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CONSTRUCTIVE DIVIDENDS RESULTING FROM TRANSACTIONS BETWEEN COMMONLY HELD CORPORATIONS

I. BASIC CONSTRUCTIVE DIVIDEND TRANSACTIONS

A determination of when constructive dividends will result from transactions between commonly held corporations is rather difficult due to the present confusion in this area. Since the economic and financial impact of a finding of such distributions can greatly affect the common shareholder and corporate entities, this area warrants careful attention. The purpose of this work is to review the basis on which such constructive dividends are established and to review the development of precedent in order to extract meaningful principles and guidelines.

The Internal Revenue Code of 1954 provides in the general definition of gross income that gross income means all income from whatever source derived including dividends. Section 316 of the Code defines the term "dividend" as meaning "any distribution of property made by a corporation to its shareholders—(1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of the earnings and profits of the taxable year . . . ." This section also provides that any distribution under this section shall be made from the most recently accumulated earnings and profits. Section 301 of the Code provides that a distribution of property that constitutes a dividend is includable in the gross income of a shareholder, and section 317(a) provides "the term 'property' means money, securities, and any other property . . . ."

The formalities of a dividend declaration need not be observed for the distribution to be taxable as a dividend. As the Third Circuit Court of Appeals stated in "Commissioner v. Makransky":

1. Hereinafter referred to as "the Code".
2. INT. REV. CODE of 1954, §61.
4. INT. REV. CODE of 1954, §301(c)(1).
5. INT. REV. CODE of 1954, §317(a).
7. 321 F.2d 598 (3rd Cir. 1963).
The Internal Revenue Code defines "dividend" in language requiring the satisfaction of four criteria: There must be (1) a "distribution" of property (2) "made by a corporation" (3) "to its shareholders" (4) "out of its earnings and profits". Int. Rev. Code of 1954, §316(a); Int. Rev. Code of 1939, section 115(a), ch. 2, 53 Stat. 46 as amended. It should be observed that these criteria do not include a requirement that the distribution be made pursuant to a formal declaration of the dividend. Informal withdrawals and distributions, although characterized by the parties as other than dividends, must be taxed as dividends if the statutory criteria are met.8

Distribution does not need to be proportioned according to stockholdings, and all stockholders do not have to participate in the distribution for there to have been a taxable distribution.9 The distribution, however, must provide the stockholder with some direct economic benefit.10 This benefit does not have to be of a financial nature but can be merely personal or paternalistic gratification, fulfillment of a moral obligation, a gift, or other non-financial benefits.11 In addition, the benefit received by the stockholder does not have to be considered a dividend by the stockholder or the corporation for it to be taxed as such.12 The reasoning underlying the taxation of a shareholder where a distribution from the corporation is made to a third person for the benefit of the shareholder is that this is essentially a distribution to the shareholder himself. Where the shareholder is the sole or controlling stockholder, the reasoning is given that power to dispose of income is equivalent to ownership of it.13 This assignment of income principle was announced in Helvering v. Horst14 and has been applied to transactions between commonly held corporations to construct a dividend to the common shareholder on the

8. Id. at 601. (Citations omitted).
12. Clark v. Comm'r, 266 F.2d 698 (9th Cir. 1959); K. R. Lane, 28 T.C.M. 890 (1969).
rationale that a distribution was made by one corporation to another for the benefit of the common shareholder.\textsuperscript{15}

These general observations concerning the judicial authority in the area of constructive dividends are helpful in defining the nature of such dividends to which the Internal Revenue Code fails to refer. Various situations can arise where a payment, although not formally made with respect to stock, is classified as a dividend for tax purposes. Such payments include payment for property transferred, loans to the shareholder, additional compensation for rendered services, interest payments on loans, and others. Closely related are situations where the stockholder receives a benefit instead of actual payment from the corporation.\textsuperscript{16} Although these situations involving a payment or benefit from the corporation to the shareholder are distinguishable from the more complex transactions of commonly held corporations, there are general principles that are applicable to both, especially where the \textit{Horst} rationale is applied for the basis of a dividend resulting to the common shareholder from intercorporate transactions. Before reviewing the situations where dividends have been found to result from transactions between commonly held corporations or that result from actual distribution subsequent to manipulations of more than one corporate entity, it is instructive to note situations where constructive dividends have arisen, the shareholder himself having received money, property or benefit from a closely held corporation.

One area where the courts have found constructive distributions by a corporation to its shareholder is where the pay-


\textsuperscript{16} One writer has distinguished between cases where amounts are paid by a corporation to a shareholder for an alleged proper business purpose (Characterization Distribution) and cases where the shareholder is charged with a constructive distribution on the basis he received an unwarranted benefit by virtue of the corporation's payment to a third person or some other arrangement even though the stockholders never receive the wherewithal to pay the tax (Benefit Distribution). He finds cases of the latter type somewhat odious and on the outermost fringes of the taxable income pattern since the Commissioner assesses monetary income tax against a nonmonetary benefit received by a taxpayer. See Teschner, "Hidden Dividends"—The \textit{Paper Tiger of Constructive Corporation Distributions}, 43 \textit{Taxes} 644 (1965). The constructive dividend theory, as it applies to intercorporate transactions between commonly held corporations, would be classified as Benefit Distribution since the controlling stockholder has benefited from a particular transaction.
ments are made indirectly to a shareholder for his benefit. These payments are usually characterized as personal expenses. The Supreme Court of the United States has said in *Old Colony Trust Co. v. Commissioner*\(^17\) that there is income realized by an employee when his legal obligation is discharged by his employer. This principal is the basis for the finding of a constructive dividend in this area\(^18\) and, in finding this basis, the courts look to see whether the particular corporate expenditure primarily benefits the corporation's trade or business or is primarily for the stockholder's personal benefit. Of course the finding that such expenditures have been made primarily for the benefit of a stockholder will not only result in a constructive dividend to the stockholder but will also result in a denial of a corporate deduction under section 162(a) of the Code. Where there is only an indirect benefit to the stockholder, the courts have found that there will be no distribution to the shareholder.\(^19\) Few situations, however, provide a benefit that is clearly direct or indirect to the stockholder; consequently, the facts and surrounding circumstances must be considered in this determination.

Other situations where the taxpayer has been charged with a constructive distribution by virtue of his receipt of such benefit as to be tantamount to a dividend include use of corporate assets by shareholders. A constructive distribution to the stockholder has been found where he has used corporate

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17. 279 U.S. 716 (1929).
18. Where the corporation paid part of a joint judgment against the corporation, the shareholder, and others, the Eighth Circuit Court of Appeals held that the shareholder's escape from a contested money claim was not equivalent to receiving income from the corporation and not taxable as a dividend. Ruben v. Comm'r, 97 F.2d 926 (8th Cir. 1938). Thus, it appears the shareholder's obligation must be firmly established for the corporation's satisfaction of it to result in a taxable distribution.
19. There is no direct benefit where the newly formed corporation assumes liability on partnership notes. Wolf v. Comm'r, 357 F.2d 483 (9th Cir. 1966); Jewell v. U.S., 330 F.2d 761 (9th Cir. 1964). Rev. Rul. 69-608, 1969-2 C.B. 42. This Revenue Ruling provides that a corporation's redemption of its stock from a retiring shareholder results in a constructive dividend to remaining shareholders only where the redemption is in the satisfaction of the remaining shareholder's primary and unconditional obligation to purchase such stock. Where there is no such primary and unconditional obligation, the benefit to the remaining shareholders is merely indirect. B. Bittker & J. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §9.25 (3rd ed. 1971).
property such as yachts and automobiles for personal purposes.\(^\text{20}\)

Another fertile ground for the finding of constructive dividends is where corporate funds are transferred to the stockholder under the pretense of "loans" with no intent to create a bona fide creditor-debtor relationship. Whether a loan is recognized as a dividend for tax purposes depends on the intent of the parties at the time of the withdrawal as extracted from an examination of the actual circumstances.\(^\text{21}\) Various factors lead to the finding of a constructive dividend rather than of bona fide debt. Where there are no notes issued, no interest provided for, no maturity date fixed, no security given, or the absence of other facts indicative of a bona fide loan, the court will find a constructive distribution.\(^\text{22}\) Advances made on open accounts simplify this type of arrangement and are especially vulnerable to a finding of a constructive dividend.\(^\text{23}\)

Another factor in the stockholder's disfavor arises where the corporation has had a poor dividend record in the past.\(^\text{24}\) Where the withdrawals were for the shareholder's personal expense\(^\text{25}\) and were not to meet a particular emergency,\(^\text{26}\) the courts have found a constructive distribution. Where the corporation makes no attempt to enforce the collection of the "loan"\(^\text{27}\) and there is no plan or means to repay the advances,\(^\text{28}\) a constructive dividend may result to the shareholder. Of course, a history of advances made to a stockholder with little or no repayment will bear positively in a finding of a constructive dividend.\(^\text{29}\) It should also be noted that loans that are bona fide when made to the shareholder can result in a

\(^{20}\) Comm'r v. Riss, Sr., 375 F.2d 161 (8th Cir. 1967); American Properties, Inc., 262 F.2d 150 (9th Cir. 1958), aff'd per curiam, 28 T.C. 1109 (1957).


\(^{22}\) Berthold v. Comm'r, 404 F.2d 119 (6th Cir. 1968).

\(^{23}\) Comm'r v. Maklansky, 321 F.2d 598 (3rd Cir. 1963).

\(^{24}\) Spheeris v. Comm'r, 248 F.2d 928 (7th Cir. 1961).

\(^{25}\) Taschler v. United States, 440 F.2d 72 (3rd Cir. 1971).

\(^{26}\) Roschuni v. Comm'r, 271 F.2d 267 (5th Cir. 1959).

\(^{27}\) C. Marcello, 28 T.C.M. 1011 (1969).


\(^{29}\) Roschuni v. Comm'r, 271 F.2d 267 (5th Cir. 1959).
constructive dividend to that shareholder when, in subsequent years, the corporation forgives that debt.\(^{30}\)

Constructive dividends can also result from bargain purchases or rentals by shareholders of property belonging to the corporation. The difference between the price the stockholder pays for corporate property and its fair market price will be the amount of the distribution.\(^{31}\) Treasury Regulation section 1.301-1(j) states in pertinent part:

If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having a distribution to which Section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value.\(^{32}\)

Under the same principle a bargain lease, as well as a bargain sale, can result in a constructive dividend to the stockholder. In this situation the dividend consists of the difference between the property's fair rental value and the amount actually paid by the shareholder.\(^{33}\)

The constructive dividend can also arise where the corporation makes excessive payments to the shareholder in leasing or purchasing property. The key test in this area, as in the bargain purchase or rental area, is whether the corporation and the shareholders arrived at arm's length

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\(^{30}\) Shephard v. Comm'r, 340 F.2d 27 (6th Cir. 1965).

\(^{31}\) Goodling v. United States, 267 F. Supp. 724 (S.D. Miss. 1966), aff'd 393 F.2d 933 (5th Cir. 1968); Maher v. Comm'r, 69-1 USTC 99194 (W.D. Mo. W.D. 1969). This rationale has also been applied to tax shareholders on a distribution where the corporation makes a bargain sale to trusts set up by the shareholders for their children, Harry L. Epstein, 53 T.C. 495 (1969), and even where a stockholder causes his controlled corporation to make a bargain sale to another corporation whose sole shareholder is a trust established to provide income for the shareholder's family. J. G. Spitz, 1971 P-H T.C. Memo 71-54. The transaction is treated in substance as a distribution by the corporation to individuals of the difference between the sales price and the fair market value of the property since the taxpayers enjoy and use this excess as if it had actually been distributed.


\(^{33}\) Rev. Rul. 58-1, 1958-1 C.B. 173; 58th St. Plaza Theatre, Inc. v. Comm'r, 195 F.2d 724 (2d Cir. 1952), cert. denied, 344 U.S. 820 (1952); International Artists, Ltd., 55 T.C. 94 (1970). Due to difficulty in ascertaining the fair rental value of the property, however, the courts have treated the excess of the corporation's depreciation charges and maintenance expenses over the rent paid by the shareholder as the distribution. See Lash v. Comm'r, 245 F.2d 20 (1st Cir. 1957); Challenge Mfg. Co., 37 T.C. 650 (1962).
terms in their transaction. If such a finding is not made, the facts in a particular transaction may indicate that it is simply nothing more than payment of an informal constructive dividend.\textsuperscript{34} Akin to this area is a situation where property is distributed to shareholders in kind by the corporation, and the shareholder leases such property back to the corporation, the objective being to deduct rental expense under section 162 (a) of the Code. The courts have found that these rental payments are in essence dividends to the shareholders, but where the transaction conforms with the reality of a reasonable business transaction, no such dividend will be constructed.\textsuperscript{35}

The constructive dividend can also be found when there are excessive salaries paid to the shareholders or their donees by the corporation. A corporation is entitled under section 162 (a) to conduct a "reasonable allowance for salaries or other compensation for personal services actually rendered."\textsuperscript{36} Of course, if no services at all are rendered the entire amount paid out as salary would be considered a constructive dividend. More frequently, however, there is an excessive payment for such services rendered, and the excess of this compensation over the "reasonable" amount is considered a constructive distribution under section 301 of the Code.

