

9-23-2015

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### Recommended Citation

Kraus, Richard J.; DiBenedetto, Joseph; and Girasa, Roy J. (2015) "Watson V. United States – The FICA Tax Dispute Concerning Wages And Distributions To Professional Employees/Owners," *North East Journal of Legal Studies*: Vol. 34 , Article 3.

Available at: <https://digitalcommons.fairfield.edu/nealsb/vol34/iss1/3>

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**WATSON V. UNITED STATES – THE FICA TAX  
DISPUTE CONCERNING WAGES AND  
DISTRIBUTIONS TO PROFESSIONAL  
EMPLOYEES/OWNERS**

by

Richard J. Kraus \*  
Joseph DiBenedetto\*\*  
Roy J. Girasa \*\*\*

**INTRODUCTION**

Individuals and businesses seek to avoid the payment of taxes beyond those demanded by the law. In particular, incorporated businesses such as closely held corporations, S corporations, LLCs, PCs and PLLCs reduce their Internal Revenue Code liabilities by distributing their assets as wages to employees. At times, however, the employees of these entities are also shareholders. In estimating and paying tax liabilities, the incorporated businesses may wish to distribute their assets to their employee/shareholders as dividends rather than as wages in order to avoid tax liability for payments of

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Federal Insurance Contribution Act (FICA)<sup>1</sup> taxes and Federal Unemployment Tax Act (FUTA)<sup>2</sup> liabilities upon employee wages. The Internal Revenue Service (IRS) seeks to ensure that the allocation of business distributions as dividends or as wages to employees/owners is reasonable and justified by the Internal Revenue Code and regulations.

*Watson v. United States*<sup>3</sup> decision typifies the controversy surrounding IRS determinations that corporate taxpayers have underpaid FICA and FUTA tax liabilities by disguising wages as dividend payments or that the dividend payments have been disguised as wages in order to avoid even more onerous corporate taxes.<sup>4</sup>

This article concentrates upon the particular controversy which arises in *Watson* concerning a professional corporation's liability for paying FICA tax upon dividend payments to a professional shareholder-employee who served as the corporation's only director and who authorized the dividend payment to himself when, in fact, a more significant portion of the dividend should have been paid as wages. At the same time, the article examines the entire controversy concerning FICA, FUTA and other tax liabilities for incorporated businesses, particularly closely held businesses, which choose to treat wages as dividends or dividends as wages in order to decrease tax liability. The article concludes that the *Watson* decision correctly determined the liability of the S corporation for FICA tax and warns that proposed legislation setting pre-determined percentages for a professional's wages must be avoided.

## **THE FICA TAX IS A TAX UPON WAGES**

After graduating from college, David Watson became a Certified Public Accountant with a Master's Degree in Taxation. In 1996, Watson incorporated his practice as David E. Watson PC (DEWPC) of which he was the sole officer, shareholder, director and employee; DEWPC elected to be taxed as an S corporation. This corporation acted as a partner in the accounting firm of Larson, Watson, Bartling, and Juffer, LLP (LWBJ). LWBJ allegedly had sufficient cash flow to distribute \$2000 a month to each partner including DEWPC; DEWPC then authorized a payment of \$2000 a month to Watson as his sole wages of \$24,000 for the tax years 2002 and 2003. But in addition to his salary Watson, by a DEWPC decision, received \$203,651 as profit distributions from LWBJ for 2002 and \$175,470 as profit distributions for 2003. The IRS investigated these distributions and determined that at least a portion of the profit distributions from DEWPC to Watson should be treated not as dividends but as wages. The Court of Appeals eventually agreed with the District Court that the reasonable amount of Watson's wages should be set at \$91,044 for both 2002 and 2003. The trial court used average billing rates rather than Watson's actual billing rates to determine the wage amount. The appeals court upheld the tax deficiency judgment against DEWPC. The judgment included unpaid employment taxes, penalties and interest amounting to \$23,431.33.

IRC section 3121 defines wages as meaning all remuneration for employment including the cash value of all such items including benefits paid in any medium other than cash. As the code regulations indicate,<sup>5</sup> wages include salaries, fees, bonuses, and commissions on sales and on insurance premiums if paid as compensation for employment. The basis upon which remuneration is paid is immaterial and includes a

percentage of the profits,<sup>6</sup> such as the distribution of profits to Watson in this case.

