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**Davis, d/b/a Mile High Calcium, Inc. v. U.S.,**  
74 AFTR 2d 94-5618

Judge: CARRIGAN, District Judge:

Memorandum Opinion and Order

Plaintiff Carol L. Davis dba Mile High Calcium, Inc. (Mile High) commenced this action against the United States, seeking a tax refund of FICA and FUTA employment taxes in the amount of \$2336.04 (first claim), as well as a declaratory judgment against the IRS (second claim). The United States has asserted a counterclaim against Ms. Davis and a claim against her husband, Henry Adams, for payment of additional FICA and FUTA taxes in the amount of \$39,220.66. Jurisdiction is asserted under 28 U.S.C. sections 1340, 1345, and 1346(a)(1).

On July 11 and 12, 1994, trial was held to the court. This memorandum sets out my findings of fact, conclusions of law and order as required by Fed. R. Civ. P. 52(a).

I. Findings of Fact.

The following constitute my findings of fact:

- (1.) Mile High was incorporated in Colorado May 20, 1981. It operated a lime slurry brokerage business in Colorado and Utah. Ms. Davis and Mr. Adams jointly owned all the corporation's stock.
- (2.) In 1981, the company properly made a subchapter S election pursuant to 26 U.S.C. section 1362. Thereafter, tax returns were filed for Mile High, Ms. Davis, and Mr. Adams consistent with the subchapter S election.
- (3.) On January 1, 1989, Mile High's charter was revoked by the Colorado Secretary of State. Since then, the company has been operated as a partnership.
- (4.) During the years here involved-1987 through 1989-Mr. Adams was nominal President of Mile High. However, he had almost no active participation in the day-to-day operations of the company. Mr. Adams [pg. 94-5619] worked during those years for other companies in other locations as a ski instructor, a truck driver, and a heavy equipment operator. During part of 1989, he resided in Dallas, Texas.
- (5.) From 1987 through 1989, Ms. Davis was Secretary of Mile High. In addition, she performed part-time clerical duties for the company, including paying bills, submitting invoices, making bank deposits, and communicating with independent contractor truck drivers. Ms. Davis also made business decisions for Mile High and took a few business trips.

(6.) The only evidence presented as to the time Ms. Davis gave to these tasks is her testimony that she spent about twelve hours per month on the operations of Mile High. The only evidence as to the value of her services is Mile High's accountant's opinion testimony that eight dollars per hour was a reasonable value for her services. The government presented no testimony at the trial.

(7.) Mile High did not have sufficient working capital at times during the 1987-1989 time period. It was necessary from time to time, therefore, for Ms. Davis and Mr. Adams to transfer money from their personal funds to pay Mile High's operating expenses. This money was repaid as Mile High's accounts allowed for repayment, and treated as loans by the company's accountant, Mr. Nittler.

(8.) All checks transferring money from Mile High to Ms. Davis and/or Mr. Adams were written to Mr. Adams and deposited in Ms. Davis's and Mr. Adams' joint personal checking account. At the end of the year, Mr. Nittler reconciled these accounts as well as other income and expense accounts. The company's net income was paid out to Ms. Davis and Mr. Adams and reported on their personal returns as non-salary income. Appropriate taxes were paid.

(9.) The Internal Revenue Service (IRS) ordered an audit of Mile High's 1987 and 1988 tax returns. In February 1991, after the audit, the IRS accepted the corporate returns as prepared and filed for Mile High by its accountants.

(10.) Thereafter, the IRS, in a proceeding involving only FICA and FUTA taxes, determined that during the period 1987 through 1989, Mr. Adams had been a Mile High employee, and classified all checks written by Mile High to his name as salary, without regard to the purpose of the payment or the identity of the person who ultimately received the funds.

(11.) The IRS classified other payments made by Mile High as salary paid to Ms. Davis, without regard to the nature of the payments, the types and extent of services Ms. Davis actually provided, or whether her alleged salary was commensurate with the value of those services.

(12.) The IRS then took the position that Mile High should have paid FICA and FUTA taxes for 1987 through 1989 based upon the respective salaries it had imputed to Ms. Davis and Mr. Adams. It assessed these taxes, plus interest and penalties, for a total assessment of \$39,220.66.

