



When Is a Constructive Dividend Not a Dividend?

BY DAVID M. FOGEL, EA, CPA

During the 18 years that I served as an Appeals Officer for the Internal Revenue Service, I resolved dozens of disputes involving constructive dividends paid by closely held corporations. This article addresses the types of situations that could result in a constructive dividend and the defenses that might apply when the IRS examiner raises the issue.

What is a Constructive Dividend?

A constructive dividend is a payment made by a corporation that results in a benefit to a shareholder even if the payment isn't made directly to the shareholder and even if no formal dividend has been declared¹. Constructive dividends occur most often with closely held corporations where dealings between the corporation and its shareholders are usually informal.

A shareholder is treated as having received a constructive dividend when (1) the corporation expends funds which do not result in a corporate deduction and (2) the shareholder receives an economic gain, benefit or income². The dividend is taxable to the shareholder to the extent of the current and accumulated earnings and profits of the corporation³.

It is important to consider several issues when the IRS proposes a constructive dividend. Does the corporation's payment represent a valid corporate deduction? Does the IRS have evidence that the shareholder actually received an economic benefit, or is it just disallowing the corporation's deduction for lack of substantiation? Are any of the defenses described in this article applicable? Were there sufficient current and accumulated earnings and profits to treat the distribution as a dividend? If there are insufficient earnings and profits, would it be more appropriate to treat the distribution as either a return of capital or capital gain?

Types of Constructive Dividends and Possible Defenses

General Defenses

Oftentimes the IRS will disallow a corporate deduction for lack of substantiation of either the business purpose or the amount (or both) and will determine a constructive dividend to the shareholder for these disallowed deductions. Proving that the corporation is entitled to the deduction will eliminate both adjustments.

The mere fact that certain payments are not deductible by a corporation as business expenses does not automatically make them taxable to the shareholder⁴. To the extent the payments do not represent some direct benefit to the shareholder, they are not taxable as a constructive dividend⁵.

Shareholder's Personal Expenses

The most common situation that can result in a constructive dividend is when a corporation pays personal expenses of the shareholder. A constructive dividend can also result when a corporation pays for improvements made to real property personally owned by a shareholder⁶. If a corporation pays the shareholder's personal expenses or makes improvements to a shareholder's property,

after reporting the amount as a constructive dividend, the shareholder may be able to deduct the expense to the extent allowed by law (e.g. real estate taxes, legal fees, depreciation on improvement, etc.)⁷.

Personal Use of Corporation's Property

Similar to paying the shareholder's personal expenses, a constructive dividend can result when a shareholder uses corporate property for personal purposes, such as use of a company-owned vehicle⁸. When a company-owned vehicle is furnished to an employee-shareholder, the corporation may be

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able to deduct the personal use portion of that vehicle as compensation under authority of the fringe benefit regulations⁹.

Unreasonable Rental Payments

Sometimes, a shareholder owns real estate that is rented to the closely held corporation. Code Sec. 162(a)(3) provides for a deduction for rental payments made to occupy business premises, but the rental payments must be reasonable. Rental payments made in excess of a reasonable amount may be constructive dividends¹⁰.

Common methods for establishing the reasonableness of rent include the use of professional appraisers and other evidence showing comparable rents paid by unrelated parties¹¹.

Unreasonable Compensation

Compensation is deductible only to the extent that it is reasonable and is in fact payment purely for services¹². Closely held corporations sometimes pay excessive compensation to employee-shareholders because the compensation is deductible while a dividend distribution is not. Excessive compensation which is a guise for the distribution of profits will be disallowed to the corporation and treated as a constructive dividend to the shareholder¹³.

The amount of compensation paid to an employee-shareholder that is considered reasonable is a factual question which must be determined in light of all of the evidence¹⁴. Factors that have been considered by the courts include (1) the employee's qualifications, (2) the nature, extent and scope of the employee's work, (3) the size and complexities of the business (4) the prevailing general economic conditions, (5) a comparison of salaries paid with the gross income and the net income of the business (6) comparison of salaries with distributions to stockholders (7) the prevailing rates of compensation for comparable positions in comparable concerns (8) the salary policy of the corporation as to all employees, and (9) in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years¹⁵.

The Ninth Circuit Court of Appeals has classified the factors into five categories: (1) the employee's role in the company, including the employee's position, hours worked, and duties performed, plus any special duties or role (such as personally guaranteeing corporate loans); (2) a comparison of the compensation paid to the employee with the

compensation paid to similarly situated employees in similar companies; (3) the character and condition of the company, including the sales, net income, capital value, and general economic fitness of the company; (4) whether a potential conflict of interest exists where the company has the ability to disguise dividend payments as deductible compensation, particularly when the employee is the sole or majority shareholder, and/or where a large percentage of the compensation is paid as a "bonus"; and (5) whether there is internal consistency in compensation, *i.e.*, whether compensation was paid pursuant to a structured, formal program and consistently applied throughout the ranks of the company¹⁶, and subsequent cases have followed this analysis¹⁷.