### **WAGES ARE REMUNERATION FOR SERVICES PERFORMED BY AN EMPLOYEE**

Although Watson argued that DEWPC was distributing to him a return on his investment in the accounting incorporated business, the critical FICA tax question concerns whether the statute and facts indicate that at least a portion of the payments made to Watson constituted remuneration for services performed by an employee. The Internal Revenue Code, Section 3121(d) defines an employee as any officer of a corporation or any individual who, under usual common law rules, has the status of an employee.<sup>7</sup> The Court of Appeals cited a series of cases which aided its decision in determining Watson's employee status.

#### *Radtke, S.C. v. United States –Services Actually Rendered Must Be Remunerated As Wages*

In *Joseph Radtke, S.C. v. United States*<sup>8</sup> the Court of Appeals for the Seventh Circuit decided that Joseph Radtke S.C. a subchapter S corporation of which attorney Joseph Radtke was its sole shareholder-employee, was subject to Social Security FICA and FUTA taxes upon distributions to him. In the tax year 1982, Mr. Radtke received no salary from the corporation but received \$18,225 in dividends for that year. He paid personal income tax on the dividend and the corporation also declared \$18,225 on its small business corporation income tax return. The IRS, with the agreement of the District and Appeals courts decided that the dividends were wages subject to FICA and FUTA contributions.<sup>9</sup> Dividends

may not be paid in lieu of compensation for services actually rendered.

*Schneider v. Commissioner – Special Scrutiny Cases Include  
Those in Which Employees Are Also Owners*

In cases such as the *Watson* controversy, special and intense scrutiny will be given to distributions where the corporation is controlled by the very employees to whom the distribution is made. Such a lack of arm's length dealing between the corporation and the employee raises suspicion of subterfuge concerning the payment of mandated taxes. In *Charles Schneider & Co. v. Commissioner*<sup>10</sup> the 8<sup>th</sup> Circuit Court of Appeals faced the other side of the wages/dividends controversy: whether wages paid to employees-shareholders were reasonable and necessary as business deductions for the corporation or dividends subject to more substantial corporate taxation upon the entity's income. The court agreed with the IRS and the United States Tax Court that the wages, including bonuses, paid to the employees-owners were not reasonable and necessary business expenses<sup>11</sup> but were corporate dividends. The court determined deficiency income tax liability against Schneider & Co for the 1966, 1967, and 1968 tax years in the amounts of \$23,512.40, \$15,333.42, and \$21,721.05 respectively. The court also held another allied furniture corporation liable for deficiencies for those tax years in the amounts of \$18,130.17, \$3,475.46 and \$7,365.58.

The facts of this case reveal that Charles Schneider organized a number of furniture and upholstery manufacturing businesses of which he was the sole or principal shareholder. The closely held corporation which Schneider directed permitted distributions to a number of other

shareholders including himself in excess of the normal amounts paid as wages including bonuses to other industry employees. The court noted that several factors helped to determine reasonableness of compensation: the employee's qualifications; the nature of the work, its size and complexity; a comparison of salaried to gross and net business incomes; the prevailing rates of compensation for comparable positions in comparable concerns and the history of compensation paid in previous years. Because this corporation was closely held, special scrutiny of all of these factors resulted in the court's conclusion that the companies paid more wages and bonuses to their employees than other similar businesses and that the payment to some of the employee-shareholders increased even though their workload decreased. The court noted finally that the bonus agreements were governed by corporation bylaws which required the employees to repay their bonuses if they were later declared by a court not to be deductible expenses for tax purposes.<sup>12</sup> It appeared that the corporations' tax counsel had already anticipated a taxability issue.

The Court of Appeals in the *Watson* decision utilized the *Schneider* reasoning to justify the intense examination of the controversy. DEWPC's distribution to *Watson* in like manner should be subject to close scrutiny: *Watson* sought to declare a portion of his wages as his wholly owned corporation's dividends to him, thereby evading FICA liability, but a closer examination of the facts helped to reveal the unjustifiable evasion tactic.

*Standard Asbestos v. Commissioner – Case Facts Help  
to Determine Tax Liabilities*

In *Watson* and in all similar controversies, the facts of each case will determine whether payments to a shareholder are compensation for services rendered or distributions of

profits from the business. *Standard Asbestos Manufacturing and Insulating Co. v. Commissioner*<sup>13</sup> once again describes a situation where a closely held corporation was determined to have paid excessive unreasonable salaries to three of its shareholders and that a pension paid to a deceased shareholder's wife was a distribution of profits and not a pension, taxable to her and not deductible by the corporation.