The constructive dividend approach has also been utilized where the shareholder, through use of fraudulent means, has intercepted a misguided payment, properly intended for the corporate treasury, before the corporation received it. The Government has preferred an assessment under section 61 rather than a dividend approach under section 301 as income received under section 61 is not limited by the amount of earnings and profits of the related corporation.\textsuperscript{37}

Where the court finds that a shareholder has made an investment in the equity of the corporation under the guise of characterizing such an investment as a "loan", the payment

\textsuperscript{34} Goldstein v. Comm'n'r, 298 F.2d 562 (9th Cir. 1962); Crabtree v. Comm'n'r, 221 F.2d 807 (2d Cir. 1955); A. A. Emerson, 44 T.C. 86 (1955).

\textsuperscript{35} Armston Co. v. Comm'n'r, 188 F.2d 531 (5th Cir. 1951); Ingle Coal Corp. v. Comm'n'r, 174 F.2d 569 (7th Cir. 1949).

\textsuperscript{36} Int. Rev. Code of 1954, §162(a).

\textsuperscript{37} This preference was especially exercised after James v. United States, 366 U.S. 313 (1961), which held embezzled funds could be taxed to the embezzler. The constructive dividend approach, however, still has widespread use. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders §§ 7.05 at 7-34 (3rd ed. 1971).
of interest or principal will be considered as a distribution to him.\textsuperscript{38} This type of distribution is comparable to a dividend or redemption of stock.

In most of these transactions between the corporation and its shareholders, tax avoidance motives are usually present. In fact, tax avoidance in some situations has risen to the level of civil or criminal fraud.\textsuperscript{39} But tax avoidance motives are not necessary to a finding that there has been a constructive distribution to the shareholder. It is, however, important to note that where the court finds clear tax avoidance manipulations, the taxpayer will be charged the distribution regardless of the particularities of the transaction under review.

II. MULTI-CORPORATE TRANSACTIONS

Where two or more corporations are commonly held, constructive distributions may be found as a result of certain manipulations or transactions. Of interest is the historical development and application of the constructive dividend theory in this area.

*Helvering v. Gordon*\textsuperscript{40} provides the starting point for an overview of the application of the constructive dividend concept in a multi-corporate context. In the *Gordon* case, the taxpayer and his wife were in sole control of B can corporation, an operation extremely profitable in light of the taxpayer's friendship with the supplier of tin used in the can company's manufacturing process. The taxpayer received discounts from the supplier but, because he feared that customers of the can company would be unwilling to pay regular prices if they knew of the discounts, had the discounts paid over to A realty company in the form of commissions. The Revenue Act of 1924 had made income tax forms open to the public. The taxpayer and his wife also owned all the stock of A realty company, but in different proportions, the taxpayer's interest being considerably less than his interest in the can company (5% as compared to 80%). The constructive dividend issue arose when the A realty company paid out this commission income as dividends in accordance with the stock

\textsuperscript{38} Id. at 7-27.

\textsuperscript{39} Montgomery Engineering Co. v. United States, 230 F. Supp. 838 (D.N.J. 1964), aff'd per curiam, 344 F.2d 996 (3rd Cir. 1965); Minnie F. Lasker, 11 T.C.M. 50 (1952).

\textsuperscript{40} 87 F.2d 663 (8th Cir. 1937).
ownership of A realty company. The Commissioner contended the distribution should be taxed as if it were a distribution of B can company, according to that company's stock ownership. The Tax Court rejected this contention, but the Eighth Circuit Court of Appeals reversed. The evidence showed the A realty company was formed solely for receiving the rebates from the tin supplier, and the circuit court stated:

The arrangement so devised and executed was a mere device for siphoning the earnings of the can company out of its treasury and into the realty company, which served merely as a container to hold such earnings until Gordon and his wife should determine to distribute them.

So regardless of the taxpayer's contention that the corporate arrangement was necessitated by business reasons in that the large profit margin of B can company had to be concealed in order to keep its customers, the distribution was treated as though it were made by the can company. The court noted the suggested business motive prior to the repeal of the revenue provision in 1926. The court did not judge the legitimacy of the motive but simply stated: "As we view the case, however, motive is immaterial. The decision must turn upon the effect of what was done." Tax avoidance weighed heavily in the court's decision.

The Gordon case has been cited numerous times for the general proposition that the substance, not the form of a

41. 29 B.T.A. 275 (1933). In a companion case, Gordon Can Co. v. Comm'r, 29 B.T.A. 272 (1933), the Tax Court employed section 45 of the Revenue Act of 1928, a predecessor of section 482 of the 1954 Code, to allocate the income to B can company from the A realty company that had received the income in the form of commissions. It is significant to note that the Tax Court found no dividend consequence from the mere allocation of this income under section 45. This result is cited as an example of the so called "nullity theory" where the effect of this type of reallocation is ignored. That is, there is no dividend consequence resulting from an allocation of B's income to A where the funds are still physically held by B. This is to be compared with dividend consequences resulting from similar transactions discussed subsequently in this note. See Jenks, Constructive Dividends Resulting From Section 482 Adjustments, 24 Tax Lawyer 83, 93 (1970).

42. 87 F.2d at 666.

43. A provision of the Revenue Act of 1924 (43 Stat. 293, § 257) provided for the making of income tax returns open to the public. The court, however, noted that the Gordon arrangement continued after the repeal of this provision in 1926.

44. 87 F.2d at 666.
particular transaction, will be determinative for tax purposes.\textsuperscript{45} As there was reallocation by the Commissioner only to the extent of actual distribution, more specifically the case has been referred to as standing for the general proposition that there is no constructive dividend to the shareholder as long as the property transferred to the sister corporation remains in corporate solution and out of the hands of the shareholder.\textsuperscript{46} This interpretation results from a rather restrictive reading of the case, in light of later developments in this area. Factually, of course, there was an actual distribution in the case. The opinion, however, does not indicate whether the court would have found a constructive distribution as a result of the receipt by one corporation of income that properly belonged to another corporation but short of any actual distribution of the income to the shareholders. In any event, the dividends constructed in \textit{Gordon} were solidly based on an actual distribution, as opposed to a transaction where the funds remain in corporate solution.

Of interest are cases involving subsidiaries of controlled corporations where there has been an actual transfer of funds out of corporate solution. In those cases advances from subsidiaries of controlled corporations have been held to be constructive distributions from the subsidiaries' parent to the shareholders.\textsuperscript{47}

In \textit{Ben R. Meyer},\textsuperscript{48} the Board of Tax Appeals found a distribution which constituted dividends to the taxpayers from parent corporation A that owned all the stock of subsidiary corporation B. The petitioners owned all the stock of A corporation and withdrew funds from B corporation. These withdrawals were listed on the corporate books in standing accounts with the petitioners. The dividend determination was made even though partial repayment, some of which was designated as interest, was made to B corporation and even though the petitioners insisted the advances were loans. The Board of Tax Appeals reached its decision by first determining that, in substance, the petitioners were stockholders of B

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  \item \textsuperscript{45} \textit{E.f.}, Bradbury v. Comm'r, 298 F.2d 111, 114 (1st Cir. 1962).
  \item \textsuperscript{47} Tollefsen v. Comm'r, 70-2 USTC \#9469 (2d Cir. 1970); Jacob M. Kaplan, 43 T.C. 580 (1965); \textit{cf.} Ben R. Meyer, 45 B.T.A. 228 (1941).
  \item \textsuperscript{48} 45 B.T.A. 228 (1941).
\end{itemize}
corporation although its stock was held by A corporation. Secondly, the Board determined that the petitioners' net withdrawals constituted dividends from the earnings and profits of A corporation as provided by Section 115(a) of the Revenue Act of 1934. The Board noted:

Through the holding of such offices, petitioners were in fact and actual practice in absolute control, petitioners, over a period of years including the taxable years in question, have withdrawn Limited's earnings or profits at their own discretion, for their own personal uses, and in a manner which best suited their own purposes.

The Board noted that, subsequent to the formation of B, corporation A had made no formal distribution of dividends, even though during each of the taxable years A corporation had accumulated earnings and profits available for distribution. The contention that the form of the transactions indicated they were loans was rejected in light of the facts and circumstances of the Board's findings. The Board looked through the form of the corporate organization and designated the recipients of the advances as the shareholders of distributing subsidiary B. Here the distributions were limited to the earnings and profits of the subsidiary.

Another approach to this type of transaction is to consider the subsidiary a mere conduit through which the earnings and profits of the parent are distributed. Using this approach, the distributions are taxable to the extent of the parent's earnings and profits, not the subsidiary's. In Kaplan v. Commissioner, the Tax Court found that "non-interest-bearing loans of infinite duration" paid to a parent corporation's sole stockholder by the parent's wholly owned subsidiary constituted taxable dividends to the stockholder. The court noted that such distributions would be taxable to the extent of the parent's earnings and profits. No corporate business purpose of either the parent or the subsidiary was shown; in fact, the subsidiary was not even in a financial position to make the loan. The intention of the stockholder at the time

49. Section 115. Distribution By Corporations:
(a) Definition of Dividend—The term "dividend" when used in this title ... means any distribution made by a corporation to its shareholders, whether in money or other property, out of its earnings or profits accumulated after February 28, 1913.
50. 45 B.T.A. at 238.
51. 43 T.C. 580 (1965).
of the loan was not to repay but to use the sums for his personal use. The court found that the petitioner dominated and controlled affairs of both corporations and considered them instrumentalities through which he handled investments. The court was convinced that the source of the withdrawals received by the petitioner was the parent corporation and stated:

\[\ldots\] and that petitioner, in the exercise of his unfettered control over both corporations, caused $968,000 to be paid out to him through the medium of Jemkap, as a conduit and subservient instrumentality.\[52\]

The Second Circuit Court of Appeals applied this same approach to a transaction in which funds had been withdrawn from a subsidiary by a taxpayer in Tollefsen v. Commissioner.\[53\] The taxpayer and his wife owned all the stock of the parent corporation, and the subsidiary was wholly owned by the parent corporation. The circuit court reiterated the importance the Tax Court gave to determining whether there was an intent to make a loan, that is, contemplation of repayment by the parties. The advances were evidenced by non-interest bearing notes, but the evidence indicated no intention or plan of repayment. The circuit court accepted the Tax Court's analysis of the transaction as consisting of two steps, the first, a transfer from the subsidiary to its parent and second, a transfer from the parent to the taxpayer. The circuit court viewed the situation as similar to Kaplan in that there was an indirect distribution by the parent corporation caused to be paid from the subsidiary.

Wiseman v. United States\[54\] was a suit for income tax refund. The plaintiff owned two corporations, A and B. A was a successful operation, but B had been losing money for several years and the plaintiff wanted to liquidate it. In order to set B's losses off against A's profits, the plaintiff transferred all of his stock in B corporation to A in exchange for an indebtedness on A's books. The First Circuit Court of Appeals affirmed the United States District Court for the District of Maine's determination that the creation of the indebtedness constituted a corporate distribution equivalent to a dividend and taxable to the plaintiff as ordinary income to the extent of A's earnings and profits. The court rejected

\[52\] 43 T.C. at 595.
\[53\] 70-2 USTC ¶9469 (2d Cir. 1970).
\[54\] 371 F.2d 816 (1st Cir. 1967).
the plaintiff's contention that the transaction was prompted by a legitimate business purpose, the liquidation of B to enable A to obtain a tax loss on the liquidation of B:

That the transaction was motivatated by a legitimate business purpose is not disputed. But where, as here, the taxpayer is the sole or dominant stockholder of the distributing corporation, motive is irrelevant. For motive to have any meaningful significance at least the line between shareholder must be more sharply drawn than it is in this case. Bradbury, supra at 118. The real question here is what was accomplished by this transaction. The answer is that plaintiff received an unfettered indebtedness.56

So in most instances involving the corporation and its shareholders, the stockholder actually receives property, money, or something of value that is later determined to be a dividend. In most intercorporate transactions involving commonly held corporations, however, the person charged with receipt of the dividend will not in fact have received the property or money.

For the sake of logical presentation and analysis, division of these cases by specific types of transactions is made.56 Important to remember, however, is that basic principles and considerations run throughout the case law, regardless of the specific type of transaction from which constructive dividends are deemed to result. Utilization of related corporations in multi-corporate transactions does not in itself result in disregard of the corporation as a separate entity and in constructive dividend treatment. The nature of the transaction, as well as the consideration of other relevant factors such as business purpose, will enter into the determination of the tax consequences of a particular transaction.