(13.) Mile High filed an administrative appeal of the IRS's assessment. The IRS denied the appeal. Thereafter, Mile High filed a refund action with the IRS; the IRS still has not ruled on it. After waiting the prescribed time, this refund action was filed. Ms. Davis has exhausted all her administrative remedies.

(14.) Following commencement of this action, Ms. Davis learned that Mile High's corporate charter had been revoked by the Colorado Secretary of State on January 1, 1989. Thereafter, Mile High's 1989 corporate return was replaced by a partnership return, and Ms. Davis's and Mr. Adams' 1989 individual returns were amended to reflect the partnership earnings, including calculation of self-employment taxes.

## II. Conclusions of Law.

The following constitute my conclusion of law:

[1] The taxpayers' burden of proof in characterizing payments from Mile High as dividends and loan repayments rather than compensation is heavy, as salary arrangements between a closely held corporation and its shareholders warrants close scrutiny. *Spicer Accounting, Inc. v. United States*, 918 F.2d 90, 92 [ 66 AFTR 2d 90-5806] (9th Cir. 1990). Nevertheless, the taxpayers' evidence is uncontroverted on the major issues, and I conclude that they have met their burden of showing that the United States' assessment of FICA and FUTA taxes against Mile High for the period 1987 through 1989 was, as to Mr. Adams, arbitrary and capricious, and without any basis in law or fact. The government's position as to Mr. Adams was not, and is not, substantially justified.

Additionally, Ms. Davis has established that the position taken by the United States as to the FICA and FUTA taxes she owes is not substantially justified.

Mr. Adams has presented substantial evidence that Mr. Adams was not a Mile High employee during the period at issue. Although 26 U.S.C. section 3121(d) defines an [pg. 94-5620] employee in part as "any officer of a corporation," there is an exception for officers who perform only minor services and who neither receive nor are entitled to receive remuneration. Treas. Reg. section 31.3121(d)-(1)(b). I conclude that Ms. Davis has demonstrated that Mr. Adams falls within that exception.

Although it is clear that Ms. Davis was a Mile High employee from 1987 through 1989, the government's calculation of her alleged salary for these years is without basis in law or fact. Ms. Davis has presented undisputed evidence that she worked about twelve hours per month performing services for Mile High. In addition, she has presented uncontroverted expert opinion evidence that her services were worth eight dollars per hour. The government disputes the plaintiff's evidence and asks this court to use its "common sense" to determine the extent and value of Ms. Davis's services. However, the court must base its findings and conclusions on evidence, not argument or speculation by government counsel. Because the government has presented no evidence as to the extent and value of Ms. Davis's services, I accept the taxpayers' evidence on these matters as dispositive.

Based upon the evidence, I find that Ms. Davis's total FICA and FUTA tax liability, including interest, is \$647.32. Her claim for a tax refund of \$2336.04, which represents the amount of FICA and FUTA taxes, plus interest and penalties, Ms. Davis has paid on Mile High's behalf, must be reduced by \$647.32.

Accordingly It Is Ordered that:

- ((1)) Ms. Davis's claim for a tax refund of the payment of assessed taxes, interest, and penalties is granted in the amount of \$1688.72, together with legal statutory interest commencing on January 29, 1992 and continuing until satisfaction of the judgment;
- ((2)) Ms. Davis's claim for a declaration that the IRS's assessment of taxes was improper is granted;
- ((3)) The United States' claims against Ms. Davis and Mr. Adams are dismissed with prejudice;
- ((4)) The United States is ordered promptly to revoke the assessment and remove any liens filed pursuant to the assessments; and

((5)) Plaintiff's motion, pursuant to 26 U.S.C. section 7430, for reasonable costs, expenses and professional fees incurred in connection with the IRS administrative proceeding and this litigation is granted. Plaintiff may file statements of the total amounts due within fifteen days of this order, and apply for an expedited hearing. As a precondition of that hearing, counsel for all parties shall meet and confer in a good faith effort to settle any remaining issues, and if the entire case cannot now be settled, to settle as many issues as possible, including the reasonable amounts of the taxpayers' costs, expenses and professional fees to be reimbursed in the event it is finally determined after appeal, if one is taken, that the government is liable to pay them.

Dated at Denver, Colorado July 15, 1994.