

KEITH C. & MEREDITH J. WHEATLEY
5310 Fall Creek Place
Northport, Alabama 35476-5305,

Taxpayers,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 95-421

FINAL ORDER

The Revenue Department assessed income tax against Keith C. and Meredith J. Wheatley (together "Taxpayers") for 1990, 1991, and 1992. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, ' 40-2A-7(b)(5)a. A hearing was conducted on April 4, 1996. Attorney Bob Monfore and CPA Steven Mitchell represented the Taxpayer. Assistant Counsel Mark Griffin represented the Department.

Keith C. Wheatley (individually "Taxpayer") is the sole owner of Wheatley Natural Gas, Inc. ("WNG"). The Taxpayer wrote checks to himself from WNG's account during the subject years. The issue is whether the money constituted "constructive dividends" to the Taxpayer, and thus should be included in the Taxpayer's taxable income for the years in question.

As stated, the Taxpayer wrote checks to himself from the WNG account during the subject years. The Department audited the Taxpayer and included the checks in the Taxpayer's taxable income in those years. The Department determined that the additional unreported income totaled \$202,000 in 1992, \$132,500 in 1991, and \$66,500

in 1990. The final assessments in issue are based on those amounts.

The Taxpayer concedes that he periodically wrote himself checks on WNG's account. He claims, however, that the amounts were loans, and thus should not be included in his taxable income. The Taxpayer claims that he repaid some of the money, and that the transactions were recorded as "loans to shareholder" on WNG's books and tax returns.

The Taxpayer also claims that some of the money included as income by the Department came from non-taxable bank loans and personal loans. The Taxpayers' representative provided records to the Department after the April 1996 hearing supporting that claim. The Department accordingly reduced the Taxpayers' liability in each year.

As stated, the sole issue is whether the checks written by the Taxpayer to himself on the WNG account should be treated as taxable constructive dividends to the Taxpayer.

A "constructive dividend" for income tax purposes was explained in David B. & Laura G. Fields v. State, Inc. 95-349 (Admin. Law Div. 5/9/96), 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, Inc. 95-349 at 3.

The Taxpayer in this case was the sole owner of WNG. He apparently withdrew money from the corporation whenever he needed it. No notes were ever executed, no

formal terms were ever agreed on, and the Taxpayer used the money for person expenditures. The loans in no way benefitted the corporation. As in Fields, the withdrawals clearly were not arm's-length loans between the corporation and the Taxpayer. See also, Norwood P., Sr. & Karla Bryant v. State, Inc. 95-298 (Admin. Law Div. 5/22/96). Consequently, the withdrawals were correctly treated as constructive dividends by the Department.

The final assessments, as adjusted, are affirmed. Judgment is entered against the Taxpayers for 1990 income tax of \$4,194.47, 1991 income tax of \$14,112.86, and 1992 income tax of \$6,799.93, with interest computed through February 5, 1997.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, ' 40-2A-9(g).

Entered February 6, 1997.

BILL THOMPSON
Chief Administrative Law Judge