



OFFICE OF
CHIEF COUNSEL

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

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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: Constructive Dividends

This Field Service Advice responds to your memorandum dated May 13, 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:

YEAR 1	=
YEAR 2	=
YEAR 3	=
YEAR 4	=
YEAR 5	=
YEAR 6	=
YEAR 7	=

YEAR 8	=
YEAR 9	=
Shareholder	=
Corporation	=
Enterprise CCC	=
\$B	=
\$C	=
\$D	=
\$E	=
\$F	=
\$G	=
DDD	=
State X	=
State Y	=
# N	=
B%	=
C%	=
D%	=
Asset	=

ISSUES:

1. Did Shareholder, a majority shareholder in Corporation, an S corporation (that was formerly a C corporation) receive constructive dividends in the amount of the fair rental lease value for the use of Asset, given that Shareholder did not pay Corporation for use of Asset from YEAR 6 to YEAR 8?

2. In the alternative, what are the Subchapter S consequences resulting from a determination that retaining Asset is compensation to Shareholder as opposed to a constructive dividend?

CONCLUSIONS:

1. Based upon the given facts, we agree with your conclusion that the Service can assert that Shareholder received constructive dividends in the amount of the fair rental value for the use of Asset for which Shareholder did not pay Corporation during the years YEAR 6 through YEAR 8.
2. If Shareholder's use of Asset is deemed to be compensation as opposed to a constructive distribution, Corporation would receive a deduction for the compensation. Shareholder would be taxed at ordinary rates on the amount of the compensation and would be unable to offset any of the compensation against Shareholder's basis in the stock of Corporation.

FACTS:

Corporation was formed in YEAR 1 and operated as a C corporation. In YEAR 6, Corporation became an S corporation and has continued to operate as such for the years at issue.

Corporation is in the business of Enterprise CCC. There are # N shareholders. The majority shareholder ("Shareholder") owns approximately B% of Corporation and is its DDD. Another party, unrelated to Shareholder, owns the remaining shares of Corporation.

According to certified financial statements for YEAR 2, YEAR 3, YEAR 4 and YEAR 5, Corporation purchased Asset in the respective amounts of \$B, \$E, \$D and \$C. Corporation purchased additional Asset in YEAR 6 and YEAR 7 in the amounts of \$F and \$G, respectively. Corporation and Shareholder entered into a lease agreement in YEAR 2 for the use of Asset. The terms of the lease required Shareholder to pay Corporation C% of Asset's fair market value each year and provided that the lease could be canceled upon default of payment by Shareholder or by mutual agreement. In the event the lease was terminated, Shareholder was required to return Asset to Corporation.

Corporation relocated its operations to State Y in YEAR 5. Shareholder retained Asset in his home in State X, but ceased making payments under the lease after YEAR 5. Shareholder contends that his residence became Corporation's corporate office in State X from YEAR 6 onward. Consequently, when the lease was terminated Asset was "returned" to Corporation. It is not clear whether legal title to Asset was ever transferred to

Shareholder. According to the facts you provided, Shareholder's use of Asset was purely for personal enjoyment and that no corporate purpose was served.

Shareholder leases several properties to Corporation. During the years when Corporation leased Asset to Shareholder, amounts owed by Shareholder for use of Asset were credited against payments owed to Shareholder by Corporation for rent. As recently as YEAR 9, Asset was still in Shareholder's residence.

LAW AND ANALYSIS

Issue 1

A. S Corporations- An S corporation is a pass-through entity. Pursuant to Internal Revenue Code Section 1363, unless otherwise provided in Subchapter S, an S corporation is not subject to any taxes imposed under Chapter 1 of the Internal Revenue Code. Accordingly, an S corporation is generally not subject to the corporate income tax under I.R.C. section 11.

The income from an S corporation is taxed to the shareholders regardless of whether the income is actually distributed to them. When an S corporation has no Accumulated Earnings and Profit (AEP), distributions are generally tax-free to the extent of a shareholder's basis in the stock of the corporation. See I.R.C. sections 1367 and 1368. The shareholder's basis in the stock is reduced to the extent of the tax free distribution. Corporate earnings that have been taxed to the shareholders, but not yet distributed, are monitored by use of an Accumulated Adjustment Account ("AAA").¹ See I.R.C. section 1368(c)(1); See also, Broadaway v. Commissioner, 111 F.3d 593, 595 (8th Cir. 1997). The Subchapter S Revision Act of 1982, Pub. L. 97-354, 96 Stat. 1669, enacted I.R.C. sections 1367 and 1368 and "obviated the conceptual need for corporate earnings and profits,"² except to the extent that an S corporation may possess accumulated earnings from prior years in which it was a Subchapter C corporation." Williams v. Commissioner,

¹ The AAA is an account of the S corporation which is adjusted in a manner similar to the adjustments under I.R.C. section 1367. See I.R.C. section 1368(e) for exceptions. Generally, the AAA reflects the earnings of the corporation that have been previously taxed less any amounts already distributed.

