



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: LOANS VERSUS CONSTRUCTIVE DIVIDENDS

This Field Service Advice responds to your memorandum dated August 30, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

- Corp 1 = _____
- Corp 2 = _____
- X = _____
- Y = _____
- Closed Years = _____
- Date 1 = _____
- Date 2 = _____
- Date 3 = _____
- Date 4 = _____
- Date 5 = _____
- Date 6 = _____
- Date 7 = _____
- a = _____
- b = _____
- c = _____
- d = _____

<u>e</u>	=	
<u>g</u>	=	
<u>h</u>	=	
<u>i</u>	=	
<u>j</u>	=	_____
<u>k</u>	=	—

ISSUES

Whether distributions by Corp 1 and Corp 2 to X during closed tax years¹ should be treated as loans and then recharacterized as constructive dividends in the first open tax year?

CONCLUSIONS

Distributions by Corp 1 and Corp 2 to X during the Closed Years should be characterized as constructive dividends in the year of receipt.

FACTS

X was, and continues to be, the Chief Operating Officer (the “CEO”) and controlling shareholder of Corp 1 and Corp 2. Both corporations were, and continue to be, closely held by the X family.

During the Closed Years, Corp 1 and Corp 2 distributed cash to X. X, Corp 1, and Corp 2 treated such distributions as loans to X. As of Date 1, the Corp 1 and Corp 2 purported loan balances were \$a and \$b, respectively. Based upon the fact that X was the CEO and controlling shareholder of the above corporations, we believe X regulated the amount, timing, and characterization of the distributions from each corporation.

In exchange for the majority of distributions from Corp 2 to X, X issued purported demand loans, with “annual interest at prime floating on the unpaid balance” for each purported loan². Corp 2 accrued Interest on the purported demand loans in a separate account. In Date 2, an open year, X made two payments with respect

¹ The term closed years (the “Closed Years”) refers to tax years in which the statute of limitations for assessment has expired. Unless stated otherwise, all transactions hereinafter are attributable to the Closed Years.

² X issued demand loans in the amount of \$c to Corp 2 for distributions totaling \$b.

to the Corp 2 purported demand loans in the aggregate amount of approximately \$d. In the following year, X made no repayments and received two distributions totaling more than \$e, for which he issued two additional purported demand loans.

The Corp 1 purported demand loans differ from the Corp 2 purported demand loans in that the Corp 2 purported loans were treated as separate loans and the Corp 1 loan balances were rolled over each year. In other words, the beginning year's Corp 1 loan balance was based on the prior year's ending loan balance, which included interest on the unpaid balance at the applicable federal rate.

During the Closed Years, X made no repayments with respect to either purported loan balance. However, in Date 3 X repaid \$g of Corp 1's purported loan balance, and in Date 2 he repaid approximately \$d of Corp 2's purported loan balance.³

No collateral or security was given for any of the purported demand loans. Since Date 6 no dividends have been paid by Corp 1, and no dividends have ever been paid by Corp 2 despite the fact that each corporation had significant earnings during the years at issue.

LAW AND ANALYSIS

The burden of proof is on the taxpayer to demonstrate that the amounts at issue are bona fide loans and not taxable distributions. Welch v. Helvering, 290 U.S. 111 (1933). The courts have always scrutinized transactions between closely held corporations and their shareholders. Electric & Neon, Inc. v. Commissioner, 56 T.C. 1324, aff'd 496 F.2d 876 (5th Cir. 1974).

A transfer of money is a loan for federal income tax purposes if at the time the funds were transferred, the transferee unconditionally intended to repay the money, and the transferor unconditionally intended to secure repayment. Haag v. Commissioner, 88 T.C. 604, 615-616, aff'd 855 F.2d 855 (8th Cir. 1988); and ; Saigh v. Commissioner, 36 T.C. 395, 419 (1961).

