T.C. Memo. 1944-025

Withdrawals by a controlling shareholder from a corporation are deemed dividends when withdrawn if the shareholder makes a permanent withdrawal of funds, even if the formalities of a dividend distribution are not observed and the payment is recorded as a loan; however, if the intent is a loan, income accrues when the debt is canceled.

Summary

The petitioner, Renwick, sought to treat withdrawals from its wholly-owned subsidiary in 1938 and 1939 as dividends in order to increase its excess profits credit for 1941. The Commissioner argued the withdrawals were loans until a 1940 dividend declaration effectively canceled the loans, making the dividend income taxable in 1940. The Tax Court held that the withdrawals were loans in 1938 and 1939, based on the petitioner's initial accounting treatment, and were only converted to dividends in 1940 when formally declared as such. The court emphasized that the petitioner's original intent, as reflected in its financial records, was controlling.

Facts

The petitioner withdrew funds from its wholly-owned Canadian subsidiary in 1938 and 1939.
These withdrawals were recorded in an open account between the petitioner and its subsidiary.
The subsidiary's balance sheets at the end of 1938 and 1939 showed the balance as an asset (receivable from the petitioner) and the petitioner's balance sheet showed a corresponding liability.
The petitioner's tax returns for 1938 and 1939 did not report any dividends received from the subsidiary.
In 1940, the subsidiary declared a dividend that included the amounts withdrawn in 1938 and 1939, which the petitioner then reported as dividend income.
Only when filing the 1941 return in 1942 did the petitioner attempt to retroactively treat the 1938 and 1939 withdrawals as dividends to reduce tax liability.
The subsidiary remained in existence after 1938 and could have performed other contracts if procured, potentially requiring the funds to be repaid.

Procedural History

The Commissioner determined that the withdrawals were loans initially and became dividends only upon the declaration in 1940.
The petitioner appealed to the Tax Court, arguing the withdrawals should be treated as dividends in 1938 and 1939 for excess profits tax calculation purposes.

Issue(s)

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Whether the withdrawals by the petitioner from its subsidiary in 1938 and 1939 constituted dividends when withdrawn, or whether they were loans converted to dividends in 1940 when the dividend was formally declared.

Holding

No, the withdrawals were loans in 1938 and 1939 because the petitioner's initial treatment of the withdrawals as loans, the subsidiary's balance sheets reflected an asset, and there was a potential for repayment if the subsidiary acquired new contracts, indicating an intent to repay.

Court's Reasoning

The court relied on the principle established in *Wiese v. Commissioner*, which states that withdrawals are deemed income when a principal shareholder makes a permanent withdrawal, even without dividend formalities, but are treated as loans if there is an expectation of repayment until the debt is canceled.
The court emphasized that the petitioner's actions, specifically the initial accounting treatment of the withdrawals as loans and the absence of dividend reporting in 1938 and 1939, demonstrated an intent to treat the withdrawals as loans initially.
The court noted the petitioner's attempt to retroactively reclassify the withdrawals as dividends only after realizing the adverse tax consequences of its original treatment, stating, "We think petitioner's treatment of the amounts in question in the ordinary course of its business and before it was confronted with an increased tax liability reflects the true intent at the time the withdrawals were made — that is, they were not intended to be and were not dividends at the time withdrawn."
The potential for the subsidiary to obtain future contracts, which would necessitate repayment of the withdrawn funds, further supported the characterization of the withdrawals as loans.
The court distinguished cases cited by the petitioner, noting that in those cases, the Commissioner initially determined the withdrawals to be dividends, and the taxpayer failed to prove otherwise, or there was no evidence of intent or occasion for repayment.
The court quoted *Commissioner v. Cohen*, emphasizing the importance of not relieving taxpayers of their burden of proof, especially when the facts are under their control, as it would allow individuals to retroactively determine when income accrued based on their advantage.

Practical Implications

This case highlights the importance of contemporaneous documentation and consistent accounting treatment in determining the tax consequences of transactions between related parties.
The case underscores that the taxpayer's initial treatment of a transaction is strong evidence of their intent, and retroactive attempts to recharacterize transactions for tax benefits are unlikely to succeed.

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Legal professionals advising closely-held businesses should counsel clients to carefully document the intent behind intercompany transfers, especially withdrawals by controlling shareholders, and to consistently treat these transfers as either loans or dividends from the outset.

The decision reinforces the Commissioner's authority to rely on a taxpayer's records and actions in determining tax liability and places a heavy burden on the taxpayer to disprove the Commissioner's determination when it is based on the taxpayer's own records.

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