² Keeping track of the amount of corporate funds that have not yet been taxed to the shareholders is a basic purpose of the earnings and profits account. Thurman v. Commissioner, T.C. Memo 1998-233 (citing Cameron v. Commissioner, 105 T.C. 380, 383-384 (1995), aff'd sub nom. Broadaway v. Commissioner, 111 F.3d 593 (1997)).

110 T.C. 27, 30 (1998) (holding that for the years at issue (years prior to 1997) adjustments to the AAA for income, losses, and deductions are done prior to considering shareholder distributions).

An S corporation may have AEP in any one of three ways: 1) by having earnings prior to 1983, when earnings and profits concepts were still applicable to S corporations; 2) acquiring a C corporation with an earnings and profits account balance; or 3) prior existence as a C corporation. See Broadaway, 111 F.3d at 595 (citing Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* § 6.08[1] (6th ed. 1994)).

For S corporations with AEP, a distribution is, to the extent of the AAA, first treated as a nontaxable return of capital to the extent of the shareholder's stock basis. See I.R.C. section 1368(c)(1). If the amount of the distribution exceeds a shareholder's stock basis, the remainder (to the extent of the AAA) is treated as gain from the sale or exchange of property. If the stock is held as a capital asset, the gain would be capital. If the distribution exceeds the AAA, the remainder is treated as a dividend and taxed as ordinary income to the extent it does not exceed the AEP of the corporation. See I.R.C. section 1368(c)(2). If the amount of the distribution exceeds the AAA and AEP, then any remaining basis in the shareholder's stock is reduced by such excess. See I.R.C. sections 1368(c)(3) and (b)(1). This portion of the distribution is a nontaxable return of capital. The remainder of the distribution, if any, is treated as gain from the sale or exchange of stock. See I.R.C. sections 1368(c)(3) and (b)(2). If the stock is held as a capital asset, the gain is capital.

The analysis is the same when the distribution is a constructive distribution. If Shareholder's use of Asset is a constructive distribution, then the mechanical rules of I.R.C. section 1368 must be followed to determine whether the constructive distribution is a dividend. I.R.C. section 1371(c)(3) provides that the earnings and profits account will be decreased for distributions to the extent the distributed amount is treated as dividend income to the shareholders. The adjusted basis of the shareholder's stock in the S corporation is not reduced by the amount of the dividend distribution. See Williams, 110 T.C. at 35. Further, distributions treated as coming from the AAA do not decrease AEP. See I.R.C. section 1371(c)(1).

For tax years beginning prior to January 1, 1997, adjustments to the AAA for income, loss and deductions must be made first, then the AAA is adjusted for shareholder distributions. Williams, 110 T.C. at 27. The AAA should be allocated among distributions if distributions made throughout the taxable year exceed the AAA balance at the end of the S corporation's taxable year. See I.R.C. section 1368(c).

B. Constructive Dividends In General- As previously discussed, a dividend is a distribution of property by a corporation to its shareholders out of earnings and profits. Dividends may be formally declared or they may be constructive. The fact that no

dividends are formally declared does not foreclose the finding of a dividend-in-fact. See Noble v. Commissioner, 368 F.2d 439, 442 (9th Cir. 1966).

Based on the facts presented, Shareholder personally benefitted from the use of Asset in his home. The benefit conferred by a constructive dividend need not be of a direct financial nature. It may be merely the pursuit of a hobby, the fulfillment of a moral obligation, or the making of a gift. See Sparks Nugget, Inc., et al. v. Commissioner, T.C. Memo 1970-74 (1970), 29 T.C.M. (CCH) 318, 336, aff'd, 458 F.2d 631 (9th Cir. 1972), cert. denied Graves v. Commissioner, 410 U.S. 928 (1973). Shareholder's possession and use of Asset clearly qualifies as a constructive dividend.

