No. 99-1281

In the Supreme Court of the United States

O.S.C. & ASSOCIATES, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, on the facts of this case, the payments made by petitioner to its shareholders were dividends rather than compensation for services rendered.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A10-A39) is reported at 187 F.3d 1116. The opinion of the Tax Court (Pet. App. A1-A9) is reported at T.C.M. (RIA) 1997-300.

JURISDICTION

The judgment of the court of appeals was entered on August 16, 1999. The petition for rehearing was denied on November 2, 1999 (Pet. App. A40). The petition for a writ of certiorari was filed on January 27, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner O.S.C. & Associates was incorporated in 1982 (Pet. App. A15). During the years at issue in this case (1990 - 1992), Allen Blazick was the chief executive officer and owned 90% of the stock of petitioner. His wife (Janette Blazick) was the secretary and treasurer of the company but owned no stock. His brother-in-law (Steven Richter) was the vice president and owned 10% of the stock. These three individuals were the sole members of petitioner's board of directors. Allen Blazick started the company as a small silk-screen business in 1970. Over the years, it grew into a large printing business with approximately 200 employees (*id.* at A2, A15).

In 1985, petitioner adopted an Incentive Compensation Plan. The only participants in the Plan were Blazick and Richter, who were petitioner's only shareholders (Pet. App. A15). The terms of the Plan expressly provided for the annual amount of incentive compensation to be allocated "according to stock ownership" (*id.* at A16). The amount of incentive compensation was computed at the end of each fiscal year by first calculating a hypothetical gross margin amount—a figure derived by multiplying petitioner's actual total sales by an adjusted industry gross margin ratio. The amount by which petitioner's actual gross margin exceeded the hypothetical adjusted industry gross margin was treated as the total incentive compensation amount (*id.* at A15).

The Plan further provided that, after computing the total incentive compensation amount and allocating 90% of it to Blazick and 10% to Richter, each participant's share would then be adjusted under a set formula. Blazick's incentive compensation was reduced by any inventory shortages in excess of $100,000 for the fiscal year and by any bad debts. Richter's incentive compensation was reduced by any inventory spoilage in excess of $100,000 for the fiscal year and by any production costs in excess of $100,000 for the fiscal year. Pet. App. A16.

Under this Plan, payments were made to Blazick and Richter that equaled 82% to 94% of petitioner's net income (Pet. App. A16). The payments made to the shareholders by the corporation during the relevant years were as follows (*id.* at A17):

	1990	1991	1992
Blazick			
salary	$ 155,372	$ 175,485	$ 173,372
ICP	490,860	1,651,146	1,324,608
total	$ 646,232	$1,826,631	$ 1,497,980
Richter			
salary	$ 57,791	$ 64,616	$ 60,000
ICP	98,036	183,461	149,179
total	$ 155,827	$ 248,779	$ 209,179

The accountant who made the annual calculations required by the Plan acknowledged that the method used to determine petitioner's cost of goods sold was not consistent with generally accepted accounting principles. He also acknowledged that he had made numerous errors in calculating the amount of the incentive compensation to be paid in each year in issue, all of which had the effect of increasing the amounts paid to Blazick and Richter under the Plan (Pet. App. A17-A18).

Since its incorporation, petitioner has never expressly declared or paid any dividends to its shareholders (Pet. App. A18). A credit memorandum prepared by an officer of Union Bank in 1992 contains the following statement (*ibid.*):

> [Blazick's] salary for 1991 was over $1.8 MM. The reasoning behind the higher salary is taxable income. Mr. Blazick does not intend to be taxed twice for the profitability of his business. He contends taking the higher salary will increase his personal tax liability, but this rate is lower than the corporate tax rate.

For each year in issue, petitioner claimed a deduction on its income tax return for the total amount of payments made to Blazick and Richter (Pet. App. A5, A17). When the Commissioner of Internal Revenue disallowed most, but not all, of the payments made pursuant to the Plan for each year, petitioner sought review of the Commissioner's determinations in the Tax Court (*id.* at A18).

2. Following a trial, the Tax Court upheld the Commissioner's determinations. In doing so, the Tax Court applied (Pet. App. A6) the two-prong test set forth in 26 U.S.C. 162(a)(1) and in *Elliots*, *Inc.* v. *Commissioner*, 716 F.2d 1241, 1243 (9th Cir. 1983). That test limits deductible salary expenses to those that are (i) reasonable in amount and (ii) actually paid for services actually provided. The factors relied on by the Tax Court in applying this test included the following: (i) the total compensation paid to Blazick and Richter represented approximately 90% of petitioner's net income, (ii) petitioner never declared or paid a dividend, and (iii) petitioner's annual payments "had the effect of arbitrarily increasing allocations above the amounts the plan authorized" (Pet. App. A6-A7). The Tax Court noted that "the most persuasive evidence of petitioner's

lack of compensatory intent is the plan itself," for (i) it applied only to shareholders, (ii) payments were allocated according to stock ownership, and (iii) the Plan did not even purport to use the value of services rendered as the basis for calculating the amounts due (*id.* at A7). The Tax Court also sustained the addition to tax for negligence because "the plan was both designed and manipulated to direct the flow of corporate earnings to Messrs. Blazick and Richter and to disguise such payments as compensation" (*id.* at A9).