In *Standard*, three brother shareholders solely managed an asbestos manufacturing and insulating business founded in 1918 by their father, whose shares upon his death had passed to his widow, the brothers' mother. During the 1920's and 1930's the Ryder Brother's received wages below the standard for the industry, until about 1937. From this year corporate resolutions substantially increase their wages in order to compensate for previous low salaries. But for the tax years 1949, 1950 and 1951 the corporate resolution in question arranged for bonuses to be paid to the brothers without referring to the fact that they were intended for services rendered in prior years. Pursuant to this resolution, each of the brothers was respectively paid the sums of \$52,232.14, \$65,290.17 and \$65,289.17 during the tax years 1949, 1950 and 1951. The Commissioner of Internal Revenue and U.S. Tax Court then determined that for the 1949, 1950 and 1951 tax years, the sums paid to each of the brothers was in excess of a reasonable amount so that tax deficiencies were assessed against them for any amounts in excess of \$42,500.00 for 1949 and \$47,500.00 for 1950 and 1951.

The Commissioner and the Court examined extensive evidence concerning the salaries of the brothers paid in prior years. On December 20, 1937 a corporate resolution directed additional payment of wages for the years 1928 to 1930 by raising the compensation by 40%; on January 6, 1941 the salaries of the Ryder brothers were raised to \$11,000 because of low salaries paid to them and on January 5, 1942 a corporate

resolution, once again, cited prior low salaries and raised the brothers' wages to \$20,000. As already stated, however, the later corporate resolution in question made no mention of prior low salaries.

The percentage of the corporation's net income used to pay the salary bonuses also led the Commissioner and the court to decide that the salaries were unreasonable. In particular, the court noted that the salary bonuses represented a very high percentage of the company's net income during the taxable years, while no other officer of the corporation received more than \$9,000.000 in income during the years in question. The court quoted *Builders Steel Co. v. Commissioner*:

The bonuses given at the end of the year, according to the minutes of the petitioner, were based to a large extent at least upon the earnings that the company had made during the year and its consequent ability to pay. In addition to the fact that there were large earnings resulting to a greater or lesser extent from the efforts of these officers and employees, we cannot escape the thought that the distribution of earnings of the company had the *effect of very substantially reducing the excess profit taxes collectible against the petitioner* [emphasis added].<sup>14</sup>

The bonuses were used as a subterfuge to avoid properly due corporate taxes.

The salaries paid to competitors in similar businesses additionally convinced the Commissioner and the court of the unreasonableness of the salary bonuses. The president of a competing company offered credible testimony that he received a salary of approximately \$16,000.00 in 1949 and approximately \$26,000.00 in 1950 and 1951; the court judged his experience and ability to be comparable to that of the taxpayer company's officers, the Ryder brothers, and that their activities and hours of work were also quite similar.

In addition, the pension paid to Alice D. Ryder, 84 years old, was not a pension for the founder's widow but a distribution of profits and hence taxable to her. The taxpayer Standard Asbestos Company paid to Alice D. Ryder, the widow of Willard E. Ryder, deceased, the following pension amounts which the company deducted from its taxable income: \$20,491.08 in 1949, \$32,645.08 in 1950 and \$32,645.09 in 1951. The Commissioner and the Tax Court noted that Alice D. Ryder's husband had held 473  $\frac{1}{4}$  shares of the company's 500 shares of stock before his death but had divided them, among others, to the three Ryder brothers and to his widow. The transfer agreement contained covenants restricting the transfer of the stock, and created a pension for Alice D. Ryder so long as she held the shares and did not re-marry. The agreement contained no references which designated the pension as recognition for the past services of her husband. The Commissioner, the Tax Court and the Court of Appeals reasoned that the pension payments were made for the purpose of assuring control over the stock and would not be deductible business expenses, but would constitute a distribution of profits taxable to Alice D. Ryder.<sup>15</sup>

In regard to the pension paid to Alice D. Ryder, the court noted that the corporate resolutions indicated that the pension was to assure control over the future alienation of shares and was not a deductible business expense but a distribution of profits taxable to the corporation.