In cases where these intercorporate transactions have taken place, the funds remain in corporate solution and the

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55. Id. at 818. The importance of a valid business purpose in precluding application of the constructive dividend theory to transactions between commonly held corporations will become apparent with a review of the cases in the area. It is submitted that the lack of importance attached to it here is due to the nature of the business purpose. That is, this motive approaches tax avoidance.

56. Difficulties exist in trying to characterize the various transactions as their nature is not always clear. Courts frequently find that a transaction is substantively different from what it appears to be and in other cases, e.g., W. B. Rushing, 52 T.C. 888 (1969), aff'd 441 F.2d 593 (5th Cir. 1971), the court has not found it necessary to identify the particular transaction once the issue of constructive distribution has been resolved.
earnings and profits of either corporation are not available to the shareholder without a distribution, even though he has been charged with a constructive dividend. The common stockholder of the closely held corporation benefits in several ways from the transfer of property from one of his corporations to another. As one writer notes:

If one corporation is operating at a profit, and the other at a loss, transferring income from the former to the latter avoids tax at the corporate level. The loan of funds or other transfer of assets may keep the losing corporation in business. Or perhaps one of the corporations has accumulated earnings tax unless it pays dividends. The stockholder may wish to sell one of the corporations and by transferring funds from the other, convert ordinary income into capital gain. Thus, non-arm's length transactions between the related corporations may be motivated by tax considerations beneficial to the stockholder. Regardless of motives, there may be an economic benefit in the transfer of funds, which the stockholder could not have obtained otherwise, except by means of a dividend and reinvestment. Under what circumstances will he be charged with constructive dividend income? 57

A. Services

This category includes transactions which result in a benefit to one of the corporations. Either there is overpayment for services performed by another related corporation, an underpayment, or actually no services performed even though payment is made.

Walter L. Morgan 58 was a case in which the Commissioner was unsuccessful in applying the constructive dividend theory after liquidation of a sister corporation. Corporation A and corporation B agreed under advisement from the I.R.S. to an allocation of gross income for tax purposes under section 45 of the 1939 Code. 59 This income had been reported on B’s return but was allocated to A for tax purposes as this was

59. Section 45 of the 1939 Code is the predecessor of section 482 of the 1954 Code, discussed subsequently. Here A corporation was the national sponsor, or underwriter, promoter, and distributor of a related corporation C. B corporation was the promoter and distributor of C corporation stock in a region of the country under a contract with A corporation. Because of the unrealistic reflection of income, deductions, credits, and allowances reported on B's return, these amounts were allocated to A corporation under section 45 to properly reflect the income of A corporation.
income received for services actually performed by A. One year later, it was decided to liquidate corporation B which still held the income for services performed by A. After this was done, the petitioners reported the gain on the liquidation of the assets of corporation B as long term capital gain. The Commissioner, on the other hand, contended that the liquidation was, in reality, a dividend to the common shareholders from corporation A as B’s assets in reality belonged to A. In other words, this was merely a liquidation of A’s assets that had remained in B’s hands, even though the value had been allocated for corporate tax purposes under section 45. The Tax Court refused to treat the liquidation as a constructive distribution to the taxpayer, noting:

Section 45 authorizes the distribution, apportionment, or allocation of gross income deductions, credits, or allowances; it does not authorize the distribution, apportionment, or allocation of net assets, surplus, or accumulated earnings and profits either specifically or by necessary implication.60

This case would seem to be a rejection of the principle in the Gordon case that there will be a constructive dividend to the common shareholders where there is distribution of earnings and assets of one corporation made by the other related corporation. This case questions the validity of the “nullity theory” that the Gordon case is considered to represent.61 Indeed, one would be hard pressed to find no dividend consequence in this transaction at all. And if such consequence does not arise as a result of liquidation, it must have arisen as a result of the allocation of the income under section 45. The court’s opinion has been criticized on the basis that here the Commissioner was not trying to allocate assets, or for that matter, anything else.62 The Commissioner was asserting that these assets remain the property of A, even though still held by B. By virtue of the Commissioner’s acquiescence in the case on this issue, one can say with a reasonable degree of certainty that if a sister corporation accumulates the earnings and profits of another commonly held corporation and, after some time, liquidates, the Commissioner will not treat the liquidation as a constructive dividend from the corporation originally entitled to the funds. One can assess that the trans-

60. 33 T.C. at 41.
61. Jenks, supra note 57 at 93.
62. Id. at 94.
fer of profits and earnings of one corporation to another
commonly held corporation would result, if at all, in immediate
tax consequences.63 Dividend tax consequences would not re-
sult from a corporate liquidation where the liquidating cor-
poration held assets properly belonging to a sister corporation.
The most appropriate time for the Commissioner to assert a
constructive dividend distribution in such a situation would
seem to be at the time the assets are diverted to the tranferee
sister corporation.64

A very significant case in this area is George W. Knipe.65
Equitable Publishing Company (hereinafter referred to as
Equitable), a profitable publishing company, and North Penn
Publishing Company (hereinafter referred to as North Penn),
a corporation in poor financial condition that had been operat-
ing at a loss since its inception, were owned equally by Knipe
and Berky. These two stockholders, who initially owned
Equitable, purchased North Penn to keep the corporation from
operating in competition with Equitable. Equitable made pay-
ments to North Penn on the basis that North Penn was
titled to such revenues in accordance with an advertising
income participation agreement. These amounts were omitted
from Equitable’s income tax return for the years in question
per the agreement whereby North Penn was to have promoted
Equitable’s advertising and subscriptions and also protected
Equitable from competition by serving as a buffer. The Com-
missioner contended that these amounts transferred from
Equitable to North Penn represented the former’s earnings
and profits and should have been included in gross income of
Equitable. The Tax Court found North Penn made no sub-
stantial contribution to the production of any of the income
that was reported by Equitable or of those funds transferred
to North Penn. As the Tax Court stated:

In our opinion, and we have found accordingly, the several advertising
income participation agreements entered into by Equitable and North

63. There should, of course, be no dividend consequence where there is a
statutory or other exception applicable. For example, where there can be
repatriation without tax dividend consequences where the income of a domestic
taxpayer has been increased by application of section 482 of the Code. See Rev.
64. Sparks Nugget, Inc., 29 T.C.M. 318 (1970), appeal pending, 9th Cir.
65. 24 T.C.M. 668 (1965) aff’d per curiam sub nom. Equitable Publishing
Penn with respect to such years did not constitute real and genuine
business transactions entered into by Equitable for profit or for any
other proper business purpose but for the mere purpose of distributing
to North Penn earnings and profits of Equitable without a business
basis therefore.66

The Commissioner also contended that one-half of the amounts
paid by Equitable to North Penn under the participation
agreements constituted constructive dividends to the part-
owner Knipe. The Tax Court found that there was indeed a
constructive dividend to the taxpayer. The petitioner argued
that the payments were for services to Equitable and that
the payments were not a gift nor did they extinguish any
obligation of the shareholder. He also pointed out that neither
shareholder had any personal obligation to satisfy any of
North Penn's obligations, and neither stockholder derived
any benefit from the transfers in question.67 The court reiter-
ated its opinion that there had been no substantial contribution
by North Penn to Equitable's production of income and that
there was a lack of any proper corporate purpose in the
advertising income participation agreement. The court util-
ized the Horst principle68 in justifying its decision that Knipe
had received a constructive distribution. The Tax Court ap-
plied this principle as follows:

As stockholders and officers of Equitable, Knipe and Berky had the
power to cause it to dispose of its income and accumulated earnings
and profits. They exercised that power by causing Equitable to make
a disposition thereof by way of distributions to North Penn in amounts
equal to the amounts of income omitted by Equitable in its income tax
returns for the respective taxable years in issue without any business

66. 24 T.C.M. at 684.
67. The taxpayer's argument here was made up of criteria that have been
determinative in other situations that there was no dividend consequence as a
result of an intercorporate transaction.
68. Power to dispose of income is equivalent to ownership of it, and the
exercising of this power to pay income to another results in enjoyment of
realization of income. Helvering v. Horst, 311 U.S. 112 (1940), aff'g 39 B.T.A.
157 (1939).

In the Horst case the taxpayer owned certain bonds and clipped the coupons
from them for his son. He delivered the coupons to his son before maturity as
a gift. Within the taxable year the son received payments on the coupons, and
he reported the amounts in his income tax return for the taxable year. The
taxpayer was the owner of the bonds throughout the taxable year and made
his tax return on the cash receipts and disbursement basis. It was held that
the amounts received by the son on the coupons were taxable to the tax-
payer as income.
purpose of Equitable. Under the Horst case, the foregoing power was the equivalent of ownership of the income and accumulated earnings and profits involved. The exercise of that power to procure payment of income and accumulated earnings and profits in amounts in question to North Penn was the enjoyment and hence the realization of income by those who exercised the power, namely, Knipe and Berkly. As a consequence the amounts in question are to be regarded as income taxable to them as dividends.89

The court's opinion cited Commissioner v. Makransky70 as pointing out that the principles in Horst had been applied in various cases71 holding the major stockholder of a corporation taxable for the distribution of corporate earnings and profits to a third party for some purpose which he wishes to serve, even where there is no receipt of financial gain by the stockholder. The Horst principle was applied in the Makransky case to tax payments made to the grantor of a trust as dividends where such payments were made to him primarily for the benefit of a trust in satisfying a judgment creditor's claim against the trust. The corpus of the trust was endangered by virtue of obligations incurred by the grantor prior to insolvency. The grantor did not gain anything from the loans; only the trust benefited from the satisfaction of the obligation.

For purposes of analysis, it is important to note that strong tax avoidance motives would appear to have dominated the arrangement in Knipe, whereby payments were made to North Penn who provided no substantial contribution to Equitable's gross income or the funds that were transferred. Also significant is the court's determination that there was no proper corporate business purpose served by this arrangement. Also pertinent for discussion in a later portion of this note is that the allocation of the transferred funds from Equitable to North Penn appears to have been made under the broad general section 61 of the Code defining gross income, rather than section 482 of the Code that provides for the allocation of income between commonly held corporations.

Worchester v. Commissioner72 involved similar facts. In

89. 24 T.C.M. at 695.
70. 321 F.2d 598 (3rd Cir. 1963), aff'd 36 T.C. 446 (1961).
71. Byers v. Comm'r, 199 F.2d 273 (8th Cir. 1952), cert. denied, 345 U.S. 907 (1953); Whitehead v. Comm'r, 148 F.2d 718 (4th Cir. 1945); Clark v. Comm'r, 84 F.2d 725 (3rd Cir. 1936). See also Biltmore Homes, Inc. v. Comm'r, 288 F.2d 336 (4th Cir. 1961).
72. 370 F.2d 713 (1st Cir. 1966).
that case payments were made from the stockholder’s A corporation to his other controlled corporation, B, allegedly for services relating to A corporation’s architectural and engineering services and construction work. The First Circuit Court of Appeals agreed with the Tax Court’s determination that this transfer of funds was income to the common controlling shareholder, Worchester. The Circuit Court noted:

Any other rule would permit a stockholder to convert income into capital gains by transferring funds from one business to another then selling the latter company at a profit; or, if that were not permitted, at least to escape strictures placed on accumulation of income by sections 531-537 of the Internal Revenue Code, 26 U.S.C. §§531-537, and thereby postpone at will the realization of taxable income.\(^73\)

The court also noted that B corporation operated its restaurant at a substantial loss, thereby avoiding any tax on most of the funds transferred from corporation A. The Worchester case also involved payments made to the corporation’s shareholders for business expenses that were unsupported, in addition to payments made to third parties for bribery of public officials. These transactions, as well as the transfer of funds from A corporation to B corporation for services that were never performed, appear to have impressed the court as a scheme of tax avoidance. The opinion indicated that the finding of obvious tax avoidance motivation is sufficient to find constructive dividends in this type of situation. In fact, both Knipe and Worchester have been characterized as involving tax avoidance manipulation that would be sufficient, without further consideration of the facts, to charge the common shareholder with a constructive distribution as a result of the transaction between the commonly held corporations.\(^74\)

Another case which would fall under the category of transactions involving services is Sterno Sales Corp. v. United States.\(^75\) In this case, the taxpaying corporation tried to invoke a constructive dividend theory to its advantage. Corporation A and corporation B were sister corporations and wholly owned subsidiaries of C parent corporation. The Tax Court held that payments by B corporation to A corporation for sales compensation were excessive and could not be deducted under section 162(a) of the Code by B corporation.\(^76\) The court

\(^{73}\) Id. at 715.

\(^{74}\) Jenks, supra note 57 at 88.

