CONSTRUCTIVE DIVIDEND WHEN CONSTRUCTION COMPANY SERVICES ARE PROVIDED TO COMPANY SHAREHOLDER

This article uses a recent Tax Court case to explore the payment issues that construction company owners may be confronted with when using their company to service another property under their ownership.

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For many closely held construction companies, it is not uncommon for the subject company employees to work on properties that are owned by the company owner. Such properties may include a personal residence or a commercial or investment property owned by the construction company owner. In such instances, the company owner does not always pay the construction company for the full value of the construction work performed. The owner's rationale may be: Why should I pay my own company for work performed on my own residence or investment property? Isn't that like taking my money out of one pocket and putting it back in another pocket?

The Internal Revenue Service (IRS) typically considers this uncompensated work performed by the construction company on the owner's property to be taxable income to the owner. In particular, the IRS typically claims that the value of the work performed by the construction company is a constructive dividend to the company owner. In such tax dispute cases, the owner typically did not pay any amount to the closely held company for the construction work performed. The IRS typically quantifies the amount of the constructive dividend as the amount

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that the construction company would not have charged to an arm's-length client for the same services.

In *Welle v. Commissioner*, the Tax Court considered the situation where a closely held construction company provided work on the owner's vacation home.[1] In this case, company owner Terry Welle paid his closely held company for all of the costs associated with the construction services. However, he did not pay his company a profit margin on its costs. On audit, the IRS alleged that the profit margin that Welle did not pay to the construction company was a taxable constructive dividend to the closely held company owner.

In its decision, the Tax Court held that Welle, the sole shareholder of the corporation, did not receive a constructive dividend when the company provided construction services to the company shareholder at cost.

The facts of the case

TWC is the name of a closely held construction company that specialized in multifamily housing projects. Terry Welle was TWC's president and sole shareholder.

Welle personally owned lakefront property in Detroit Lakes, Minnesota. Welle decided to build a second home (the "lakefront home") on this vacation property. In 2004, Welle began the construction of the lakefront home. To keep track of the material and other construction costs, Welle authorized TWC to open a "cost plus" job account on its company books. However, Welle personally contacted all of the subcontractors and building supply vendors that built or supplied materials for the lakefront home, and he personally acted as his own general contractor during the vacation home construction.

IN ITS DECISION, THE TAX COURT HELD THAT WELLE DID NOT RECEIVE A CONSTRUCTIVE DIVIDEND WHEN TWC PROVIDED CONSTRUCTION SERVICES TO HIM AT COST AND HE TIMELY PAID TWC FOR THE SERVICES.

During the construction, TWC paid the subcontractors and vendors directly, and the TWC framing crew framed the lakefront home. Welle repaid TWC for all of the amounts that TWC paid to the subcontractors, and he also reimbursed TWC for all of its labor and overhead costs. TWC, however, did not charge to Welle, and Welle did not pay to TWC, an amount equal to the customary profit margin that TWC normally used to calculate the contract price that it would charge to its unrelated clients (its "forgone profit").

On audit, the IRS determined that Welle received a constructive dividend of $48,275 from TWC in 2006. The IRS determined that this constructive dividend was equal to the TWC forgone profit on the construction services it provided to Welle. Welle challenged the IRS's tax deficiency notice in Tax Court.

Constructive dividends

Under Internal Revenue Code Section 61(a)(7), a taxpayer includes dividends in gross income. Section 316(a) defines a dividend as any distribution of property that a corporation makes to its shareholders (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits for the subject tax year. Under Section 317(a), property includes money, securities, and any other property except stock in the corporation making the distribution. Under some circumstances, the provision of services provided by a closely held corporation to its shareholders constitutes property within the meaning of Section 317(a).

A constructive dividend occurs when a corporation confers an economic benefit on a shareholder without the expectation of repayment. Generally, the amount of a constructive dividend is measured by the fair market value (FMV) of the economic benefit conferred on the company's shareholder.

