DAVID B. & LAURA G. FIELDS 755 Petersburg Road Tuscaloosa, Alabama 35406,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 95-349
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed income tax against David B. and Laura G. Fields (jointly "Taxpayers") for the years 1991 and 1992. The Taxpayers appealed to the Administrative Law Division, and a hearing was conducted on November 27, 1995. CPA A. D. Christian, Jr. represented the Taxpayers. Assistant Counsel Jeff Patterson represented the Department.

David Fields (individually "Taxpayer") is sole owner of Fields Child Care, Inc. ("Fields Child Care" or "corporation"). The issue in this case is whether cash advances from the corporation to the Taxpayer during the subject years were "constructive dividends", in which case they should be treated as taxable income to the Taxpayer, or as loans, in which case they would not be income to the Taxpayer.

The Taxpayer formed Fields Child Care in approximately 1980. The Taxpayer was involved in other business activities during the mid to late 1980s. Fields Child Care was inactive during that period. The other businesses were unsuccessful, and the Taxpayer again began operating through Fields Child Care in mid-1990.

The Taxpayer initially drew a salary from Fields Child Care. However, he claims that he quit receiving a salary sometime in

1991 because the corporation had cash flow problems. Instead, anytime the Taxpayer needed money for personal reasons, he wrote a check on the corporation's account payable either to himself or directly to a creditor.

At the end of each month, the Taxpayer's CPA recorded the personal advances on the corporation's general ledger as "loans to shareholder." The Taxpayer executed a promissory note dated December 31, 1991 for the total amount advanced to him by the corporation during that year, $101,575.73. The note was payable "on demand" and did not require the payment of interest.

The Taxpayer continued writing checks from the corporation to himself during 1992. He thereafter executed a second promissory note dated December 31, 1992 in the aggregate amount of $141,155.01, which included the advances from 1991. That note was also payable "on demand", and bore interest at the applicable federal rate.

The Taxpayer continued drawing money and did not repay any amounts to the corporation until 1994, when the corporation finally obtained an SBA loan. The loan proceeds were used as follows:

The Taxpayer first paid off various miscellaneous debts of the corporation. The Taxpayer personally owns the real estate on which the corporation's child care facilities are located. Part of the SBA money was also used to pay-off the Taxpayer's personal mortgages on that property. The total advances by the corporation to the Taxpayer during 1991 through 1993, plus the Taxpayer's personal mortgages that were paid-off by the SBA loan money, were rolled into a single mortgage amount. The mortgage was amortized over 15 years at 8% interest, which resulted in monthly mortgage payments by the Taxpayer to the corporation of approximately $6,200.00. The corporation in turn used part of the monthly payment to pay-off the SBA loan. Presumably, the mortgage was secured by the Taxpayer's real estate, although that property was also used to secure the SBA loan. The corporation also paid the Taxpayer a monthly rent on the real estate.

The Department audited the Taxpayers, treated the advances as constructive dividends, and accordingly included them in the Taxpayer's income in the year received.

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.

The Taxpayer in this case argues that the advances in question were loans, not constructive dividends. I disagree. The advances clearly were not arm's-length loans between the corporation and the Taxpayer. Rather, the Taxpayer controlled the corporation, and he simply drew money from the corporation for personal reasons whenever he needed it.

The annual promissory notes were unenforceable, and in effect worthless. They were payable "on demand", and the Taxpayer never paid any principal or interest over a three year period. The Taxpayer, as sole owner, could have never repaid them if he chose to. The Taxpayer conceded that point under questioning by the Department's attorney, as follows:

Q. You are repaying these amounts?

A. Yes, sir. Yes, sir.

Q. If you ceased repaying these, quote/unquote, loans, who would enforce their collection?

A. Nobody.

Q. Would they even be enforceable since the notes themselves state that payment is to be made on demand, if you know that?

A. I don't know. I don't know. I doubt it.

Q. It's conceivable that the corporation could just say we'll never demand payment. They're on demand and we'll never demand payment.

A. Right.

Q. And you'd never have to pay it back?

A. Right.

Q. And you stated you are Fields Child Care, Inc., so you could in essence excuse yourself from repaying these amounts, right?

A. Correct.

Transcript, at page 68.

Substance over form must govern. Greene v. U.S., 13 F.3d 577

(2nd Cir. 1994); Newman v. C.I.R., 902 F.2d 159 (2nd Cir. 1990). Clearly, the advances were nothing more than salary or dividends that the Taxpayer paid himself whenever he needed money. The Taxpayer cannot by creative accounting be allowed to re-characterize those taxable advances as non-taxable loans. If so, then the owner of every closely held corporation could do the same indefinitely and never pay personal income tax on the income received from the corporation.

The Taxpayer has attempted to draw money from the corporation for his personal use without paying tax. He then lumped the total amount received from the corporation, plus his personal mortgages paid by the SBA loan, into a lump-sum mortgage payable to the corporation. He then also deducts the monthly mortgage payments. However, the Taxpayer and Fields Child Care are one in the same. The Taxpayer cannot create fictitious "loans" and "mortgages" between himself and his solely owned corporation simply to avoid or manipulate his taxes.

The payments in issue clearly constituted constructive dividends, and were properly included as taxable income by the Department.

The above considered, the final assessments are affirmed. Judgment is entered against the Taxpayers for 1991 income tax of $5,020.49 and 1992 income tax of $5,274.55, plus applicable interest.

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

Entered May 9, 1996.

BILL THOMPSON
Chief Administrative Law Judge