\(^{75}\) 345 F.2d 552 (Ct. Cl. 1965).

\(^{76}\) Sterno, Inc., 18 T.C.M. 1149 (1959), aff'd 286 F.2d 548 (2d Cir. 1961).
further held that the excessive compensation remained taxable to A Corporation which received it, even though the compensation was non-deductible under section 162(a) for corporation B. In a suit for refund of the tax paid by A on the compensation determined excessive, the plaintiff argued that the excessive compensation was actually a contribution to capital from the parent corporation C, following a constructive dividend from B corporation to the parent C. The Court of Claims rejected the plaintiff's argument, commenting on the nature of the funds in question:

Compensation remains compensation even if it is held unreasonable in amount, and, accordingly, not deductible as a business expense. The payment does not change in character solely because it is characterized as excessive or undue. The non-deductibility of the expense by the payer, because it is unreasonable in amount, does not transform the payment in the hands of the payee.77

The court said the taxpayer could only take advantage of recharacterization of the nature of a transaction when the Government changed its mind as to the nature of the transaction. Two judges dissented in the opinion of the court, viewing the actual effect of the transaction as a payment of a dividend that resulted from a shifting of the earnings and profits of B corporation. Considering the court's opinion in Sterno, it is of interest to consider whether there would have been a constructive dividend consequence to the parent corporation C if the Commissioner had invoked the theory, after making a correlative adjustment by excluding the compensation payment deemed excessive from the corporation A's gross income.78

In Commissioner v. Offutt,79 the Commissioner contended that a constructive dividend resulted to the sole stockholder of a development company when he caused the company to transfer water and sewer utilities to another wholly-owned corporation formed to provide the service for the development company's subdivision. The transfer was gratuitous, other than the utility company's obligation to main-

77. 345 F.2d at 554.
78. If section 482 of the Code is used to allocate gross income between commonly held controlled corporations, Treas. Reg. §1.482-(d)(2) would require a correlative adjustment to be made to the corporation from which income has been allocated.
79. 336 F.2d 483 (4th Cir. 1964).
tain and provide water and sewerage service to the subdivision. Noting that such a transfer was common for real estate developers in that state and that such utilities were necessary to meet the approval of county and state authorities, the court held that there was no dividend involved in these transfers since there was a valid business purpose.

Relying heavily on this decision, the Tax Court held in Walter K. Dean\textsuperscript{80} that where the sole shareholder of a corporation engaged in the business of developing residential subdivisions in Florida had transferred utilities to a utility company indirectly controlled by the taxpayer’s son-in-law, the transfer did not result in a constructive dividend to the shareholder. The court pointed out the necessity for having such utilities for F.H.A. and V.A. financing of the subdivision homes and that an absence of monetary consideration for the transfer did not necessarily mean an absence of any consideration, as the utility was assuming the maintenance of the system and any possible liability for pollution. The court said the test was whether the stockholder of a transferor corporation benefited from the transaction and noted a valid business purpose here:

\ldots Warrington had a valid business purpose in making these transfers and that, other than in a derivative way, Dean did not benefit from these transfers. \textit{W. B. Rushing supra.}\textsuperscript{81}

\section*{B. Sales}

Constructive dividend problems in this area could arise from unreasonable inter-corporate pricing arrangements, bargain sales of property between sister corporations, and property sales by one related corporation to another at a premium price.\textsuperscript{82} Early cases espoused the principle that where funds are transferred from one controlled corporation to another for the benefit of the majority stockholder, taxable dividends will result.\textsuperscript{83}

In \textit{Byers v. Commissioner},\textsuperscript{84} the Eighth Circuit Court of Appeals affirmed the Tax Court’s determination that excess-

\begin{itemize}
\item 80. 57 T.C. No. 5 (Oct. 6, 1971).
\item 81. Id. at 3463.
\item 82. Eustice, \textit{Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations}, 16th Annual Tul. Tax Inst. 57, 82 (1966).
\item 83. Biltmore Homes, Inc. v. Comm’r, 288 F.2d 336 (4th Cir. 1961); Byers v. Comm’r, 199 F.2d 273 (8th Cir. 1952), \textit{cert. denied}, 345 U.S. 907 (1953).
\item 84. 199 F.2d 273 (8th Cir. 1952), \textit{cert. den.}, 345 U.S. 907 (1953).
\end{itemize}
sive payments made from a controlled corporation to a partnership set up by the corporation's controlling stockholder were constructive distributions to the controlling stockholder in the amount in excess of what a disinterested third party would have charged the corporation for excess operating expenses. The controlled corporation was engaged in a trucking operation, and the controlling stockholder conceived the idea of setting up a partnership for his son and daughter to provide gasoline for the operation. The corporation paid the partnership two cents more per gallon than it had previously paid a distributor, even though it could have continued to purchase gasoline from the distributor at this lower price. The partnership initially sold only gasoline to the corporation, and this remained its principal source of income even though a service station was opened to the public some years later. In assessing a constructive dividend to the majority stockholder, Byers, the court found the arrangement to be an overall scheme for tax avoidance:

As to the deficiency against Byers, the circumstances also plainly seem to us to have significant logical probative force to support the view that the formation of the daughter-and-son partnership and the buying of gasoline from it at a two cent excess over the corporation's previous source constituted a plan on Byers' part to divert earnings of the corporation from himself as major stockholder to his children as family members; that this siphoning off of corporate earnings, on each occasion that the excess was paid, amounted in the situation to dividend distributions at these various times; and that such payments therefore had the nature and effect of a receiving of dividend income by Byers, to the extent of his stockholding.86

The court found it of no moment that Byers might not have had a current right to the income, as it cited the Horst principle to the effect that the power to have received funds was sufficient to charge him with a dividend consequence:

... Byers' disposition of his power to have received such funds as dividends subsequently, through the effecting of a present payment of them to his daughter and son as gasoline priced in the manner done, would still be capable of making their receipt by the children constitute the realization of income by him during the taxable year involved, as a model of paternal satisfactions in the family relationship. ...86

Another case analagous to those involving actual sales between related corporations is Biltmore Homes, Inc. v. Com-

85. Id. at 275.
86. Id. at 276.
missioner. In this case, three brothers owned a real estate corporation, Biltmore Homes, Inc., and also two finance and mortgage corporations that had been held to be exempt from federal income taxes during the years in question under section 101(4) of the Internal Revenue Code of 1939. By transferring to one of the mortgage companies a mortgage that was in excess of what was actually paid out for the construction of a particular project, an excess ended up in the mortgage and finance companies, and Biltmore deducted the full price of the mortgage first transferred. Although the court could not specifically locate the amount which represented the difference between base value of the mortgages and the amounts actually paid out by the mortgage and finance companies, it concluded that since the excess was not paid to Biltmore (as evidenced by the stockholder's receiving no part of this profit when the liquidation of Biltmore occurred) the amounts must have been diverted into other channels for the benefit of Biltmore's stockholders. Here again the court found the transactions to be an overall plan for tax avoidance:

The only reasonable explanation is that by a complicated course of transactions they hoped to make it appear that one or the other or both of the tax exempt corporations received the profit so that it might escape taxation altogether.

Sammons v. United States was a suit for refund of taxes paid upon a determination that a constructive dividend occurred to the common stockholder when stock was transferred between corporations. One corporation that was indirectly controlled by Sammons purchased the fixed assets of a paper bag corporation, while other assets were acquired by a corporation which had five corporate owners controlled by Sammons. The fixed assets were then leased to the corporation that acquired the other assets in order to carry on an operating business. Then the five corporations sold their stock in the corporation operating the bag business for cost to another corporation controlled by Sammons. This corporation then sold the stock for over $500,000 profit.

87. 288 F.2d 336 (4th Cir. 1961).
88. Section 101(4) of the 1939 Code was the predecessor of section 501 of the 1954 Code that provides tax exemption for certain corporations.
89. 288 F.2d at 339.
90. 433 F.2d 728 (5th Cir. 1970).
In conclusion, we hold Sammons received a constructive dividend when he moved the paper bag business between wholly-owned or controlled corporate entities at a price which the jury reasonably concluded to be one-half million dollars below fair market value. In reality then, the taxpayer took money from his five corporations and placed it in a sixth. It is of little consequence that he personally received no money from the transaction, for it is the power to dispose of income and the exercise of that power that determines whether taxable income has been received.91

Once again the court employed the Horst principle to charge the controlling stockholder with a constructive dividend.

Where there has been a less than arm's length sale of stock or notes from one controlled corporation to another, to prevent the common controlling stockholder from becoming personally liable on a corporate loan, the constructive dividend theory has been applied.

In Charles A. Sammons92 the Commissioner charged a business tycoon with a constructive distribution as a result of a transaction that took place within a complex multi-corporate structure. Sammons owned a number of insurance companies which owned some 60 commercial corporations. He acquired Aero-Test Equipment Company (hereinafter referred to as Aero) from bankruptcy in hopes of resurrecting the corporation into a profitable enterprise. Sammons obtained indirect control of Aero by the utilization of several of his controlled corporations. The Bankruptcy Court had required that Aero secure a million dollar line of credit so that the company might have an adequate amount of operating capital. The First National Bank of Dallas, Texas, was unwilling to accept the guarantee of the several controlled corporations for this million dollar line of credit. The bank required the loans be personally guaranteed by Sammons. Therefore, he gave them his personal guarantee for all loans made to Aero up to one million dollars. After the company began operations under the Sammons organization, it consistently lost money and suffered losses during the entire time of its operation. The bank, concerned with the million dollar loan which it had made to Aero, required Sammons to substitute his personal note for the money, and this note was renewed twice. Aero, although clearly insolvent, was able to

91. Id. at 732. (Citations omitted)
92. 30 T.C.M. 626 (1971). This case involves the same taxpayer as Sammons v. United States, id.
pay off this million dollar indebtedness as a result of complex inter-corporate transactions involving the sale of Aero preferred stock for cash. Four controlled holding corporations indirectly owned by Sammons did not have funds to purchase the $1,200,000 preferred stock issue of Aero. These corporations issued their own shares of preferred stock in the same amount and substantially in the same form as the issue of Aero preferred stock. The issue of preferred stock in the holding companies that was worthless at the time of issue, or became worthless shortly thereafter, was purchased by four insurance companies controlled by Sammons. The four insurance companies had on hand accrued earnings and profits in excess of the cost of the issue of preferred stock and promptly issued their checks to the holding companies. The holding companies in turn issued their checks to Aero for the preferred issue, and Aero issued a check to Sammons. Aero never paid any money on its preferred stock, and liquidation of the company occurred a year or two later. The Commissioner contended that Sammons received a constructive dividend as a result of these transactions that extinguished the indebtedness of Aero. He alleged that the amount of money Sammons received emanated from the earnings and profits of Sammons' insurance companies and that the money was used to save the petitioner from a losing business investment. Sammons, on the other hand, argued that the sale of Aero's preferred stock represented a recapitalization and that the payment to Sammons from Aero, as a result of this sale of stock, was prompted by a valid business purpose, that of improving Aero's debt to equity ratio.

The court found the Gordon, Kaplan, and Tollefson cases relevant to its decision in this situation. The Court found the money advanced was primarily intended to satisfy the obligations Aero owed to the petitioner. This dividend emanated from the earnings and profits of Sammons' four controlled insurance companies. The court noted that the removal of the obligation from Aero's balance sheet may have indirectly benefited it by improving its equity position. The court, however, did not think this sufficient to supply such a valid business purpose as to preclude the constructive dividend treatment. Of significance was the question as to why these insurance companies would invest heavily in a losing operation. Also, no economic compulsion existed for the corpora-
tions to invest in Aero, as there was no evidence to indicate that they would be required to assume responsibility for the indemnification agreement. In view of Aero's cash position and the outstanding short-time obligations, it was unlikely that any investor would have pumped such a large amount of money into Aero, considering that this money might be used to satisfy Aero's existing obligations. In short, the court found that the transactions were an integrated scheme designed to reimburse the petitioner for money expended by him on the Aero project. The Tax Court had two theories within the constructive dividend area on which it could have based its decision. First was the thesis that distribution from a corporation to others for the controlling stockholder's benefit, where there is no proper business purpose, will result in a constructive distribution to that shareholder. Secondly, where a corporation extinguished the personal obligation of the controlling stockholder, this extinguishment will result in a constructive distribution. The court's opinion stated that the primary objective of these transactions was to relieve Sammons of his obligations in regard to Aero. This would appear to be a sufficient basis on which to base the holding of the court, but the opinion goes on to say that there is no valid business purpose attached to the transactions. This raises questions whether the court would have found a constructive distribution if there had been a valid business purpose behind the transactions, notwithstanding the personal obligations of the petitioner to repay the loan. This language serves to emphasize the importance the Tax Court will attach to a finding of a valid business purpose.