Once again, the Court of Appeals used the facts of *Ryder* decision to justify its agreement with the findings of the Commissioner and the Tax Court in the *Watson* controversy. The facts of *Watson* clearly indicate that David Watson received at least a portion of DEWPC's profits as remuneration for wages paid for his services. The \$24,000 annual salary

which he received could not at all recompense him for his contributions of skill and work given to the corporation which he himself wholly owned.

### **THE REASONABLENESS CRITERION FOR DETERMINATION OF EMPLOYEE STATUS AND AMOUNT OF REMUNERATION**

The Eighth Circuit Court in *Watson* noted that the Commissioner and the Tax Court had to determine the proper basis for treating David Watson as an employee and the reasonable amount of salary paid to him for the personal services which he actually rendered. Although reasonable compensation usually concerns corporate income tax deduction, a 1974 IRS Revenue Ruling concerning small business corporation dividends paid instead of salaries had stated that the concept applies equally to FICA tax cases.<sup>16</sup> In its ruling, the IRS indicated that the dividend payments of an S corporation constituted wages for FICA tax purposes because the corporation's two shareholder-employees performed reasonably substantial services for the corporation, but received no reasonable wages for those services; in fact no wages at all were paid to them. The Service, in response to the revenue ruling inquiry, concluded that the dividends were paid as reasonable compensation for the reasonably substantial services of those shareholder-employees.

In the *Radtko* controversy mentioned above the attorney sole shareholder of an S corporation also received no salary and the Seventh Circuit Court of Appeals affirmed the conclusions that attorney Radtko had performed reasonably substantial services as an employee of the corporation and that the so-called dividend payments were clearly reasonable remuneration for those services rather than a return of investment to a shareholder.

*Veterinary Surgical Consultants, P.C. v. Commissioner*<sup>17</sup> in like manner decided that a veterinarian tax payer, the sole shareholder of a professional S corporation, cannot claim that the distributions to him were merely dividends which represented a return on his investment. The Third Circuit Court of Appeals agreed with the Tax Court and Commissioner that a reasonableness criterion must apply to the facts of this case to determine the substantiality of work performed and the wages paid in relationship to that work.

Dr. Kenneth K. Sadanaga practiced veterinary medicine in Pennsylvania during the tax years 1994, 1995 and 1996. Dr. Sadanaga functioned as a full-time employee of Bristol-Myers Squibb Co. during this time and reported wages from the company of \$91,212.18 in 1994, \$95,851.15 in 1995 and \$102,031.14 in 1996; the company withheld the necessary Social Security taxes from his wages. During the same period, however, the Veterinary Surgical Consultants, P.C. S Corporation (VSC) paid to Dr. Sadanaga “non-employee compensation” of \$83,995.50 in 1994, \$173,030.39 in 1995 and \$161,483.35 in 1996. Dr. Sadanaga was VSC’s sole shareholder and its only officer. All of VSC’s income was generated from the consulting and surgical services performed by Dr. Sadanaga; he was the sole signatory on the corporation’s bank account and handled all of its correspondence; he performed substantial services for the corporation working approximately 33 hours a week.

The Tax Court concluded, and the Court of Appeals agreed, that the Commissioner had found overwhelming and certainly reasonable evidence that Dr. Sadanaga performed the entire substance of the work for the corporation and that the distributions in 1994, 1995 and 1996 constituted a reasonable compensation for the veterinarian and were subject to FICA and even FUTA taxes. The Tax Court noted that the form of payments could be but a subterfuge for the reality of their

payment and that the intention of receiving the payments as dividends or distributions of profits had no bearing on the tax treatment of his wages.<sup>18</sup>

The Court of Appeals also agreed with the Tax Court that the 1978 Revenue Act Section 530 safe harbor provisions<sup>19</sup> do not apply to the facts of this case. It is true that VSC did not treat Dr. Sadanaga as an employee for any tax period in question but VSC could not reasonably rely on any of the following three additionally needed exceptions to the rule that Dr. Sadanaga need not be treated as an employee: (a) judicial precedent, published rulings, technical advice or a letter ruling; (b) past IRS order of the taxpayer; or (c) long standing industry practice. The two judicial precedents upon which VSC relied, *Durando v. United States*<sup>20</sup> and *Texas Carbonate Co. v. Phinney*<sup>21</sup>, did not produce reasonable bases for any exception. The *Durando* decision concerned the treatment of S Corporation shareholders as shareholders and would not affect a determination that Dr. Sadanaga, although a shareholder, was also an employee of VSC<sup>22</sup>. *Texas Carbonate* improperly read the provisions of Section 530 but properly determined in any event that a shareholder-director-manager of a company was an employee for federal employment tax purposes.<sup>23</sup>

*Elliotts, Inc. v. Commissioner*<sup>24</sup> also treated the topic of reasonableness. The Court of Appeals for the Ninth Circuit, however, did not agree with the Commissioner and Tax Court concerning the reasonableness of the bonus paid to its CEO and sole shareholder.