One way to demonstrate that the amount treated as wages was reasonable is to submit data from a compensation survey showing that the amount was within the range of compensation paid to similarly situated employees in similar companies. There are numerous organizations that maintain data on executive compensation, broken down by the type and size of the company, geographic location and the individual's position with the company¹⁸.

Another defense is that the shareholder was under-compensated in prior years and therefore, the compensation paid in the current year was to make up for under-compensation that existed in prior years¹⁹. In order to be allowed the deduction, the taxpayer must establish both the amount of the under-compensation in prior years²⁰ and that the payment in the current year was intended as compensation for services performed in the prior years²¹.

Be careful in making this argument because if the compensation was for years in which the corporation operated as a different entity — such as a sole proprietorship, partnership or limited liability company, the compensation isn't generally deductible. Most courts have held that compensation paid by a corporation for services rendered before the date that the business incorporated isn't deductible²².

Another defense involves the existence of a repayment provision in the corporation's bylaws which will mitigate the effect of the constructive dividend to the shareholder. Under this defense, if (1) the IRS disallows excessive compensation, (2) the corporation's bylaws contain a repayment provision requiring the shareholder to repay the excess to the corporation, and (3) the shareholder repays this excess to the corporation, then the shareholder is entitled to deduct the repayment²³.



If the IRS prevails in treating the excessive compensation as a constructive dividend, then the shareholder's individual return will need to be adjusted to reclassify the excessive compensation from wages (taxed at normal tax rates) to dividends (taxed currently at a 15% rate). In most cases where the only issue raised by the IRS on the corporation's tax return is excessive compensation, the IRS will not generally adjust the shareholder's income tax return because this would result in a tax refund. The IRS usually believes that it is the taxpayer's responsibility to file a claim for refund. Because the dispute over the amount of excessive compensation may last several years, in order to protect the client's rights to this potential refund, you should file a protective claim before the expiration of the statute of limitations of your client's individual income tax return.

Shareholder Withdrawals

A frequently litigated issue is whether withdrawals made by a shareholder from a corporation are bona fide loans or constructive dividends. This issue is primarily a question of fact to be determined on the basis of all the surrounding circumstances²⁴. Courts have considered various factors when deciding whether withdrawals are constructive dividends or loans: (1) the extent to which the shareholder controlled the corporation; (2) whether the corporation had a history of paying dividends; (3) the existence of earnings and profits; (4) the magnitude of the advances and whether a ceiling existed to limit the amount the corporation advanced; (5) how the parties recorded the advances on their books and records; (6) whether the parties executed notes; (7) whether security was provided for the advances; (8) whether there was a fixed schedule of repayment; (9) whether interest was paid or accrued; (10) whether the shareholder made any repayments; (11) whether the shareholder was in a position to repay the advances; and (12) whether the advances to the shareholder were made in proportion to his stock holdings²⁵.

A form of shareholder withdrawal occurs when a shareholder diverts corporate funds for his or her own personal use²⁶. The same "loan" factors listed above might apply as a defense.

In general, a corporation's payment of a shareholder's personal expenses results in a constructive dividend, and can't later be recharacterized by a journal entry as either a loan or compensation²⁷. This is because the intent of the corporation's payment is determined at the time the payment is made, not afterwards²⁸.

Transfer of Property From a Controlled Corporation to Another Entity

A transfer of property from a closely held corporation to another entity controlled by the shareholder may constitute a constructive dividend to an individual who has an ownership interest in both entities²⁹. To decide whether such a transfer constitutes a constructive dividend, two tests are normally applied. The first test is whether the transfer caused funds or

other property to leave the control of the transferor corporation and whether it allowed the shareholder to exercise control over such funds or property either directly or indirectly through some instrumentality other than the transferor corporation. The second test is whether the primary purpose of the transfer was to benefit the shareholder and whether the shareholder received an actual economic benefit.


Defenses to Constructive Dividends Before the IRS Audits the Return

Perhaps the best defense is to take some steps that could prevent the constructive dividend issue from arising in the first place.

For example, to mitigate the effect of a constructive dividend based on excessive compensation, have the corporation amend its bylaws to add the repayment provision discussed above.

Another example involves the corporation's payment of the shareholder's personal expenses. If the shareholder insists that the corporation continue to pay his or her personal expenses, then set up a system in which these expenses are booked—at the time they are paid—to a shareholder loan account. Make sure that the shareholder signs an interest-bearing promissory note for the loan balance at regular intervals, and that the shareholder makes frequent repayments.