*Tirzah A. Cox* is another case in which the controlling stockholder was charged with a constructive dividend as a result of transfers of funds from one corporation to another so that one corporation could pay off the loan on which the controlling stockholder was personally liable. The three petitioners in this case were the sole owners of C and D Construc-

93. In *Old Dominion Plywood Corp.*, 25 T.C.M. 678 (1966), no constructive dividend treatment was applied for the entire advances from one controlled corporation to another where they were made for valid business purposes; however, irregardless of this business purpose, a constructive dividend was found to exist to the controlling stockholder as a result of these advances to the extent the stockholder had personally guaranteed a bank loan to the corporation.

94. 56 T.C. No. 100 (Sept. 13, 1971).
tion Company, Inc., a sales construction company. One of the petitioners, Copple, was also the controlling owner of Commonwealth Company, an industrial loan and investment company. Early in 1961, two corporations, which later became defunct, executed notes in favor of Commonwealth for a total which was in excess of $50,000. Several months later, these notes were sold by Commonwealth to C & D. In the latter part of 1964, C & D and Commonwealth executed a release which discharged the corporate and individual makers of these notes from liability. In 1966, when C & D was financially unable to pay its $80,000 note that had been used for purchase of the notes from Commonwealth and that had been renewed several times and signed by Copple as an accommodation endorser, Commonwealth paid to C & D sums that were the principle balances of the notes purchased by C & D in 1961. This money was used by C & D primarily to make interest and principal payments on the bank note that was endorsed by the petitioner, Copple. The facts indicate that the notes were initially sold by Commonwealth to C & D because Copple, as president, feared that the Nebraska Department of Banking would order Commonwealth to charge off some of these notes, and that this would jeopardize Copple’s solvency. The Commissioner's position was that the payments made by Commonwealth constituted constructive dividends to the petitioner, Copple. As C & D was without funds or assets to pay its banknote, Copple arranged and caused Commonwealth to transfer the funds that extinguished Copple’s liability as an endorser and alleviated the financial plight of C & D. The petitioners contended that the sale of notes to C & D was really a loan, as there was an understanding that Commonwealth would repurchase the notes, and that, in fact, the payments in 1961 by Commonwealth were pursuant to a repurchase agreement. The petitioners alleged that they never received any part of or any benefit from these payments.

The Tax Court found that there was no evidence to indicate that this was a bona fide loan or to indicate that there was any side agreement providing for repurchase of the notes. In short, the Tax Court found that this was a purchase of notes with no recourse. The court found that, even though the notes were never endorsed or delivered, the notes were validly transferred. The Tax Court found that the petitioner,
Copple, received constructive dividends to the extent that the amounts transferred to C & D were used to the satisfaction of the bank note. With the insolvent condition of C & D, Copple, as an accommodation endorser, was only one step away from liability. As the transfers were caused by Copple in order to avoid liability on his endorsement, this corporate discharge of the shareholder's personal liability was a dividend to Copple to the extent of the corporation's earnings and profits. In not finding any legal obligation on the part of Commonwealth to repay C & D, the court stated that it could not discern any valid business purpose for the transfers in 1966. This again would seem to imply that the finding of such purpose might have precluded the application of the constructive dividend theory irregardless of the benefit to the shareholder in extinguishment of his liability on the note.95 The court found no constructive distribution to the other petitioners and stockholders as they were not personally liable on the note. The theory that they received a constructive dividend by virtue of their being spared the expense of liquidation losses or money contributions was rejected by the court since "we think it is too tenuous under these particular facts and circumstances."96

The Commissioner has taken the position that certain bargain sales between brother-sister corporations will result in a constructive dividend to the common stockholder after section 482 of the Code is employed to allocate the bargain element of the transaction.97 This approach will be elaborated on in a subsequent part of this paper, discussing application of section 482 and one of its collateral effects, a constructive dividend to the common stockholder.

C. Loans

In this type of transaction, the corporation that transfers the money or property to the receiving corporation usually receives no tax benefit in transferring the funds. That is,

95. The finding of such a valid business purpose could possibly result in a finding that the benefit to the stockholder, in having his personal liability extinguished, becomes only derivative and secondary to the primary business purpose of the transaction. W. B. Rushing, 55 T.C. 888 (1969), aff'd 441 F.2d 593 (5th Cir. 1971).
96. 56 T.C. No. 100 at 881.
the lending corporation does not exclude such amounts from its gross income or take deductions for the amounts.98

In Washington Institute of Technology, Inc.99 the Commissioner disallowed a bad debt deduction taken by a taxpayer corporation on the basis of advances made by this corporation to a corporation whose outstanding stock was owned by the owner of the lending corporation's stock. The type of operations carried on by the taxpayer corporation were entirely different from those of the corporation that received the advances. The common stockholder of these two corporations chose this method of financing this corporation to insure retention of control of the receiving corporation. The Tax Court rejected the Commissioner's contention that these advances were gifts rather than loans and also rejected his contention that these advances were contributions to capital. The construction of a distribution to the common stockholder of the two corporations from the transfer of the advances was rejected:

Respondent's contention that the petitioner's advances would have benefited only Colonel Mashbir and that these advances were in the nature of indirect dividends disregards the doctrine of corporate entity and is contrary to the accepted treatment of dividends. These advances were not regarded as dividends on the petitioner's books, no declaration of dividends was made, nor were the advances made to a stockholder. We have no evidence before us that Colonel Mashbir regarded the advances as dividends in any accounting of his personal finances. We accordingly hold that advances by petitioner were loans and not dividends. Tri-State Realty Co., 12 T.C. 192 [Dec. 16, 800]; aff'd. (C. A., 5th Cir., 1950) 180 F.2d 593 [50-1 USTC ¶5951].100

The Tax Court found that the common stockholder's legitimate expectations as to the eventual success of the recipient corporation were an acceptable business purpose for making the advances.

The Tax Court's language, above, is interesting in that it indicates that some corporate action may be necessary to evidence a distribution in the form of dividends. This type of

98. The lending corporation could, however, derive a benefit in that the corporation would be subject to the accumulated earnings tax under section 531 of the Code if the transfer of the funds were not made.
99. 10 T.C.M. 17 (1951).
100. 10 T.C.M. at 19.
reasoning seems to have lost its potency.\textsuperscript{101} The case, however, still appears to support the proposition that if there are acceptable business reasons for a transfer between two commonly held corporations, there will be no constructive dividend treatment.\textsuperscript{102}

The Commissioner was more successful with his constructive dividend argument in \textit{David A. Aylsworth}.\textsuperscript{103} Here the petitioner owned one-half interest in Westley Shipping Company and owned, indirectly through a joint venture in another corporation, one-half of a Panamanian corporation, Caribbean Line. Westley advanced funds to Caribbean to provide for a downpayment of $70,000 on purchase of a ship with the balance of $143,000 financed by a bank. These advances made from Westley to Caribbean were on an open account. In deciding that these advances constituted dividend distributions, one-half of which was taxable to the petitioner, the Tax Court pointed out that the form of the transactions in question did not even assume the appearance of a loan, which the petitioner contended the transactions were. There was no security for the "loan", no interest paid on the advances, and no evidence of a planned fee. The court found the constructive dividend theory applicable to the transaction in this manner: Caribbean Line had authorized an issuance of its stock and had accepted the subscription for the stock from two corporations in which the petitioner owned half interest, Guatemala and West Line. There was no evidence to indicate that either of these subscribers of the stock ever paid Caribbean any consideration. The advance from Westley to Caribbean constituted the capitalization that was supposed to have been supplied by Guatemala and West Line. The court stated that the payment from Westley in effect discharged the obligation of the two corporations to purchase capital stock of Caribbean.

Such distributions of corporate funds made to a shareholder or to a prospective shareholder who was obligated to purchase stock in the same corporation or in another corporation consistently have been held to constitute dividend distributions to him.\textsuperscript{104}


\textsuperscript{102} Welles, \textit{supra} note 46.

\textsuperscript{103} 22 T.C.M. 1111 (1963).

\textsuperscript{104} 22 T.C.M. at 1113. The court's reasoning as to how a constructive distribution resulted to the two subscribing corporations by virtue of an
As a result of this constructive distribution to West Line and Guatemala, the court found a dividend distribution to the petitioner because the constructive distribution to the corporations would "inure to the direct financial benefit of the petitioner because of the increase in value of his equity therein." The court stated that, in substance, the transaction was tantamount to the petitioner's withdrawing the money from the earnings of Westley and subsequently investing it in Caribbean as risk capital.

The court here made no mention of the advances being made for a proper corporate business purpose. It has been suggested that there was as much a proper corporate business purpose in this situation as there was in other cases where the finding of such a purpose prevented the application of the constructive dividend theory. In other words, there seems to have been a significant business purpose in the Aylsworth case since the acquisition of a ship by Caribbean would have conceivably increased Westley's shipping business.

In Old Dominion Plywood Corp., the stockholders of the petitioner corporation formed another corporation, World Woods, to supply the petitioner corporation. Old Dominion made advances to the supplier corporation on written 90 day notes at five percent interest. The supplier corporation later became insolvent and was liquidated, with none of the notes or any of the interest having been paid. After noting that any reasonable expectation of repayment of the advances would have necessarily depended upon the financial success of World Woods, the Tax Court found that the advances were in the nature of capital contributions rather than a bona fide loan. Thus, the bad debt deductions the petitioner corporation was seeking to take as a result of World Woods' insolvency were extinguishment of their obligations to purchase stock from Caribbean appears to be an around about way of constructing dividend consequences to the petitioner. The approach itself does not seem applicable in this situation because here the subscribing corporations were not shareholders or prospective shareholders of Westley, the corporation making the advance. The cases cited here would only support the proposition that a constructive distribution results to the stockholders of a corporation where that corporation satisfies the stockholder's obligation to purchase stock in that corporation or another corporation.

105. Id.
106. Jenks, supra note 57 at 90. See W. B. Rushing, 52 T.C. 888 (1969), aff'd 441 F.2d 593 (5th Cir. 1971).
denied. The Tax Court, however, refused to accept the respondent’s contention that the entire amount of the advances resulted in a constructive dividend to the stockholders, emphasizing the operation of World Woods as a separate corporate entity, carrying on separate business activities. The court, however, did find a constructive dividend to the controlling stockholder who had personally guaranteed one of World Woods’ debts that had been satisfied by part of the advances. It was their opinion that the discharge of the personal liability of this stockholder was a dividend to the extent of the availability of Old Dominion’s earnings and profits. The earnings and profits were sufficient to cover the amount of the note on which the stockholder was personally obligated, and this amount was deemed taxable to him as dividend, the court noting Old Dominion had not paid a formal cash dividend during the entire period in question. As the court summed up its findings:

We cannot accept respondent’s analysis of the transaction apart from the $25,000 discharge of Cecil J. Stone, Sr.’s liability because these advances to World Woods were not made for the personal benefit of its shareholders but were rather capital outlays made by Old Dominion to a corporation which it previously hoped would constitute its source of supply. Nor can we conclude that the value of their equity in World Woods was in any way increased on account of these advances or that they received any tangible benefit therefrom, since they were made with the expectation of dissolution of World Woods, and upon that dissolution, none of the shareholders received or could anticipate receiving any distribution in liquidation.\(^{108}\)

So the court found that the advances were not made for the personal benefit of the stockholders, with the exception of the one note that was personally guaranteed. The court further buttressed its decision by noting there was no increase in the shareholders’ equity in World Woods.

Underlying the court’s decision appears to be the feeling that this was a legitimate, business-oriented arrangement with proper attention being given to the separate corporate entities. The opinion also serves as an indication that a personal guarantee satisfied by advances made under the guise of “loans” will result in constructive distribution to the guarantor-stockholder on the principle that this is an extinguishment of his personal legal obligation.

\(^{108}\). *Id.* at 700, 701.
In *Morrison Industries, Inc. v. Commissioner*, the constructive dividend issue arose out of a plan of liquidation for an iron manufacturer. As part of this plan for liquidation, book transfers of assets were made to some subsidiary companies. The court found constructive distributions to controlling stockholder Albert as a result of transactions under the plan of liquidation.

Albert received the direct benefit of the $100,000 which was deposited in Tradesmens Bank and which was applied to his loan. He also shared in the $179,500 paid to or for the benefit of L. Albert & Son, a partnership in which he had a 90 percent interest. In addition, the transfers from LCM, Inc. to corporations owned or controlled by him, constitute constructive transfers to Albert himself. To the extent of his equitable ownership of the corporate transferees, Albert received the benefit of these transfers. The situation is exactly the same as if the funds had first been paid over to Albert and then paid over to the corporations, thereby increasing his equity in them. In an analogous situation in *Helvering v. Gordon* [37-1 USTC 77 9088], 87 F.2d 663 (C.A. 8, 1937), the Court of Appeals held that where there were transfers of income from one corporation to another, both of which were wholly owned by individual taxpayers, the transfers were in effect taxable distributions from the first corporation to the individual shareholders. The court rejected the taxpayers' argument that they were not chargeable with income since they had never personally received the funds...