Elliotts, Inc., the taxpayer, was a closely held Idaho corporation which sold John Deere Company equipment and services equipment from Deere and other manufacturers. Edward G. Elliott was the corporation's chief executive officer and sole shareholder during the tax period in question; he always had total responsibility for the business as its manager of some 40 employees. The corporation paid Elliott a fixed salary of \$2000 a month plus a bonus fixed at 50% of its net

profits. For the tax years 1975 and 1976, the corporation paid Elliott a total compensation of \$181,074 for 1975 and \$191,663 for 1976. The Tax Court agreed that the compensations paid were unreasonable, but adjusted the Commissioner's finding to seek deficiency assessments of compensation paid in excess of \$120,000 for 1975 and \$125,000 for 1976.

The Court of Appeals agreed that Elliott obviously was an employee of the corporation. He performed the duties of an employee as its manager and was reasonably entitled to compensation for his services. The appeals court, however, remanded the case to the Tax Court on the issue of reasonableness of compensation. The court closely examined the shareholder-employee problem; it recognized that this situation is troublesome because the corporation and the shareholder-employee do not deal with each other at arm's length. The Commissioner and the Tax Court, however, must determine the proper allocation between compensation paid for services rendered and a share of profits distribution not deductible by the corporation. The Court observed that IRC Section 162(a) (1) permits a corporation to deduct "a reasonable allowance for salaries paid for personal services".<sup>25</sup> The payments must satisfy the statute's two-prong test that the compensation be in fact reasonable and be made purely for services rendered.<sup>26</sup>

The Court of Appeals then suggested five criteria to determine the reasonableness of compensation paid to Elliott. The court noted that a. Elliot's role as employee in the company included 80 hours of work per week as its sole and dedicated manager; b. compared to other companies' managers, Elliott did the work of three people compared to managers at other John Deere dealers; c. the character and condition of the company's sales, net income and capital value revealed the complexity of the business which Elliott managed; d. the conflict of interest which exists in the shareholder-employee relationship does not prevent Elliott from

distributing a bonus to himself despite the close scrutiny which must be given to the relationship, provided that an independent shareholder would permit a large bonus to Elliott and not view the bonus as an impairment of the shareholder's equity in the corporation; e. internal consistency in the distribution of the bonus to Elliott existed because, since its incorporation, the business had a longstanding, consistently applied compensation plan in which it paid to Elliott an annual incentive bonus equal to fifty percent of its net profits.

### **DECISION OF THE WATSON COURT**

Taking all factors and evidence into account, the Court of Appeals agreed with the District Court that DEWPC was subject to a FICA tax deficiency assessment because the wholly owned S corporation had understated David Watson's wages by \$67,044.00. The Court reasoned that the following assisted in the computation of a reasonable compensation for Watson: his superior qualifications as certified public accountant, including his advanced taxation degree and 20 years' professional experience; his 35 to 45 hour work week for LWBJ, which grossed between \$2 million and \$3 million for the tax years 2002 and 2003; the \$200,000 distributed by LWBJ to DEWPC in both 2002 and 2003 compared to the exceedingly low \$24,000 annual salary paid to Watson by DEWPC. The Court then agreed that, by comparing Watson's qualifications with similar professionals in the market, the District Court properly set Watson's wages at \$91,044.<sup>27</sup>

### **CONCLUSION**

The Internal Revenue Code, IRS publications and the decisions described above correctly indicate that the wages of a professional such as David Watson should be subject to FICA

and FUTA tax liabilities. Profit or dividend distribution to such professionals should not be used as a subterfuge to avoid the payment of such taxes, just as the payments of excessive salaries or bonuses may not be used to disguise liabilities for taxes owed by the corporations themselves.