It is our understanding of the facts that legal title to Asset was not transferred to Shareholder. Therefore, the amount of the constructive distribution is the fair rental value of Asset per year. The constructive distribution will be tax free to the extent it does not exceed the AAA and Shareholder's basis in the stock. Such a distribution would reduce Shareholder's basis in stock. Any amount in excess of Shareholder's basis in stock, but less than the AAA, will be a gain from the sale or exchange of property, with the character of the gain dependent upon how the stock was held, i.e., if stock was held as a capital asset the gain would be capital. Any remaining amount of the distribution will be a dividend to the extent of AEP and taxed as ordinary income. If there is any remaining amount of the distribution, Shareholder's remaining basis in stock will be reduced. This portion of the distribution would not be taxable. After stock basis is exhausted, any remaining distribution will generally result in capital gain.

Issue 2

If it is determined that, instead of a constructive distribution, the use of Asset by Shareholder is compensation to Shareholder, the entire amount would be taxable as ordinary income. Shareholder would not be able to exclude an amount equal to Shareholder's basis in the stock of Corporation. Further, the amount would be subject to employment taxes and income tax withholding. Subject to meeting the requirements under the Internal Revenue Code and the regulations promulgated thereunder with respect to a valid deduction for reasonable compensation, Corporation would deduct the amount of the compensation³ on Form 1120S (U.S. Income Tax Return for an S Corporation), line 7 (Compensation of Officers). Adjustments would not be made to Shareholder's stock basis or Corporation's AAA or AEP.

³We do not have enough facts to determine whether Corporation's deduction for compensation paid to Shareholder is reasonable and do not opine on whether Corporation comports with all of the requirements of a valid deduction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Case Development

Facts to be Determined-

[REDACTED]

[REDACTED]

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In the event the use of Asset is compensation, we do not make any representations with respect to whether Corporation may take a deduction. You might therefore review whether such a deduction would be reasonable compensation and whether it comports with the necessary requirements of I.R.C. section 162, and or I.R.C. section 83, and the regulations promulgated thereunder.

Gift Argument- We agree with your conclusion that corporations generally do not make gifts. I.R.C. section 2501; Treas. Reg. '25.0-1(b). If a gift is made of corporate assets, the gift is deemed made from the shareholders of the corporation. If the recipient of the gift is a shareholder, then the gift is deemed made by the other shareholders of the corporation to the extent such gift exceeds the recipient shareholder's interest in the corporate asset. Here, it is unlikely that the other shareholder has made a gift to Shareholder. Since the other shareholder only owns D% of Corporation, the other shareholder is a minority shareholder and could probably exert little control over whether Corporation makes gifts or not. Therefore, we agree with your memorandum that there was no gift of the use of Asset by Corporation to Shareholder.

Corporation Arguments- Shareholder argues that after Corporation moved to State Y, Asset was held in the State X branch of Corporation. Shareholder contends that the State X branch of Corporation is Shareholder's home. We do not have enough facts to determine whether and to what extent Corporation engaged in business in State X and the extent Shareholder's State X residence was used as a corporate branch office. Further investigation is necessary to ascertain whether any business was conducted at Shareholder's home, otherwise Shareholder's argument may have some merit.

The exact balances of the AAA, Shareholder's basis in Corporation and the AEP account must be determined for each year at issue before it can be determined whether a constructive distribution would be a dividend.

If additional facts indicate that the constructive distribution should be treated as a second class of stock, that issue should be developed. However, based upon our limited knowledge of the facts, this might not be an issue.

Status as S Corporation- There is the potential risk that Corporation may lose its status as an S corporation. Disproportionate constructive distributions among shareholders may indicate that there are two classes of stock of Corporation. An S corporation may only have one class of stock. See I.R.C. section 1361(b)(1)(D). Corporation's S election will terminate if there is more than one class of stock. If all of the shares of Corporation confer identical rights to distribution and liquidation proceeds there is only one class of stock. See Treas. Reg. ' 1.1361-1(l)(1). This determination is made based on the corporate charter, articles of incorporation, bylaws, applicable state law and binding agreements relating to distributions and liquidation proceeds. Id. Constructive distributions that differ in timing or amount should be given appropriate tax effect based on the facts and circumstances of the particular case. Id. We are not providing a conclusion with regard to whether there are two classes of stock in this case.

If you determine that the facts justify arguing the S corporation status was lost, we recommend the submission of an additional FSA request.

If you have any further questions, please call (202) 622-7880.

Deborah A. Butler
Assistant Chief Counsel

By: _____
ARTURO ESTRADA
Acting Branch Chief (Corporate)
Associate Chief Counsel (Domestic)

Attachment (1): One Page Diagram of Facts