In this case, as in others, the court merely applied the principle that a distribution from one corporation to another for the benefit of a controlling stockholder will result in a constructive distribution to him. The court also noted an increase in the shareholder's equity by virtue of these transfers.

In *Christie Coal & Coke Co.*, the Commissioner contended that individual shareholders were required to recognize as dividend income advances made by three related corporations to a fourth corporation, Ruth-Elkhorn Coals, Inc. (hereinafter referred to as Ruth). Ruth had secured a loan through the Small Business Association to continue its coal mining operations. In order for Ruth to receive the loan, three related corporations were required to guarantee the loan and submit trust deeds for the property they held. Periodically, when Ruth was unable to meet its financial obligations, the related corporations made advances in order

110. Id. at 864.
111. 28 T.C.M. 498 (1969).
for Ruth to meet these obligations. These advances were not evidenced by notes nor was there interest added to the principal amount. The Tax Court first determined that the advances made by the corporations to Ruth were not deductible as bad business debts under section 166 of the Code. The facts indicated that the Small Business Association was furnishing money to Ruth primarily on the credit of these guarantor corporations. The court found no bona fide debtor-creditor relationship intended between the three corporations and Ruth as a result of their guarantee on the loan and that there was no reasonable expectation of repayment except out of future profits that Ruth might make. The Tax Court then rejected the Commissioner’s contention that stockholders X and Y must be charged with dividend income, the amount of the advances made by the three corporations on behalf of Ruth. Although the court had determined these advances were not valid business debts and, with the exception of the advances made by one corporation, were not trade or business expenses deductible under section 162(a), the court refused to charge the shareholders with a constructive distribution. In regard to the one corporation that was allowed to deduct the advances as a business expense (its royalty income was dependent on the success of Ruth), the court stated:

Accordingly, that a corporation makes expenditures for a valid business reason which may also benefit one or several shareholders does not give rise to dividend income.  

With regard to the other two corporations which were refused deductions for the advances either as bad business debts or business expenses, the court did find sufficient business reasons for making these advances. The finding of this business purpose, in the court’s opinion, precluded any constructive dividend consequence to the shareholders because such advances would not be only for the benefit of the shareholders in funding Ruth.

However, we do believe there was a business purpose, tenuous though it was, for making these advances. Accordingly, we find the advances were not solely for the personal benefit of the shareholders T.M. and O.L. This is not to say there cannot be constructive dividends where inter-corporate advances and guarantees are paid which rebound to the benefit of the majority or sole stockholders in related corporations.  

112. Id. at 524.
113. Id.
It is important to note the importance the court attaches to the business purpose it finds for the advances made to Ruth. The court indicated that even a finding of an insubstantial business purpose would be sufficient to keep the benefit of such advances from accruing only to the shareholders and thus resulting in a constructive distribution. The business purposes for the advances made by the three corporations were: If Ruth’s operations were successful, Ruth would be a source of coal from which X corporation would be able to draw in order to produce a very profitable type of coke, assuming X corporation was able to purchase expensive equipment. Corporation Y would benefit from Ruth’s successful operations as it would serve as sales agent and would derive sales commissions. Corporation Z, the owner of the land on which Ruth would carry out its operations, would prosper as a result of royalty income. The promotion of the economic interest of all three of the corporations was conditioned upon the future success of Ruth.

*W. B. Rushing*114 illustrates how heavily a valid business purpose for an inter-corporate transfer will weigh in a determination that there is no constructive distribution to the common shareholder. Rushing was the sole shareholder of Lubbock Commercial Building, Inc. (hereinafter referred to as L.C.B.) and Briercroft & Co. (hereinafter referred to as Briercroft). Briercroft was organized by the petitioner, Rushing, to purchase a tract of land which adjoined land owned by L.C.B. L.C.B. was a commercial developer and planned to develop this land as a shopping center. The tract of land purchased by Briercroft was to be developed for residential purposes to increase the population around the shopping center, thus enhancing the economic outlook for the center. Rushing formed Briercroft as a separate corporation so that knowledgeable residential developers that would be brought into the project would not also get an interest in Rushing’s commercial ventures. This was Rushing’s first venture outside the commercial development area, and he thought that other developers, more knowledgeable in the residential area, would have to be brought in for the success of Briercroft. As it turned out, however, Rushing did not find it necessary to bring others into the residential project. Briercroft’s initial capitalization was only $1,000. Briercroft gave a purchase

114. 52 T.C. 888 (1969), aff’d 441 F.2d 593 (5th Cir. 1971).
money note for over $400,000 for the land it acquired. At the request of the sellers of the property, the note was co-signed by L.C.B. L.C.B. made advances to Briercroft starting in 1959, the year of the purchase. There were no notes as evidence of the advances, and no interest was paid on them, although Briercroft did repay some of the advances with proceeds it received from the sale of residential property. In 1962, L.C.B. advanced over $60,000 to Briercroft that was used by Briercroft for the final payment on the purchase money note given in 1959. Neither of these corporations had ever paid a formal dividend. L.C.B. and Briercroft merged in 1965, the net unpaid advances from L.C.B. to Briercroft totaling over $60,000. The principle reason for the merger was the elimination of Briercroft’s outstanding debts to L.C.B.

The Tax Court rejected the Commissioner’s argument that the net unpaid balance on the advances was a constructive dividend to the petitioner. The Commissioner argued that these advances were not bona fide debt and should be treated as contributions to capital from Rushing. The court found it unnecessary to decide whether the advances were bona fide debt in order to find a constructive distribution to the petitioners. The test was said to be whether advances made from one commonly held corporation to the other were primarily to benefit Rushing. The court pointed out that Briercroft was a separate taxable entity and that just because Rushing was the sole shareholder of both corporations was not a sufficient basis for concluding that Rushing constructively received the advances of L.C.B. The court further found that whatever personal benefit, if any, the petitioner received was derivative and not direct in nature. The court also noted that L.C.B. had a significant business interest in Briercroft’s success since increased residences adjacent to the shopping center would increase business for the shopping center. As the court expressed:

We have decided that whatever personal benefit, if any, Rushing received was derivative in nature. Since no direct benefit was received, We cannot properly hold he received a constructive dividend.

The record further indicates that L.C.B. as a corporation had a significant interest in Briercroft’s successful development of its acreage. Briercroft’s success in the development of homesites on land adjacent to L.C.B.’s shopping center would inevitably lead to increased patronage for the shopping center.116

115. Id. at 894.
The Tax Court mentioned two lines of cases which it termed relevant to the constructive dividend issue under consideration. The first line deals with a corporation’s purchase of life insurance on the lives of its shareholders, the proceeds to be used for redemption of stock of the corporation’s shareholders. The I.R.S. has conceded that the premiums paid on this insurance do not constitute constructive dividends to an insured shareholder.\textsuperscript{116} The second line of cases deals with cases holding that when a shareholder’s stock is redeemed, the remaining shareholders do not receive a constructive dividend since the benefits they receive are only indirect.\textsuperscript{117} Apparently, the reason for the Tax Court’s mention of these cases, which would not seem directly applicable to the presented situation, would have been to illustrate and emphasize the indirect and incidental benefits received by the shareholders.\textsuperscript{118}

It is interesting to note that the court found it unnecessary to decide whether the advances were bona fide debts.\textsuperscript{119}

\textsuperscript{117} Milton F. Priester, 38 T.C. 316 (1962); Robert N. Peterson, 23 T.C.M. 63 (1964); Henry C. Goss, 22 T.C.M. 1219 (1963); William A. Green, 22 T.C.M. 1241 (1963).
\textsuperscript{118} A second look, however, reveals the factual situations and the principles behind these two lines of case and suggests another possible point of relevance. The real basis of the Commissioner’s concession in the insurance purchase cases is that the corporation is only converting one asset, cash, into another asset, insurance. Although the court did not determine it, it would appear that the advances made by L.C.B. to Briercroft were equity investments in light of the thin capitalization of Briercroft and other factors. So, considering L.C.B. as becoming a stockholder in Briercroft, the reasoning of the above line of cases has more relevance, that is, there is no dividend consequence to the shareholder when the corporation only converts one asset, cash, into another asset, stock.

Assuming L.C.B. became in effect a shareholder in Briercroft, the second line of cases mentioned has relevance if the repayment of part of the advances by Briercroft is considered a redemption of part of the stock ownership of L.C.B. Of course, the line of cases would have even more relevance if the merger of the two corporations could, in some way, be considered a redemption of L.C.B.’s stock ownership. The result in both situations would be only an indirect benefit to the common stockholder and no constructive dividend.

\textsuperscript{119} The transferor corporation in Rushing was not claiming a bad debt deduction which would have made such a determination necessary. Other cases that have involved constructive dividend issue where the transferor corporation claimed such a deduction have, of course, had to make this determination. See, e.g., Washington Institute of Technology, Inc., 10 T.C.M. 17 (1951); Old Dominion Plywood Corp., 25 T.C.M. 678 (1966); Christie Coal & Coke, Inc., 28 T.C.M. 598 (1969).
The Commissioner argued that since these advances were not a bona fide debt they were to be treated as contributions to capital resulting from constructive dividends to the common shareholder. As the Tax Court displayed in Christie Coal & Coke Co.,\textsuperscript{120} advances transferred that are not a bona fide debt, and thus, not deductible as a business debt, and not an ordinary and necessary business expense deductible under section 162(a), do not necessarily result in a constructive dividend to the common shareholder. So the characterization of advances as not being a bona fide debt is not conclusive by any means to a determination that there is a constructive distribution to the common shareholder of the transferor and transferee corporations. In Christie, the advances were deemed to be equity investment due mainly to the shaky capital structure of the transferee corporation, a situation somewhat analogous to Rushing. The finding of a business purpose for the advances in Christie prevented the application of a constructive dividend treatment. In Rushing, the finding of a business purpose was also important in denying constructive dividend treatment. The Tax Court used the word “primarily” in Rushing\textsuperscript{121} and “solely” in Christie\textsuperscript{122} in referring to the nature of the benefit accrual to the shareholder that will result in constructive dividend treatment. After Rushing, the Commissioner was given a dual test with undefined meaning to apply in this area. In order for there to be a constructive distribution to a common shareholder as a result of the transaction between two commonly held corporations, the Commissioner must show that the transaction was primarily for the benefit of the shareholder. The benefit must also be direct rather than derivative to the shareholder. The finding of a valid business purpose would make it difficult, if not impossible, to charge the common shareholder with the constructive distribution.

\textbf{D. Rentals}

Rentals between related corporations may give rise to application of the constructive dividend theory where two corporations have not dealt with each other at arm’s length. An allocation by the Commissioner of income from one com-

\begin{itemize}
\item \textsuperscript{120} 28 T.C.M. 498 (1969).
\item \textsuperscript{121} 52 T.C. 888, 893 (1969).
\item \textsuperscript{122} 28 T.C.M. 498, 524 (1969).
\end{itemize}
monly held corporation to another to properly reflect an arm's length transaction may result in a dividend consequence to the common shareholder.

In The Challenger, Inc.,\textsuperscript{123} the Tax Court \textit{held} that rents paid by Challenger, a casino corporation, to several sister corporations for the lease of one hundred slot machines were excessive and unreasonable, and, therefore, nondeductible by Challenger under section 162(a)(3) of the Code. Although the court refused to specifically characterize the amount of the rentals deemed excessive, the court viewed the amounts as either: (1) a nullity which would give rise neither to a deduction to the lessee, nor income to the lessor; (2) a capital contribution from the lessee to the lessor; or (3) a constructive dividend from the lessee to the common stockholders, followed by a capital contribution from the common shareholders to the lessor. In Sparks Nugget, Inc.,\textsuperscript{124} a case arising from the findings of the Tax Court in Challenger, the Tax Court agreed with the Commissioner's contention that these excessive amounts constituted constructive dividends to the common stockholders, the Graves. Mr. Graves had always separated his operating and landholding interests. Sparks Nugget was operated by Challenger, and the income generated from this casino was used to support the Graves' other interests. The casino property on which Sparks Nugget operated was purchased by a Graves' family trust with a contribution from the Graves and a bank loan which was to be repaid through the rental income of Nugget Enterprises, which was a joint venture of four of Graves' corporations. Nugget Enterprises constructed casino improvements with funds contributed by the four corporations and with the rental of the improvements by Challenger. The source of income of three of the four corporations in Nugget Enterprises was the excessive slot machine rental paid by Challenger. The court also \textit{held} that excessive rents paid by Challenger for parking lots resulted in a constructive dividend to Graves. These parking lots were acquired by Sparks Development on loans that were to be repaid through the rental of the lots to Challenger.