Thus, for X to treat the distributions from Corp 1 and Corp 2 as loans, X must prove that at the time of each distribution he unconditionally intended to repay the amounts received and the corporation unconditionally intended to require payment. Haag v. Commissioner, supra at 615-616, and Miele v. Commissioner, 56 T.C. 556-567 (1971), aff'd 474 F.2d 1338 (3d Cir. 1973), cert. den. 414 U.S. 982.

³ During Date 4, X's salary from each corporation exceeded \$h. In Date 2 and Date 5, X's combined salary from Corp 1 and Corp 2 was approximately \$i and \$j, respectively.

Whether shareholder withdrawals are bona fide loans is a question of fact, the answer to which must be based upon a consideration and evaluation of all surrounding circumstances. Courts have considered the following factors in deciding whether distributions from a C corporation to a shareholder are loans: (1) the extent to which the shareholder controls the corporation, (2) the earnings and dividend history of the corporation, (3) the magnitude of the withdrawals and whether a ceiling existed to limit the amount the corporation advanced, (4) how the parties recorded the withdrawals on their books and records, (5) whether the parties executed notes, (6) whether interest was paid or accrued, (7) whether security was given for the loan, (8) whether there was a set maturity date, (9) whether the corporation ever required repayment, (10) whether the shareholder was in a position to repay the withdrawals, and (11) whether there was any indication the shareholder attempted to repay withdrawals. Jones v. Commissioner, T.C. Memo 1997-400.

Based on the following: (1) X controlled Corp 1 and Corp 2 during the Closed Years, (2) X continues to control Corp 1 and Corp 2, (3) notwithstanding the fact that each Corp 1 and Corp 2 has sufficient earnings and profits, neither corporation has paid any dividends for the past k years, (4) the amounts of distributions were not limited, (5) no security was given for any of the distributions, (6) none of the purported loans set a maturity date, (7) neither Corp 1 nor Corp 2 ever required repayment, (8) based on X's salary during the Closed Years, X had the means to make payments on each of the purported loan balances, and (9) during the Closed Years, X never attempted to repay any amount of the loan balances, we do not believe that the purported loans during the Closed Years are bona fide loans for federal income tax purposes.

When a corporation confers an economic benefit upon a shareholder, in his capacity as such, without an expectation of reimbursement, that economic benefit becomes a constructive dividend, taxable as such. Loftin & Woodward, Inc. v. United States, 577 F.2d 1206, 1214 (5th Cir. 1978). Accordingly, a distribution made by a corporation for the personal benefit of its shareholders may result in the receipt of constructive dividends. Ireland v. United States, 621 F.2d 731, 735 (5th Cir. 1980); and Nicholls, North, Buse Co., v. Commissioner, 56 T.C. 1225, 1238 (1971).

In determining whether constructive dividends have been received, the key factors are whether the shareholders received economic benefits from the corporation without expectation of repayment, and whether the company provided benefits made available to the shareholders were primarily of a personal nature rather than in the business interests of the corporation. Ireland v. United States, *supra*, at 735; and Loftin & Woodward, Inc. v. United States, *supra*, at 1215-1217.

It is clear that X received economic benefits from both the Corp 1 and Corp 2 distributions.⁴ Our next inquiry is whether X intended to repay either Corp 1 or Corp 2 for the distributions during the Closed Years. Based upon the aforementioned factors used in determining that the purported loans should not be treated as loans for federal income tax purposes, we believe any repayment of the purported loans was at the discretion of X. Coupled with the irregular payment history, the complete discretion suggests there was never any intent to repay the loans. Predicated upon our conclusions that (i) X received economic benefits from the Closed Year distributions, (ii) X did not unconditionally intend to repay the purported loans, and (iii) neither Corp 1 nor Corp 2 unconditionally required repayment of the Closed Year distributions, we conclude that the distributions from Corp 1 and Corp 2 during the Closed Years were constructive dividends in the year of receipt.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

4 [REDACTED]

5 [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

If you have any further question, please call (202) 622-7930.

DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL
(FIELD SERVICE)

By: _____
ARTURO ESTRADA
Acting Chief, Corporate Branch

6 [REDACTED]