deferred compensation agreement, a reasonable employee would not accept such an arrangement governing the lion's share of his or her salary.

Ultimate Conclusions of Law

1. Plaintiff's claim for $2,861.44 is without merit.

2. The Court finds that Defendant's counterclaim for additional tax assessments in the amount of $22,385.92 is valid.

IT IS HEREBY ORDERED:

1. Judgment entered against Plaintiff in the amount of $22,385.92

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated this 19th day of May, 2006.

Ralph R. Erickson

Ralph R. Erickson, District Judge
United States District Court

EXHIBIT 7

COMPARISON OF LIMITED LIABILITY STRUCTURES[1]

	LIMITED PARTNERSHIP	LIMITED LIABILITY COMPANY ("LLC")	S CORPORATION	C CORPORATION
Liability for Debts of Entity	General partner liable. Limited partners protected unless participate in management.	All members protected.	All shareholders protected.	All shareholders protected.
Participation in Management	Participation by limited partners generally restricted to preserve limited liability.	No restrictions.	No restrictions.	No restrictions.
Transferability of Interests	Restrictions imposed by state law, by securities laws, and generally by the partnership agreement; generally, partner may assign right to receive distributions/allocation, but assignee becomes partner only if all partners consent.	Restrictions imposed by state laws, securities laws, and LLC Regulations, if any; generally, member may assign right to receive distributions/allocations, but assignee becomes member only if all members consent.	Restrictions are imposed by securities laws, and by a shareholder's agreement, if any.	
Term	Partnership Agreement specifies terms.	Varies, often not to exceed 30 years; can reconstitute.	Perpetual.	Perpetual.
Will Entity be Dissolved Upon Death, Retirement, Resignation, Expulsion, Bankruptcy, or Dissolution of Participant?	Yes, if general partner is affected; but can be reconstituted by remaining general partner or by agreement of all remaining partners.	Yes, unless Regulations provide otherwise or remaining members unanimously consent to continue business.	No.	No.
Are Ownership Interests Securities?	Limited partners' interests are securities.	Possibly not, if all members have management rights.	Shares are securities.	Shares are securities.

[1] Original prepared by: Sol S. Reifer, Dallas, TX; Modified by James Publishing, Costa Mesa, CA (1994). Used by permission and modified by the Author.

	LIMITED PARTNERSHIP	LIMITED LIABILITY COMPANY ("LLC")	S CORPORATION	C CORPORATION
Subject to Federal Income Tax at Entity Level	No, if lacks two of four corporate characteristics: (i) limited liability; (ii) free transferability of interest; (iii) continuity of life, and (iv) centralized management.	No, if lacks free transferability of interests and continuity of life. Occasionally, an LLC may lack centralized management.	No, however, any shareholder may cause loss of tax status.	Yes.
Qualification	A limited partnership generally needs an individual general partner or a corporate general partner with substantial assets.	No restrictions.	Various eligibility requirements, including a restriction on the number of shareholders and on the ownership of subsidiaries.	No restrictions.
Number of Owners	At least 2; no upper limits.	1 is disregarded entity (equivalent to a sole proprietorship); at least 2 to be considered a partnership for tax purposes; no upper limits.	No lower limit; upper limit is 75 shareholders.	No upper or lower limits.
Form of Permissible Investment	In most states, cash, property, services rendered, promissory notes, or obligation to transfer property.	In most states, cash, property, services rendered, promissory note, or obligation to transfer property.	Any tangible or intangible benefit to the corporation, including cash, promissory note, services rendered, contracts for future services, or other securities of the corporation.	Any tangible or intangible benefit to the corporation, including cash, promissory note, services rendered, contracts for future services, or other securities of the corporation.
Will Contribution of Appreciated Property be Taxable?	No, regardless of control by partner, unless recharacterized as sale or partner has net reduction in liabilities in excess of tax basis in contributed property.	No, regardless of control by member.	Yes, except if controls corporation (80% voting power) immediately after transfer.	Yes, except if controls corporation (80% voting power) immediately after transfer.
Managing Body	General partner. Limited partners may not participate in management.	Managers, unless Regulations reserve to members. All members can participate in management.	Board of Directors.	Board of Directors.
Officers	No.	Yes, if designated by managers.	Yes.	Yes.
Rules for Management of Entity	Limited Partnership Agreement.	Regulations.	Bylaws.	Bylaws.