The court first reiterated the basic principle that a constructive dividend can result where a transfer of funds is

\begin{itemize}
  \item \textsuperscript{123} 23 T.C.M. 2096 (1964).
  \item \textsuperscript{124} 29 T.C.M. 318 (1970), \textit{appeal pending}, 9th Cir.
\end{itemize}
made from the corporation for the stockholder's benefit. The court then proceeded to point out the benefits that the Graves received from these transfers:

When he transferred funds from one corporation to another, the transfer had a good deal more significance than a transfer from one bank account to another. Because Challenger paid excessive rentals for the use of the slot machines to Pub, Waldorf, and Saratoga, those corporations had available funds to be used in the construction of the casino building that would otherwise have had to be obtained in some other manner. For example, without such excessive rentals, it might have been necessary for Mr. Graves to make capital contributions to such corporations out of his income on which he paid taxes . . . In other words, as a result of the payment of excessive rentals, the equity in Sparks Development, Pub, Waldorf, and Saratoga was increased, and when the Challenger stock was sold to the Ascuagas, the Graves were left with valuable corporations, Sparks Development, Pub, Waldorf, and Saratoga.125

The court then rejected the petitioner's contention that the excessive rentals amounted to a capital contribution by Challenger to its sister corporations. The court did so on the basis that when a non-shareholder makes a contribution to capital, he expects to benefit materially or in some other way from the corporation having the additional capital.126 The court noted that Challenger could expect no benefit from making such contributions; in fact, Challenger could have purchased the slot machines for the amounts it paid each year in rentals. The court also rejected the petitioner's argument that Challenger had a legal obligation to pay the full amount of the rentals as provided by state law on the basis that the provisions of the Internal Revenue Code take precedence over local law and also rejected their argument that there was no justification in taxing the excessive rentals since

125. Id. at 336, 337.
126. This does not appear to be a correct application of this principle. Two cases cited by the court for this proposition should be examined more closely. In Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), and Edwards v. Cuba R.R. Co., 268 U.S. 628 (1925), the Supreme Court espoused the principle that where amounts were transferred by a governmental unit or community group with the expectation of general benefit to the interests involved, such payments would be contributions to capital. Those cases are distinguishable from a situation where one corporation transfers funds to another. Here any benefit expected would accrue to the transferor corporation as a unit. This type of transaction would be closer to a direct payment for services (ordinary income) than a capital contribution. See Teleservice Co. of Wyoming Valley v. Comm'r, 27 T.C. 722, aff'd 254 F.2d 105 (3rd Cir. 1958), cert. denied, 357 U.S. 919 (1957).
they would remain in the corporate solution and eventually be distributed to the common stockholders. In regard to the latter contention, the court pointed out the separate legal entity of the corporation and noted that, in the absence of some statutory or other exception, the transfer of funds from one corporation to another has tax consequences that are immediate.

It is interesting to note that the benefit the court deemed accrued to the Graves was the additional capital supplied by the excessive rents. The court pointed out that had the excessive amounts not been available, Graves would have had to secure capital from some other source. The court felt, as an example, that it might have been necessary for Mr. Graves to make capital contributions himself to the corporations out of income on which he had paid taxes. Certainly this same reasoning would apply to the Rushing case where Rushing might well have had to supply additional capital for Briercroft out of his income on which he had already paid taxes. So the benefit received by the stockholder in Rushing is not any less direct, nor less substantial, than the benefit received by the Graves in Sparks Nugget, Inc.

The court in Sparks Nugget, Inc., did not mention the presence or absence of a proper business purpose. The Commissioner had contended the excessive amounts of the rents could not have been paid for a valid business purpose, but this approach disregards the nature of the overall transaction. The lease of the slot machines and property obviously served a business purpose of Challenger which needed the machines and location for its operations and which also provided the leasing corporations with a source of income. Was not the substance of this transaction the same as in Rushing, a transfer of funds from one commonly held corporation to another, ostensibly for business reasons? The characterization of the particular transaction should not control whether dividend consequences will result. At first, it might appear that Challenger was avoiding corporate tax on the amounts of the rental deductions, but the excessive rentals, included in the sister corporations' gross income, bore the full corporate tax.

Sparks Nugget, Inc. stands as a caveat to the common shareholder of commonly held corporations who, in light of

127. 52 T.C. 888 (1969), aff'd 441 F.2d 593 (5th Cir. 1971).
Rushing, thinks he can transfer funds from one corporation to another, on the basis of a valid business purpose, and incur no dividend consequence. Sparks Nugget, Inc. represents a repeal of the attitude displayed by the Tax Court in Rushing. Of course, due to the subjective nature of the Rushing test, that a transfer taxable to the common stockholder must be primarily for his benefit and direct in nature, one can argue that the test has as much validity as ever. That is, the benefits to the Graves were the primary motive for the transactions, and the Graves received direct benefits from them. A close examination of Sparks Nugget, Inc., however, does not reveal valid distinctions between the two cases.

E. Recent Decisions of Interest

In W. C. Hudlow, Jr.,\textsuperscript{128} the Tax Court disallowed a bad debt deduction that arose from a transfer of funds from petitioners’ controlled corporation, Chattanooga, to controlled corporation, Jefferson. Noting the poor business condition of the transferee corporation, the court found the transfers occurred as a result of the personal wishes of the petitioners to supply needed capital and charged petitioners with a constructive distribution. The transfers brought no significant corporate benefits to the transferor, Jefferson. The court rejected the petitioners’ contention that a valid business purpose existed because the transferee corporation rented equipment from the transferor corporation. Nor was any business purpose found to exist because the transfers enabled the transferee to operate successfully, thus enhancing the transferor’s reputation and increasing its business.

In J. C. Spitz,\textsuperscript{129} a corporation owned by a decedent and his wife sold property to another corporation whose sole shareholder was a trust set up for the decedent’s family. The Tax Court found a constructive dividend to the decedent and his wife to the extent of the difference between the fair market value of the property and the lower bargain price for which it was sold. A gift was then found to have been made by the petitioners to the trust, sole shareholder of Belle Corporation. Deciding the transaction was, in substance, a transfer from a corporation to the individual stockholders, the court

\textsuperscript{128} 30 T.C.M. 894 (1971).
\textsuperscript{129} 30 T.C.M. 43 (1971).
employed section 1.301(j) of the Income Tax Regulations\textsuperscript{130} to charge the petitioners with a distribution to the extent of the difference between the amount paid for the property and its fair market value.

To the extent that the bargain sale contributed to this cause, the decedent enjoyed the excess of the value of the property over the sales price as much as if such excess had been distributed to him, then given to the trust, and simultaneously contributed by the trust to Belle to provide it with needed capital.\textsuperscript{131}

\textit{Glenn E. Edgar}\textsuperscript{132} involved a transfer of land to a foundation. The Strain Ranch, consisting of several parcels of land with improvements in Montana, was transferred to a foundation. The Commissioner determined that the transfer of the ranch resulted in constructive dividends from Strain Brothers Corporation to Russell Strain and Harriet Strain, life income beneficiaries of the trusts that contained the stock of the Strain Brothers Corporation. The evidence showed that Russell and Arthur Strain were not willing to relinquish control over the ranch which contained their family cabins. The ranch was a losing business venture, and the Tax Court found that, in owning and maintaining the ranch, the foundations were merely instrumentalities, organized and operated for the benefit of the Strains. While citing Rushing as indicative that not every distribution made without adequate consideration is a dividend, the court stated it wasn't necessary that a distribution be paid directly to the shareholder. The transaction was found not to be motivated by business or humanitarian reasons but for family reasons to insure the Strains could continue to own and enjoy the property as long as they wished to do so. The nature of the arrangement for the continuous control was sufficient to justify invocation of constructive dividend treatment to the controlling stockholders.

\footnotesize
\textsuperscript{130} Treas. Reg. §1.301(j), T.D. 6752, 1964-2 C.B. 84, provides in part: \textit{Transfers for less than fair market value.} If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value.

\textsuperscript{131} 30 T.C.M. at 51.

\textsuperscript{132} 56 T.C. No. 58 (July 8, 1971).
Although all of these recent applications of the constructive dividend theory can be distinguished factually from situations like *Sparks Nugget, Inc.*, and *Rushing*, they are indicative of the liberal trend of the Tax Court in applying the theory.

III. CONSTRUCTIVE DIVIDENDS—A COLLATERAL EFFECT OF SECTION 482 ADJUSTMENTS

Section 482 of the Code provides:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interest, the Secretary or his delegate may distribute, apportion, or allocate gross income deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.\(^{133}\)

Where the Commissioner uses his power under this section to allocate income or deductions between brother-sister corporations there is a possibility that one of the indirect effects will be constructive dividend treatment. As seen, in applying the constructive dividend principle to transfers between brother-sister corporations, the Commissioner's contention is that one commonly held corporation makes a distribution to the controlling shareholder, and this distribution is followed by a capital contribution by the shareholder to the other corporation. Under a section 482 allocation, the Commissioner would allocate income between controlled corporations to adequately reflect income for tax purposes. The constructive dividend theory would apply subsequently to such an allocation to provide a means of explaining how this income, determined to belong to one corporation for tax purposes, actually wound up in another corporate pocket.

None of the cases reviewed previously, involving transactions between commonly held corporations that resulted in a constructive dividend to the common stockholder, were based on a section 482 allocation. While section 162(a) of the Code has been relied on as a basis for denying excessive deductions that result in constructive dividends,\(^ {134}\) it is assumed where

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133. *Int. Rev. Code*, of 1954, §482. Section 45 of the 1939 Code is the predecessor of this section.

the court has not specifically relied on section 482 that the

general taxing power of section 61 is the basis for allocation

of income in other transactions that have resulted in a distri-

bution to the common shareholder.\textsuperscript{135}

The Tax Court raised doubt in \textit{Seminole Flavor Co.}\textsuperscript{138}
as to whether the Commissioner, having power to allocate

income under the predecessor section of section 482, could

charge the stockholder with a constructive distribution in the

absence of corporate action. Later, the court, in \textit{Forcum-

James Co.},\textsuperscript{137} indicated that the Commissioner had the power
to so charge the stockholders. In the \textit{Forcum-James} case, the

Commissioner allocated income received by a partnership to a
corporation and charged the common stockholder partners

with a preferred dividend to the extent of the allocation. The

Tax Court upheld the Commissioner's contentions, thus en-
dorsing application of the constructive dividend theory to an
allocation under section 45 of the 1939 Code. Although this
case involved allocation from a partnership to a corporation,
the court's endorsement of the application of the constructive
dividend theory should apply equally to allocations between
commonly held corporations. Regardless, there has been little
use of section 482 in constructive dividend cases.\textsuperscript{138}

\textsuperscript{135}George W. Knipe, 24 T.C.M. 668 (1965), \textit{aff'd per curiam sub nom.};

Equitable Publishing Co. v. Comm'r, 356 F.2d 514 (3rd Cir. 1966), \textit{cert. denied},


\textsuperscript{136}4 T.C. 1215 (1945). The Commissioner's allocation here was from a

partnership to a corporation. The court said section 45 did not authorize the

Commissioner to distribute this amount as dividends to the shareholders who

were separate and distinct from the corporation. The court refused to allocate

the partnership income to the corporation using as a reason that no tax had

been evaded or avoided, since, as no dividend tax could be imposed, the corpora-
tion escaped less tax than the stockholder partners paid on the income. The

same reasoning, however, was rejected in \textit{Balletine Motor Co. v. Comm'r}, 39


\textsuperscript{137}7 T.C. 1195 (1946), \textit{acquiesced in}, 1948-1 C.B. 2. In \textit{Nat Harrison


Northwest Food Club, Inc.} 23 T.C.M. 29 (1964) there was, however, no

indication that the amounts allocated should be treated as a constructive dividend
to the common stockholder.

\textsuperscript{138}This is unusual especially in light of a preference the courts have

expressed for utilization of section 482 rather than section 61 to allocate

income among controlled taxpayers. In \textit{Rubin v. Commissioner}, 429 F.2d 650

(2d Cir. 1970), the Second Circuit Court of Appeals remanded the case to the

Tax Court for a determination of the issues under section 482 where an income


136. 4 T.C. 1215 (1945). The Commissioner's allocation here was from a partnership to a corporation. The court said section 45 did not authorize the Commissioner to distribute this amount as dividends to the shareholders who were separate and distinct from the corporation. The court refused to allocate the partnership income to the corporation using as a reason that no tax had been evaded or avoided, since, as no dividend tax could be imposed, the corporation escaped less tax than the stockholder partners paid on the income. The same reasoning, however, was rejected in Balletine Motor Co. v. Comm'r, 39 T.C. 348 (1962), aff'd 321 F.2d 796 (4th Cir. 1963).