Conclusion

As demonstrated in this article, there are many situations that could result in constructive dividends. Being aware of these situations and of the possible defenses that exist will give you additional tools that could enable you to defend your client from an IRS attack. 

David M. Fogel, EA, CPA is a non-attorney tax advisor for the Sacramento law firm of McDonough Holland & Allen PC and a regular contributor to *California Enrolled Agent*. He assists in resolving clients' tax disputes and providing tax research support for transactional planning, mostly in the estate planning area. David spent more than 26 years working for the IRS—8 years as a Tax Auditor and Revenue Agent, and 18 years as an Appeals Officer. David is an Enrolled Agent, a CPA, and is also admitted to practice before the United States Tax Court, having passed the Court's examination for non-attorneys. He can be reached at dfogel@mhalaw.com.

¹ *Truesdell v. Commissioner*, 89 T.C. 1280, 1295 (1987).

² *Meridian Wood Prods., Inc. v. United States*, 725 F.2d 1183, 1191 (9th Cir. 1984); *Palo Alto Town & Country Village, Inc et al v. Commissioner*, 565 F.2d 1388 (9th Cir. 1977).

³ Code Sec. 316(a).

⁴ *Dolse v. United States*, 605 F.2d 1146, 1152 (10th Cir. 1979); *Falsetti v. Commissioner*, 85 T.C. 332, 356-357 (1985); *Ashby v. Commissioner*, 50 T.C. 409, 418 (1968).

