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TAX MATTERS

No constructive dividend from services rendered at cost

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The Tax Court held that the sole owner of a construction corporation did not receive a constructive dividend in the amount of forgone profit when the corporation built a lakefront home for him and his wife at cost. The shareholder fully reimbursed the corporation for its costs, including overhead, and no corporate assets were diverted to or for his benefit. The court found that the corporation's failure to charge the shareholder an amount equal to its customary profit margin was not a constructive dividend because it did not result in a distribution of property that reduced earnings and profits.

Sec. 316(a) defines a dividend as any distribution of property by a corporation to its shareholders out of earnings and profits. Sec. 301(b) provides that the amount of the distribution is equal to the distributed property's fair market value on the distribution date. Case law has established that services provided by a corporation to its shareholders may, in some situations, constitute property. A constructive dividend arises when a corporation confers an economic benefit on a shareholder without the expectation of repayment.

Terry Welle was the sole owner of TWC, a construction company specializing in multifamily housing projects. In 2004, Welle and his wife began construction of a second home on lakefront property in Detroit Lakes, Minn. To keep track of material and other construction costs, Welle had TWC open a "cost plus" job account on its books. The Welles, however, acted as their own general contractor during construction, and they personally contacted all the subcontractors and vendors who built or supplied materials for the home.

During construction, TWC paid the subcontractors and vendors directly, and its crew framed the home. The Welles reimbursed TWC for the cost of its services, including overhead, but they did not pay the customary 6% to 7% profit margin that TWC used to calculate the contract price charged to unrelated customers. The IRS contended that Welle received a constructive dividend from TWC when it built the lakefront home for him without charging its standard profit margin.

In determining whether Welle received a constructive dividend equal to the forgone profit on construction of the home, the court looked at the benefit conferred on Welle by TWC and whether this benefit constituted a distribution of property that reduced the corporation's earnings and profits. The court found that Welle at most used TWC as a conduit in paying subcontractors and vendors and that he fully reimbursed the corporation for all costs, including overhead, associated with the limited services he received from corporate employees. Thus, the provision of the services to Welle without charging the customary profit margin did not result in a distribution of property that reduced current or accumulated earnings and profits, as required by the Sec. 316(a) definition of a dividend. The court therefore concluded that Welle did not receive a constructive dividend when TWC provided services to him at cost because the reimbursement arrangement did not operate as a vehicle for the distribution of TWC's earnings and profits.

■ *Welle*, 140 T.C. No. 19 (2013)

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