3. The court of appeals affirmed, with one judge dissenting (Pet. App. A10-A39). The court held that the Tax Court had correctly applied the two-prong test and that its finding that the payments were disguised dividends, and were not made for services actually rendered, was not clearly erroneous (*id.* at A21-A22). The court noted that, under its prior decision in *Elliotts, Inc.* v. *Commissioner*, 716 F.2d 1241, 1243 (9th Cir. 1983), "if there is evidence that the payments contain disguised dividends, the corporation must separately satisfy both the reasonableness and the compensatory intent prongs of the test. Reasonableness alone will not suffice" (Pet. App. A21).

Judge Wiggins dissented "from the well-written Majority Opinion" (Pet. App. A23). He concluded that the Tax Court should have made an independent apportionment between the amount allowed as deductible compensation and the amount determined to be non-deductible disguised dividend payments (*ibid.*).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. a. Section 162(a) of the Internal Revenue Code allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," including "a reasonable allowance for salaries or other compensation for personal services actually rendered." 26 U.S.C. 162(a)(1) (1994 & Supp. III 1997). To be deductible under this Section, compensation must be reasonable in amount and for personal services actually rendered. *Elliotts, Inc.* v. *Commissioner*, 716 F.2d at 1243; *University Chevrolet Co.* v. *Commissioner*, 199 F.2d 629, 630 (5th Cir. 1952). This two-pronged test is applied most commonly with closely-held corporations "having few shareholders, practically all of whom draw salaries," where "[a]n ostensible salary paid by a corporation may be a distribution of a dividend on stock" and thus a disguised distribution of profits. 26 C.F.R. 1.162-7(b)(1). Accord *University Chevrolet Co.* v. *Commissioner*, 199 F.2d at 630. Bonuses paid to employees are deductible "when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered." 26 C.F.R. 1.162-9. Regardless of its form, compensation may not be deducted if it exceeds an amount that is reasonable under all the circumstances—an amount that "would ordinarily be paid for like services by like enterprises under like circumstances." 26 C.F.R. 1.162-7(b)(3).

When a taxpayer challenges the Commissioner's disallowance of a claimed deduction, the taxpayer bears the burden of proving that the Commissioner's determination is incorrect. Tax Ct. R. 142(a); *Welch* v. *Helvering*, 290 U.S. 111 (1933); *Botany Worsted Mills* v.

United States, 278 U.S. 282, 289-290 (1929) (burden rests upon corporate taxpayer to show that payments to directors were ordinary and necessary business expenses); see also *Griffin & Co.* v. *United States*, 389 F.2d 802, 810 (Ct. Cl. 1968). The taxpayer bears the burden of proving both that the payments were reasonable in amount and that the payments were for services actually rendered. *Nor-Cal Adjusters* v. *Commissioner*, 503 F.2d 359, 362 (9th Cir. 1974); *Ruf* v. *Commissioner*, 1993 T.C.M. (RIA) ¶ 93,081, aff'd, 57 F.3d 1078 (9th Cir. 1995). This burden is particularly heavy when, as here, the challenged compensation has been paid to the shareholders and officers of the corporation. See, *e.g.*, *Rapco, Inc.* v. *Commissioner*, 85 F.3d 950, 954 (2d Cir. 1996); *Pepsi-Cola Bottling Co. of Salina, Inc.* v. *Commissioner*, 528 F.2d 176, 179 (10th Cir. 1975); *Griffin & Co.* v. *United States*, 389 F.2d at 810. Particular scrutiny is warranted when such payments are made to the shareholders of closely-held corporations, who are in a position to direct distributions of corporate profits in the form of excessive salary payments in an effort to obtain an improper deduction for dividends. *Botany Worsted Mills* v. *United States*, 278 U.S. at 293. See also *Owensby & Kritikos, Inc.* v. *Commissioner*, 819 F.2d 1315, 1322-1323 (5th Cir. 1987); *Charles Schneider & Co.* v. *Commissioner*, 500 F.2d 148, 151 (8th Cir. 1974), cert. denied, 420 U.S. 908 (1975); 26 C.F.R. 1.162-7(b)(1).

b. The Tax Court correctly sustained the Commissioner's determination that certain amounts paid by petitioner to Blazick and Richter were not reasonable compensation for services actually rendered during the years at issue but were instead dividends paid because of their stock ownership (Pet. App. A8). The Tax Court's findings on this issue were properly upheld by the court of appeals. As that court concluded (*Id.* at A21):

> The Commissioner did indeed come forward with overwhelming evidence of disguised dividends, evidence that fully supported the Tax Court's conclusion that the plan allocations were not intended as compensation, regardless of whether the amounts could be justified as reasonable.

These findings, "concurred in by two lower courts" (*Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982)), do not warrant further review. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n. 5 (1985).