It should be noted that the employment tax rules for S corporations may be subject to change in that S corporation shareholders who significantly participate in the business of the corporation may have to treat 70% of their combined compensation distributive share as net earnings from self-employment, and the remaining 30% as earnings on invested capital.<sup>28</sup> The *Watson* and allied decisions are certainly a more accurate way of determining tax rules, even though more complicated, rather than simplified.

## ENDNOTES

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<sup>1</sup> See 26 U.S.C.S. 3101-3126.

<sup>2</sup> See 26 U.S.C.S. 3301 – 3311.

<sup>3</sup> 668 F.3d 1008 (2012).

<sup>4</sup> Although the *Watson* decision deals with the payment of wages as dividends, other cases in the court's analysis deal with the payment of dividends as wages in order to avoid even greater tax liability; see, for example, *Standard Asbestos v. Commissioner* 276 F.2d 289 (Eighth Circuit, 1960).

<sup>5</sup> See 26 CFR 31.3121(a)-1.

<sup>6</sup> See 25 CFR. 31.3121 2(a)2(d). In *H B & R Inc. v. United States*, 229 F.3d 688 even an employee's airfare may be subject to FICA tax withholding unless the airfare was to the job site and ordinary and necessary to the corporation's business.

<sup>7</sup> *Joly v. Commissioner*, 76 T.C.M (CCH) 633, states that several interdependent factors must be considered to determine the employer-employee relationship: 1. the degree of control exercised by the principal over work details; 2. the relative investments of the party; 3. the hired party's role in hiring and paying others for the permanency of the

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relationship; 5. the hired party's discretion concerning work hours and places; 6. whether the work performed constitutes and integral part of the business; 7. the relationship the parties believe they have created; 8. the provision of employee benefits.

<sup>8</sup> 895 F.2d. 1196 (1990).

<sup>9</sup> In its reasoning the Seventh Circuit Court agreed with the reasoning contained in *Royster Co. v. United States*, 479 F.2d 387 (4<sup>th</sup> Circuit, 1973).

<sup>10</sup> 500 F.2d 148 (8<sup>th</sup> Circuit, 1974).

<sup>11</sup> See IRC Section 162 (a) (1).

<sup>12</sup> 500 F.2d 154 (8<sup>th</sup> Circuit, 1974).

<sup>13</sup> 276 F.2d 289 (8<sup>th</sup> Circuit, 1960); certiorari denied, 340 U.S. 904 (1960).

<sup>14</sup> 197 F.2d 263, at 264.

<sup>15</sup> See *Union Packing Co v. Commissioner, 1955 P-H T.C. Memorandum Decisions, par. 55, 308.*

<sup>16</sup> See Revenue Ruling 74-44, 1974-1 C.B. 287. The Court of Appeals in *Watson* observed that such rulings need not have the force of precedent but may be used to guide the court's reasoning.

<sup>17</sup> 117 T.C. 141 (U.S. Tax Court, 2001); the decision, as noted in the footnote below was affirmed as part of the 2002 *Yeagle* decision, which included the *Veterinary Surgical Consultants* ruling in it's title.

<sup>18</sup> The *Veterinary Surgical Case* was affirmed under a different name, *Yeagle Drywall Co. v. Commissioner*, 54 Fed. Appx. 100 (Third Circuit 2002) ; See also *Spicer Accounting, Inc. v. U.S.*, 918 F. 2d 90 (Ninth Circuit, 1990) for a discussion of the immateriality of the taxpayer's intent to treat the payments as distributions rather than as wages.

<sup>19</sup> See section 3 of Rev. Proc. 85-18, P.1.95-600 as amended.

<sup>20</sup> 70 F.3d 548 (9<sup>th</sup> Circuit, 1995).

<sup>21</sup> 307 F.2d 289 (5<sup>th</sup> Circuit, 1962).

<sup>22</sup> See the *VSC* decision, 117 T.C 141 at 145.

<sup>23</sup> See the *Texas Carbonate* discussion in *Yeagle* 54 Fed. Appx. 100 at 103.

<sup>24</sup> 716 F.2d 1241 (9<sup>th</sup> Circuit, 1983).

<sup>25</sup> 716 F.2d 1241 at 1243.

<sup>26</sup> See Treasury Regulations Section 1.162-7 (a)(1960).

<sup>27</sup> 668 F.3d 1017.

<sup>28</sup> See 2014 KPMG LLP publication concerning 2014 Ways and Means Chairman's Tax Reform Discussion Draft, p. 34. This proposal, however, has received no further impetus.