137. 7 T.C. 1195 (1946), acquiesced in, 1948-1 C.B. 2. In Nat Harrison Association, Inc., 42 T.C. 601 (1964), acquiesced in, 1965-2 C.B. 5 and Pacific Northwest Food Club, Inc. 23 T.C.M. 29 (1964) there was, however, no indication that the amounts allocated should be treated as a constructive dividend to the common stockholder.

138. This is unusual especially in light of a preference the courts have expressed for utilization of section 482 rather than section 61 to allocate income among controlled taxpayers. In Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970), the Second Circuit Court of Appeals remanded the case to the Tax Court for a determination of the issues under section 482 where an income
Perhaps one reason why Section 482 allocations have not been used more by the Commissioner in constructive dividend situations is because of Revenue Procedure 65-17.139 Although this Revenue Procedure was designed primarily for domestic taxpayers and controlled foreign subsidiaries to prevent dividend tax consequences from repatriation where income of the domestic taxpayer has been increased by a 482 adjustment,140 it would apply where both sister corporations were domestic or where one of the corporations is domestic and its income has been increased by a 482 allocation.141 This Revenue Procedure will permit the domestic taxpayer corporation whose taxable income has been increased by the section 482 allocation to (1) exclude from his income an equivalent amount received by him as a dividend from the corporation from which the allocation was made or (2) establish an account receivable in an equivalent amount from the other party to the allocation and receive payment of the account without tax consequences. So by utilizing this Revenue Procedure, the common shareholder would escape constructive dividend consequences when the corporation which has incurred additional tax liability by virtue of section 482 restores the funds to the other corporation. There are, however, limitations on the availability of this Revenue Procedure. It does not apply where the Commissioner determines the transaction resulting in a section 482 allocation has as one of its principal purposes tax avoidance. It also does not apply where the taxpayer decides to fight the section 482 determination in the courts.

allocation was made earlier by the Tax Court between a stockholder and his controlled corporation under section 61. This decision indicates section 482 will apply not only to allocations between controlled corporations but also between the controlling stockholder and the corporation. Noting that section 61 is properly used in situations where transactions are freighted to a large extent with tax motives, the court said that section 482 was preferable here, as it commanded an analysis of the substance of the transaction and of who was the true earner of income.


140 Jenks, supra note 57 at 95.

141. A realization of the harshness of the combined effect of a section 482 allocation and a resulting constructive dividend, along with the desirability of permitting a tax-free transfer of funds to conform with the allocation, have been given by one writer as the reasons for the relief given by Revenue Procedure 65-17. Asbill, The Application of Section 482 to Domestic Taxpayers—Current Status and Trends, 1967 So. CALIF. TAX INST. 673, 708 (1967).
unless he makes application for this relief prior to a determination of this issue.¹⁴² The account receivable created by the repayment must be set up within 90 days of the section 482 determination and discharged within the period by actual payment of the delivery of the note. And in order for the Procedure to apply, the taxpayer must enter into a closing agreement with the Commissioner. It has been argued that even those who cannot comply with these administrative requirements under this Revenue Procedure should be entitled to this relief, as a matter of sound law, to prevent constructive dividend treatment by repayment of the allocated amount.¹⁴³

The common shareholder who is charged with a constructive distribution as a result of transactions between his commonly held corporations could conceivably argue that section 482 authorizes the Commissioner to “create income”. It is submitted that the constructive dividend issue can be distinguished from the creation of income issue under section 482, but the line of precedent establishing the income creation principle merits review as an area of possible relevance.

In *Tennessee-Arkansas Gravel Co. v. Commissioner*,¹⁴⁴ the stockholders of one corporation formed another corporation in order to obtain a contract in another state and allowed the newly formed corporation to use equipment without rental charges. The Commissioner, invoking section 482, alleged the taxpayer had rental income in the amount of the value of the use of the equipment. The Sixth Circuit Court of Appeals rejected the Commissioner's position, holding that the Commissioner did not attempt to allocate any of the income of the using corporation to the taxpayer corporation, but simply increased the income of the taxpayer corporation.

Section 45, supra, did not authorize the Commissioner to set up income where none existed. The principal purpose of this section was to clearly reflect income that did exist.¹⁴⁵

In *Smith-Bridgeman & Co.*,¹⁴⁶ a subsidiary corporation made an interest-free loan to its parent. The Commissioner

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¹⁴⁴. 112 F.2d 508 (6th Cir. 1940).
¹⁴⁵. *Id.* at 510.
¹⁴⁶. 16 T.C. 287 (1951) *acquiesced in*, 1951-1 C.B. 3.
contended that a four percent interest charge should have been included in the gross income of the subsidiary with respect to the loan. The Tax Court cited the Tennessee-Arkansas Gravel Co. case for the proposition that section 45's application was predicated on the existence of income, and this interest income could not be created by requiring the subsidiary to accrue interest.

The I.R.S. acquiesced in the above two cases, only concurring in the proposition that, where allocations and adjustments are made to income or deductions under section 482 among related business entities controlled by the same interest, corresponding adjustments must be made to the income or deductions of the corporations from which these allocations were made.147 Two cases148 cast doubt on the proposition that the creation of income issue was laid to rest by the comprehensive regulations of section 482 which provide for such corresponding adjustments. In Huber Homes, Inc.,149 the Tax Court refused to allocate income to X corporation where a number of houses had been transferred to Y subsidiary for less than the fair market value of the houses. Y corporation retained the houses and operated them as rental units although its total operations resulted in a loss for the years in question. The Commissioner alleged that X realized a profit to the extent of the difference between the cost of the houses and their fair market value at the time of the transfer and that section 482 would apply to allocate the profit to X corporation. The court held that there was no income to allocate within the meaning of that section. The court noted that to uphold the Commissioner's contention would result in a creation of income which section 482 definitely did not authorize. The court specifically stated that it was not deciding whether section 482 would apply to such a situation where there was a bargain sale and, as a consequence of use or consumption by the transferee, income would be realized within the controlled group. The court also specifically stated that they were not

147. Rev. Rul. 67-79, 1967-1 C.B. 117; Treas. Reg. §1.482-1(d)(2), T.D. 6952, 1968-1 C.B. 218. This regulation is a part of the comprehensive regulations of section 482 and provides for a correlative adjustment when income is allocated from one corporation to another.
149. 55 T.C. 598 (1971).
deciding the validity of the regulations under section 482 that would allocate taxable income to a sister corporation, as the regulations plainly contemplated "a situation where one or more controlled groups sells to another at less than fair market value and where it is expected that the control vendee would in turn resell the property to a third party." The Tax Court distinguished the present case from that situation as it found that here there was no intention to resell the houses and that it did not appear to be in production of any net income. Also the court stated that they did not pass upon the validity of the regulations which apply to situations where there is a contemplation of a resale after a bargain sale, whether or not, in fact, such a resale ever occurs. The case, however, does point out that a mere correlative adjustment (here to the basis of the cost of the homes) will not prevent, in some situations, the creation of income principle from precluding application of section 482.

In \textit{PPC Industries, Inc.,}\textsuperscript{151} the Tax Court refused to allocate income to the parent corporation from a foreign subsidiary as a result of an interest-free loan made some years earlier. The court stated that to charge interest on this loan was actually an imputation of interest income on an interest-free loan that would result in a creation of income. The Tax Court also determined in this case that there was no bargain sale between the two subsidiaries since the transfer of net sales proceeds in question was for a demonstrable business reason, to avoid adverse tax and exchange control consequences in Brazil.

\textit{Huber Homes, Inc.} and \textit{PPC Industries, Inc.}, both illustrate that the creation of income issue under section 482 is quite viable today. Both of these cases involved bargain sale transactions to which the court refused to apply section 482. In 1969 I.R.S. issued a Revenue Ruling\textsuperscript{152} concerning the applicability of section 482 to bargain sales between sister corporations, the effect of which is a constructive dividend to the common shareholder.

Revenue Ruling 69-630\textsuperscript{153} is an answer to a request for advice as to the treatment of a bargain sale between X

\textsuperscript{150} Id. at 610.
\textsuperscript{151} 55 T.C. No. 93 (Dec. 31, 1971).
\textsuperscript{153} Id.
corporation and Y corporation. Where A, an individual, owns all the stock of X and Y corporations, and A causes X to sell property to Y corporation for less than an arm's length price, a constructive dividend will result to A, subsequent to a section 482 allocation. The ruling states that the sale has as one of its principle purposes the avoidance of federal income tax and that the transaction results in significant understatement of X corporation's taxable income. Applying section 482 to this situation where there is a bargain sale between brother-sister corporations, the amount of allocation will be treated as a distribution to stockholder A with respect to his stock in X and as a capital contribution by A to the other corporate entity. As a result of the correlative adjustment provided by section 1.482.1(d)(2) of the Income Tax Regulations, the basis of property in the hands of Y corporation will be increased to reflect an arm's length price. The Ruling further states that in this type of situation, Revenue Procedure 65-17154 would not apply because the transaction had as one of its principal purposes the avoidance of federal income tax. So even if the qualifications and administrative requirements of Revenue Procedure 65-17 are met, X corporation will not be able to receive payment from Y corporation of the allocated amount without further income tax consequences.

There is no doubt as to the I.R.S.'s position that section 482 will apply in a bargain sale between brother-sister corporations and result in a constructive dividend to the controlling shareholder. As Revenue Ruling 69-630 stated as a matter of general application:

Section 482 of the Code applies to bargain sales transactions between brother-sister corporations that result in significant shifting of income. Where an allocation is made under section 482 of the Code as a result of the bargain sale between brother-sister corporations, the amount of allocation will be treated as a distribution to the controlling shareholder(s) with respect to the stock of the entity whose income is increased and as a capital contribution by the controlling shareholder(s) to the other entity involved in the transaction giving rise to the section 482 allocation.155

The lack of factual specificity as to the type of situation covered by this Revenue Ruling and the lack of cases interpreting it have left unanswered questions as to the constructive dividend treatment in a bargain sales transaction between

154. Supra note 139.
155. Supra note 152.
related corporations. This treatment of a bargain sale between brother-sister corporations could be a trap for the unwary common stockholder as it could result in large tax consequences, both at the corporate and personal income tax level. Revenue Ruling 69-630 is an indication of the Commissioner’s conviction to use aggressively the power granted to him by statute (section 482) to police the area where a number of corporations are controlled by the same interests —where opportunities for tax abuse are always present.

IV. CONCLUSION

Various principles and analyses have been used to charge the controlling stockholder with constructive receipt of dividends from a single closely held corporation where the transaction was out of the ordinary course of business or was not at arm’s length. The same principles and analyses have been applied to multi-corporate transactions to determine whether certain transactions result in a dividend distribution to the common stockholder. The assignment of income principle of the Horst case and corporate satisfaction of the stockholder’s obligation are only two of these. Regardless of the nature of the intercorporate transaction that may give rise to a distribution, certain substantive consistencies can be noted from an examination of the cases. Whenever the court is convinced that a transaction between commonly held corporations is part of a scheme for overall tax avoidance, constructive dividend consequences will be found. Another significant aspect of the cases is the great importance the courts attach to a finding of a valid business purpose as the reason for a particular transaction. The cases indicate that a finding of a proper business purpose, no matter how tenuous, will compensate for an otherwise one-sided, non-arm’s length transaction and preclude any constructive distribution consequence. Only when a particular transaction is carried out primarily for the common stockholder’s benefit will he be charged with dividend distribution. Of course, the problem is to determine when such transactions will be considered as primarily for the benefit of the common shareholder. An examination of the facts and circumstances of each situation, in light of precedent in this area, is essential. Counterbalancing the theory that a transfer of funds between corporations with common ownership is tantamount to a dividend distribu-
tion is the policy of recognizing the corporations as legal entities, separate and distinct.

Sparks Nugget, Inc. announces a liberal trend of the Tax Court in applying the constructive dividend theory and a dilution of the valid business purpose doctrine that precludes such dividend treatment. Future litigation will determine just how far this trend will go.

Possible constructive dividend fall out to the common shareholder, as a result of a section 482 allocation, is a distinct reality that must be considered. Moreover, in view of the I.R.S.'s pronouncement in Revenue Ruling 69-630, it is clear when section 482 is employed in certain bargain sales situations, the controlling stockholder will be charged with a constructive distribution without an opportunity to resort to administrative relief under Revenue Procedure 65-17 that might be otherwise available.

A review of this area justifies the conclusion that, in view of the Commissioner's assault in asserting constructive dividends in numerous multiple entity cases and the court's acceptance of his contentions, a controlling stockholder of commonly held corporations would be well advised to consider the dividend consequences of any transfer of funds between the corporations. The stakes can be high in this multi-corporate shell game.

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