	LIMITED PARTNERSHIP	LIMITED LIABILITY COMPANY ("LLC")	S CORPORATION	C CORPORATION
Must Formalities be Observed to Preserve Limited Liability?	No.	Unclear.	Yes, unless corporation adopts close corporation status.	Yes, unless corporation adopts close corporation status.
Types of Owners	No restrictions.	No restrictions.	Ownership is limited to US residents and citizens and to certain US trusts (no corporations, nonresident aliens, partnerships, certain trusts, and pension plans).	No restrictions.
Filing Required	Certificate of Limited Partnership.	Articles of Organization.	Articles of Incorporation.	Articles of Incorporation.
Entity Name	Must contain "Limited Partnership," "Limited," "LP," or "Ltd."	Usually must contain "Limited," "LC," "LLC," or "Ltd."	Must contain "Corporation," "Company," "Incorporated," or abbreviation thereof.	Must contain "Corporation," "Company," "Incorporated," or abbreviation thereof.
Washington State Organizational Filing Costs	Name Reservation: $10.00 Original Filing: $175.00 Note: Limited Liability Partnership Name Reservation Fee is $30.00.	Name Reservation: $30.00 Original Filing: $175.00 Initial Annual Report: $10.00	Name Reservation: $30.00 Original Filing: $175.00 Initial Annual Report: $10.00	Name Reservation: $30.00 Original Filing: $175.00 Initial Annual Report: $10.00
Ability to do Business in Other States	Yes.	Unclear in those states that do not have an LLC status.	Yes.	Yes.
Limited Liability of Participants Recognized in Other States	Yes.	Unclear in those states that do not have an LLC status.	Yes.	Yes.
Levels of Income Tax	Partner level only.	Member level only.	Generally, only shareholder level. However, former C corporations may be subject to tax. In addition, some states will tax S corporations.	Corporate and shareholder level. 35% flat rate on Personal Service Corporations.
Formation	Nontaxable, unless disguised sale or the partner is relieved from debt.	Nontaxable, unless disguised sale or the member is relieved from debt.	Taxable; however, if the transferors meet the 80% control test of IRC §351, nontaxable except to the extent of debt relief.	Taxable; however, if the transferors meet the 80% control test of IRC §351, nontaxable except to the extent of debt relief.

	LIMITED PARTNERSHIP	LIMITED LIABILITY COMPANY ("LLC")	S CORPORATION	C CORPORATION
Special Allocations of Income and Loss Between Participants	Yes.	Yes.	No, all allocations are pro rata, since only one class of stock permitted.	Preferences in distributions can be given to certain classes/series of stock.
Deductibility of Losses Attributable to Entity Debt	General partners only may deduct partnership losses to the extent of basis, unless limited partnership assumes liability, which increases their tax basis in their partnership interest which includes their allocable share of partnership debt.	Members may deduct the LLC's losses only to the extent of their tax basis in their LLC interest which includes their allocable share of LLC debt.	Shareholders may deduct the corporation's losses only to the extent of their tax basis in their stock which does not include any portion of the corporation's debt.	Shareholders may not deduct any of the corporation's losses.
At-Risk Limitations	Applicable.	Applicable.	Applicable.	Applicable, if closely held.
Passive Activity Limitations	Limited partner can be active under only 3 of 7 test (i.e., essentially, the limited partner must participate in the activity for 500 hours).	It is not clear whether members or managers can qualify under all 7 or only 3 tests.	All 7 tests apply.	Not applicable.
Fiscal Year	Generally calendar.	Generally calendar.	Calendar.	No restrictions.
Cash Distributions	Nontaxable to the extent of a partner's tax basis.	Nontaxable to the extent of a partner's tax basis.	Generally nontaxable to the extent of a partner's tax basis.	Taxable as dividends to the extent of the corporation's earnings and profits and then nontaxable to the extent of the shareholder's tax basis.
Liquidation	Nontaxable to the extent of a partner's tax basis.	Nontaxable to the extent of a partner's tax basis.	Generally nontaxable at corporate level and taxable at shareholder level through flow-through of corporate tax items.	Taxable to both corporation and shareholders.