

NORWOOD P., SR. & KARLA BRYANT	§	STATE OF ALABAMA
Post Office Box 580		DEPARTMENT OF REVENUE
Irvington, Alabama 36544,	§	ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 95-298
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed income tax against Norwood P., Sr. and Karla Bryant ("Taxpayers") for the years 1988 and 1989. The Taxpayers appealed to the Administrative Law Division, and a hearing was conducted on January 19, 1996 in Mobile, Alabama. Bob Galloway represented the Taxpayers. Assistant Counsel Duncan Crow represented the Department.

This case involves three issues, as follows:

(1) The primary issue is whether payments to or on behalf of the Taxpayers by a corporation owned by the Taxpayers should be treated as "constructive dividends";

(2) A related issue is whether business expenses claimed by the corporation that the corporation was unable to substantiate should also be treated as constructive dividends to the Taxpayers; and

(3) If the Taxpayers are deemed as having received constructive dividends, a third issue is in what year should the dividends be included in the Taxpayers' income.

The Taxpayers owned and operated Bryant Fisheries, Inc. during the years in issue. The Taxpayers periodically withdrew money from the corporation for personal use during those years. The

corporation also sometimes directly paid the Taxpayers' personal debts. The Taxpayers concede that they personally benefited from the cash advances and the payments by the corporation.

The Department audited both the corporation and the Taxpayers individually for the years in question. The Department disallowed various business expenses claimed by the corporation because they were unsubstantiated. The corporation did not contest the disallowed deductions, and its liability for both years has been settled and is not directly in issue in this case.

However, the Department included the disallowed expenses claimed by the corporation as taxable constructive dividends to the Taxpayers. The Department also treated the cash advances or payments by the corporation to or on behalf of the Taxpayers personally as constructive dividends.

In computing the amount of the constructive dividends to be taxed to the Taxpayers in each year, the Department used the corporation's financial statements for its fiscal year ending April 30. The Department examiner explained that the Department must wait until the end of a corporation's fiscal year before deciding if advances by the corporation during the fiscal year should be treated as constructive dividends. Consequently, the Department treated the payments by the corporation to the Taxpayers during the corporation's fiscal year May 1987 through April 1988 as taxable constructive dividends in the Taxpayers' calendar year 1988. That amount included \$38,895.87 that the Taxpayers received from the corporation from May 1, 1987 through December 31, 1987. The

constructive dividends for the Taxpayers' calendar year 1989 was computed in the same manner, that is, based on the payments made during the corporation's fiscal year ending April 30, 1989.

Issue 1 - Should the advances or payments be treated as constructive dividends?

The concept of constructive dividends was discussed in David B. & Laura G. Fields v. State, Admin. Law Docket Inc. 94-439, decided May 9, 1996, as follows:

The concept of constructive dividends for tax purposes was explained in U.S. v. Mews, 923 F.2d 67 (7th Cir. 1991) as follows:

By "constructive dividend" the law means simply a corporate disbursement that is a dividend in the contemplation of law though not called such by the corporation making the disbursement. *Hadley v. Commissioner*, 36 F.2d 543, 544 (D.C.Cir. 1929); *Sachs v. Commissioner*, 277 F.2d 879, 882-83 (8th Cir. 1960). Every disbursement that is not an expenditure for the corporation's benefit - that is not a purchase, a loan (as in *Mills* itself, or *Joseph Lupowitz Sons, Inc. v. Commissioner*, 497 F.2d 862, 868 (3d Cir. 1974)), the repayment of a debt, an ordinary and necessary business expense, etc. - must be a dividend, for if it does not benefit the corporation it must benefit the shareholders.

It need not be paid to the shareholders any more than it need be called a dividend. Just as you cannot escape income tax by assigning the right to receive your income to somebody else, *Lucas v. Earl*, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930); *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 398-99, 103 S.Ct. 1134, 1151-52, 75 L.Ed.2d 130 (1983), so a shareholder cannot, by directing his corporation to pay to X rather than to himself what corporation law deems a dividend to him, avoid having to report it as income. *Hardin v. United States*, 461 F.2d 865, 872-73 (5th Cir. 1972).

U.S. v. Mews, at page 68.

When a corporation gives an economic benefit to a shareholder, by money or otherwise, and there is no definite expectation of repayment, the benefit constitutes a constructive dividend. "The inquiry whether corporate funds have passed to a shareholder as bona fide loans, creating a creditor-debtor relationship, depends on whether the parties definitely intended that the sums advanced would be repaid." Alterman Foods, Inc. v. U.S., 611 F.2d 866, 869 (1979).

Factors to be considered are the extent to which the receiving shareholder controls the corporation, the formality with which the advances are made, i.e. the execution of notes, a fixed repayment schedule, the payment of interest, etc., the ability of the shareholder to repay or the corporation to require repayment, and importantly, was the payment primarily for the shareholder's benefit, and not the corporation. See generally, Loftin and Woodard, Inc. v. U.S., 577 F.2d 1206 (1978); Alterman Foods, Inc. v. U.S., supra.

Fields v. State, page 3.

The Taxpayers argue that the advances were temporary loans by the corporation, and not constructive dividends. I disagree. The Taxpayers controlled Bryant Fisheries, and they simply used the corporation to advance themselves cash or pay their personal expenses whenever they needed it. The annual promissory notes were "on demand" and required no interest payments. There was no fixed repayment schedule, and the Taxpayers chose not to "repay" any of the advances during either 1988 or 1989. Finally, the payments and cash advances clearly benefited the Taxpayers personally, and did not serve any business purpose for the corporation.

In Fields, supra, the taxpayer claimed that he quit drawing a salary from his closely-held corporation, and instead attempted to recharacterized payments from the corporation to himself as loans.

Those payments clearly constituted constructive dividends.

This case is not as clear-cut as Fields. The record does not reveal if the Taxpayers also received a regular salary or otherwise received dividends from the corporation aside from the advances in question. But under the circumstances, the cash advances and personal expenses paid by the corporation on behalf of the Taxpayers were not arm's-length loans, and thus must be treated as taxable constructive dividends.

Issue 2 - Should the disallowed corporate business expenses also be treated as constructive dividends to the Taxpayers?

The Department also taxed the disallowed corporate expenses as constructive dividends to the Taxpayers individually. However, to constitute a constructive dividend, the Department must establish that the expenses by the corporation primarily benefited the Taxpayers personally, and did not serve a legitimate business purpose to the corporation. The fact that the corporation failed to substantiate its claimed expenses does not establish that they did not serve a business purpose. Other than the Disney World expenses conceded by the Taxpayers, the Department has not established that the disallowed corporate business expenses were personal in nature and not business related. Consequently, except for the Disney World expenses, the disallowed corporate business expenses should not be treated as constructive dividends to the Taxpayers.

Issue 3 - In what year should the Taxpayers include the constructive dividends as income?

Cash basis taxpayers must report income, including constructive dividends, in the year the income is actually received. Although not absolutely necessary, as a practical matter, it is reasonable for the Department to view a corporation's activities over its entire fiscal year before deciding if constructive dividends have been issued. However, if any payments are deemed constructive dividends, they must then be taxed to the shareholder in the calendar year they are received by the shareholder. Consequently, the constructive dividends received by the Taxpayers in 1987 cannot be taxed as income in 1988. Those amounts should be deleted from the Taxpayers' 1988 tax base.

The Department is directed to recompute the Taxpayers' liability for the years in question in accordance with the above findings. The Department should notify the Administrative Law Division of the Taxpayers' adjusted liabilities. A Final Order will then be entered.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered May 22, 1996.

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BILL THOMPSON  
Chief Administrative Law Judge