- ⁵ See *Ashby v. Commissioner*, *supra*.
- ⁶ *Gibbs v. Tomlinson*, 362 F.2d 394 (5th Cir. 1966); *Flanigan v. Wood*; 66-1 USTC (CCH) ¶9174, 17 AFTR2d (RIA) 149 (Dist. Az. 1965); *L.R. Schmaus Co., Inc. v. Commissioner*, T.C. Memo. 1967-197; *American Insulation Corp. v. Commissioner*, T.C. Memo. 1985-436; *Clevenger v. Commissioner*, T.C. Memo. 1986-149; *Jaeger Motor Car Co. v. Commissioner*, 284 F.2d 127 (7th Cir. 1960).
- ⁷ See, e.g., *Cummins Diesel Sales of Oregon, Inc. v. United States*, 321 F.2d 503 (9th Cir. 1963), where a corporation paid personal nursing services for its principal stockholder, the payments were dividends, but after including them in income, the shareholder could claim the payments as medical expenses on Schedule A.
- ⁸ *Moran v. Commissioner*, T.C. Memo. 2005-66, citing *Melvin v. Commissioner*, 88 T.C. 63, 79 (1987), *aff'd* 894 F.2d 1072 (9th Cir. 1990).
- ⁹ See Treas. Reg. Sec. 1.61-21(a)(1) which provides that an automobile provided by an employer to an employee is considered compensation for the employee's services, and as compensation, it follows that the employer is entitled to deduct the costs of maintaining the automobile, including depreciation.
- ¹⁰ *Sparks Nugget, Inc. et al. v. Commissioner*, 458 F.2d 631 (9th Cir. 1972); *Mackinac Island Carriage Tours, Inc. v. Commissioner*, 455 F.2d 98 (6th Cir. 1972); *Audano et al. v. United States*, 428 F.2d 251 (5th Cir. 1970); *Place v. Commissioner*, 17 T.C. 199 (1951), *aff'd* 199 F.2d 373 (5th Cir. 1952), *cert. denied* 344 U.S. 927 (1953).
- ¹¹ *Sparks Nugget, Inc. et al. v. Commissioner*, *supra*; *J.J. Kirk, Inc. v. Commissioner*, 34 T.C. 130 (1960), *aff'd* 289 F.2d 935 (6th Cir. 1961); *Ross Auto Parts, Inc. v. Commissioner*, T.C. Memo. 1957-120; *Audano et al. v. United States*, *supra*; *Robinson Truck Lines, Inc. v. Commissioner*, 183 F.2d 739 (5th Cir. 1950); *Tillotson v. McCrory*, 202 F.Supp. 925 (Dist. Neb. 1962).
- ¹² Treas. Reg. Sec. 1.162-7(a).
- ¹³ Treas. Reg. Sec. 1.162-7(a); *Botany Worsted Mills v. United States*, 287 U.S. 282 (1929).
- ¹⁴ *Pacific Grains, Inc. v. Commissioner*, 399 F.2d 603 (9th Cir. 1968), *aff'g* T.C. Memo. 1967-7; *Hoffman Radio Corp. v. Commissioner*, 177 F.2d 264 (9th Cir. 1949); *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (2d Cir. 1987).
- ¹⁵ *Mayson Manufacturing Co.*, 178 F.2d 115 (6th Cir. 1949).
- ¹⁶ *Elliotts, Inc.*, 83-2 USTC ¶9610, 716 F.2d 1241 (9th Cir. 1983).
- ¹⁷ *RAPCO, Inc. v. Commissioner*, 85 F.3d 950 (2nd Cir. 1996), *aff'g* T.C. Memo. 1995-128; *Leonard Pipeline Contractors, Ltd. v. Commissioner*, T.C. Memo. 1996-316.
- ¹⁸ See David M. Fogel, "How to Defend Against EDD's Audits of S Corp. Income," *California Enrolled Agent*, Oct. 2003
- ¹⁹ *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930); *Cropland Chemical Corp. v. Commissioner*, 75 T.C. 288, 297-298 (1980), *aff'd* 665 F.2d 1050 (7th Cir. 1981); *R.J. Nicoll Co. v. Commissioner*, 59 T.C. 37, 50-51 (1972).
- ²⁰ *American Foundry et al. v. Commissioner*, 59 T.C. 231, 239-240 (1972), *aff'd* 536 F.2d 289 (9th Cir. 1976).
- ²¹ *Perlmutter et al. v. Commissioner*, 373 F.2d 45 (10th Cir. 1967), *aff'g* 44 T.C. 382, 403 (1965); *Jerry Lipps, Inc. v. Commissioner*, T.C. Memo. 1990-293.
- ²² *Young v. Commissioner*, 650 F.2d 1083 (9th Cir. 1981); *U.S. Asiatic Co. v. Commissioner*, 30 T.C. 1373 (1958); *Bianchi v. Commissioner*, 66 T.C. 324 (1976), *aff'd per curiam* 553 F.2d 93 (2nd Cir. 1977); *LaMastro v. Commissioner*, 72 T.C. 377 (1979).
- ²³ See, e.g., *Oswald v. Commissioner*, 49 T.C. 645 (1968).
- ²⁴ *Williams v. Commissioner*, 627 F.2d 1032, 1034 (10th Cir. 1980), *aff'g* T.C. Memo. 1978-306; *Alterman Foods Inc. v. United States*, 505 F.2d 873, 875-876 (5th Cir. 1974); *Berthold v. Commissioner*, 404 F.2d 119, 121 (6th Cir. 1968), *aff'g* T.C. Memo. 1967-102; *Chism's Estate v. Commissioner*, 322 F.2d 956 (9th Cir. 1963); *Kaplan v. Commissioner*, 43 T.C. 580, 595 (1965).
- ²⁵ *Piggy Bank Stations, Inc. v. Commissioner*, 755 F.2d 450, 453 (5th Cir. 1985), *aff'g* T.C. Memo. 1982-365; *Alterman Foods, Inc.*, *supra* at 877 n.7; *Pierce v. Commissioner*, 61 T.C. 424, 430 (1974); *Estate of Sell v. Commissioner*, T.C. Memo. 1992-430; *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990).
- ²⁶ See, e.g., *DiLeo v. Commissioner*, 96 T.C. 858, 867 (1991), *aff'd* 959 F.2d 16 (2d Cir. 1992); *Falsetti v. Commissioner*, 85 T.C. 332, 356 (1985); *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976), *cert. denied* 430 U.S. 930 (1977); and *Frank Guerrini Vending Machines, Inc. v. Commissioner*, T.C. Memo. 1969-272.
- ²⁷ See, e.g., *Leonard v. Commissioner*, T.C. Memo. 1989-423 (a corporation's payment of the shareholder's personal expense could not be characterized as a loan); *Challenge Manufacturing Co. v. Commissioner*, 37 T.C. 650, 663 (1962) (a corporation's payment of the shareholder's personal expenses was a dividend and could not be characterized as compensation); *Electric & Neon, Inc. v. Commissioner*, 56 T.C. 1324 (1971), *aff'd per curiam* 496 F.2d 876 (5th Cir. 1974) (shareholder withdrawals from a corporation were dividends rather than loans, and could not be characterized as compensation).
- ²⁸ See *Busch, Jr. v. Commissioner*, 728 F.2d 945 (7th Cir. 1984); and *Chism's Estate v. Commissioner*, 322 F.2d 956 (9th Cir. 1963).
- ²⁹ *PK Ventures, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2005-56, citing *Stinnett's Pontiac Serv., Inc. v. Commissioner*, T.C. Memo. 1982-314, *aff'd* 730 F.2d 634 (11th Cir. 1984); *Marcy v. Commissioner*, T.C. Memo. 1994-534; and *Cirelli v. Commissioner*, 82 T.C. 335, 351 (1984).