The Tax Court's decision

In its decision, the Tax Court held that Welle did not receive a constructive dividend when TWC provided construction services to him at cost and he timely paid TWC for the services. The Tax Court found that the TWC provision to Welle of construction services at cost did not result in (1) a diversion of the TWC assets or (2) a distribution of the TWC earnings and profits.

At trial, the IRS relied on the Tax Court's decision in *Magnon v. Commissioner*.[2] In *Magnon*, a shareholder received a constructive dividend equal to the cost of the construction services provided by a corporation to the shareholder plus the corporation's customary profit margin. At trial, Welle argued that he did not receive a constructive dividend from TWC. This was because a shareholder does not receive a constructive dividend when a corporation provides services to the company shareholder at cost.

UNDER THIS MEASURE, THE DISCUSSION IN THIS CASE SHOULD HAVE BEEN ABOUT THE FMV OF THE CONSTRUCTION SERVICES THAT TWC PROVIDED TO WELLE, NOT ABOUT WHETHER ANY FORGONE PROFITS WERE A CONSTRUCTIVE DIVIDEND TO WELLE.

The Tax Court admitted that in a number of prior cases, including *Magnon*, it had held that there was a constructive dividend where a corporation provided construction services to a shareholder and the shareholder did not pay for those construction services. However, the Tax Court stated it had not held in any of these prior cases that the amount of the constructive dividends should include the construction company's forgone profits.

Citing a wide variety of its own and appellate court precedent, the Tax Court found that, for a constructive dividend to occur, there must be a distribution or diversion of corporate property to or for the benefit of the shareholder, and that distribution or diversion must have reduced the corporation's earnings and profits. The Tax Court had held in the past that a constructive dividend occurs (1) where there is a bargain sale of property by a corporation to a shareholder, or (2) where a shareholder uses corporate property and does not pay full value for the use of that property. However, the Tax Court pointed out that it had also found that an incidental or insignificant use of corporate property may not be considered a constructive dividend.

Looking at the facts in the instant case, the Tax Court noted that TWC had an existing corporate workforce and infrastructure for its general business purposes. The Tax Court noted that Welle's use of TWC was incidental to those business purposes. Because Welle fully reimbursed the corporation for all of its costs, including overhead, TWC did not divert actual value otherwise available to it by failing to apply its customary profit margin in determining how much Welle had to pay for the construction services.

Accordingly, the Tax Court concluded that the provision of construction services by TWC to Welle was not a vehicle for the distribution of earnings and profits to Welle. Therefore, the Tax Court concluded that Welle had not received a constructive dividend from TWC.

Implications of this decision

As the Tax Court mentions early in its published opinion, the usual measure of a constructive dividend is the FMV of the economic benefit conferred on the shareholder. Under this measure, the discussion in this case should have been about the FMV of the construction services that TWC provided to Welle, not about whether any forgone profits were a constructive dividend to Welle.

The IRS argued that the value of the construction services provided to Welle should be the FMV of the services to an arm's-length client of TWC. That is, the IRS claimed that the cost to the arm's-length client would be TWC's costs for the construction services plus the company's normal profit margin markup. Therefore, the issue to the IRS was not that forgone profits were not included in the constructive dividend. Rather, the issue to the IRS was the value of the constructive dividend for the construction services was improperly determined. Nonetheless, the Tax Court elected to focus on whether there had been a distribution or diversion of corporate property that benefited Welle and reduced the corporation's earnings and profits. The Tax Court decided that the mere use of the closely held corporation as a conduit did not amount to a distribution that reduced its earnings and profits.

Conclusion

It is surprising, given the results in the long line of judicial decisions that the IRS cited, that the Tax Court did not find a constructive dividend in *Welle*. Perhaps this decision may signal a new and less stringent standard in these situations. However, given the IRS's litigation position and prior case history, closely held construction company owners should probably not count on it. In other words, the IRS will probably continue to pursue construction company owners who do not pay full price for the construction services provided to them by their closely held company. ■

NOTES

1 *Welle v. Commissioner,* 140 T.C. No. 19 (2013).

2 *Magnon v. Commissioner*, 73 T.C. 980 (1980).