2. Petitioner errs in asserting that the courts below created and applied "a new all-or-nothing 'compensatory intent' test" (Pet. 7). In applying the two-pronged test under this statute, the Tax Court correctly found that petitioner had failed to prove that payments made to Blazick and Richter—in excess of the amounts allowed by the Commissioner— were made for services actually rendered. The court of appeals agreed with the Tax Court that the Commissioner had presented "overwhelming evidence of disguised dividends, evidence that fully supported the Tax Court's conclusion that the plan allocations were not intended as compensation" (Pet. App. A21). The court cited numerous objective factors that supported that finding: (i) that petitioner paid Blazick and Richter approximately 90% of its net income each year; (ii) that petitioner had never paid dividends; (iii) that the Plan was manipulated to increase the payments made to petitioners; and (iv) that the Plan applied only to shareholders and allocated payments according to stock ownership instead of according to the value of services rendered (*id.* at A21-A22).

Petitioner incorrectly contends (Pet. 8-20) that, even though the challenged payments were not compensation for services at all, the Tax Court should nonetheless have made some sort of apportionment of the payments between dividends and compensation. The burden was on petitioner to show that some portion of the amount at issue was reasonable compensation paid for services actually rendered. *Nor-Cal Adjusters* v. *Commissioner*, 503 F.2d 359, 362 (9th Cir. 1974). Petitioner failed to meet that burden in this case. Indeed, as the court of appeals noted, it was petitioner that had urged an "all or nothing" approach in this case (Pet. App. A18 n.2):

> OSC does not raise and we do not address any apportionment issue, i.e., whether any further portion of the disallowed part of the incentive compensation should have been allowed as reasonable compensation. OSC's contention is that the entirety of the claimed amounts of incentive compensation should have been allowed.

Petitioner is plainly wrong in claiming that "a finding that there was no compensatory intent necessarily means that no services were provided" (Pet. 19-20) (emphasis omitted). Independent of their "incentive" plan payments, Blazick and Richter received significant salaries; the deductions claimed by petitioner for those salary payments were allowed by the Commissioner. Indeed, the Commissioner allowed deductions for compensation paid to Blazick and Richter that totaled $444,606, $494,437, and $508,482 for the years 1990, 1991, and 1992, respectively. The Tax Court and court of appeals sustained those determinations; neither they nor the Commissioner applied an "all-or-nothing" test (Pet. App. A17).*

3. a. Petitioner errs in contending (Pet. 11-14) that the decision in this case conflicts with *Commissioner* v. *R.J. Reynolds Tobacco Co.*, 260 F.2d 9 (4th Cir. 1958). In *R.J. Reynolds*, the company adopted a by-law under which a specified percentage of its profits was paid to employees each year in proportion to their stock ownership of the company. The company paid relatively small salaries, and the amount of stock owned by each employee was not directly related to the employee's value to the company. The Commissioner argued that the payments made under the by-law were dividends, rather than compensation, and therefore not deductible by the company. The Fourth Circuit, however, sustained a finding of the Tax Court that a portion of the by-law payments for each year represented reasonable compensation rather than dividends. The Fourth Circuit rejected the Commissioner's argument that all of the by-law payments "were necessarily of the same nature, and hence either all dividends or all compensation." 260 F.2d at 12. The court stated:

> If there is a reasonable basis in the record for isolating that part of the payment which is reasonable compensation for services, we think that a deduction for that part should be allowed. This is true whether the excess is classified as unreasonable compensation or as dividends. There is no

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* Petitioner errs in asserting (Pet. 17-19) that the decision in this case conflicts with 26 C.F.R. 1.162-7(a). That regulation states that "[t]he test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services." *Ibid.* That is precisely the determination made by the courts below in this case.

> basis in reason, the Tax Code, or administrative practice for the insistence that the part which is not deductible fatally infects the part which clearly is.

Ibid. (emphasis added).

Contrary to petitioner's assertion (Pet. 13), the Commissioner did not make the same "all-or-nothing" argument rejected by the court in *R.J. Reynolds*. In this case, the Commissioner determined that all of the amounts paid as salary plus a portion of the amounts paid to Blazick and Richter under the ICP for each year were reasonable and were paid as compensation for services rendered. Only a *portion* of the ICP payments was disallowed for each year (Pet. App. A5). The conclusion of the courts below that, on the record of this case, petitioner failed to prove that some additional portion of the payments made under the Plan was for services rendered does not conflict with the decision of the Fourth Circuit in *R.J. Reynolds*.

b. Petitioner similarly errs in asserting (Pet. 14-17) that the decision in this case conflicts with the decision of the Fifth Circuit in *Owensby & Kritikos, Inc.* v. *Commissioner*, 819 F.2d 1315 (1987). Petitioner contends (Pet. 16) that in *Owensby*, unlike in this case, "no independent, all-or-nothing 'compensatory intent' test was applied to preclude an apportionment of the compensation payments." In fact, however, as we just described, the courts below in this case held simply that the portion of the Plan payments challenged by the Commissioner represented disguised dividends, rather than compensation. Nothing in that finding, anchored as it is in the particular facts of this case, conflicts with either the holding or the rationale of *Owensby*.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MARCH 2000