74 T.C. 60 (1980)

Transfers of funds between related corporations can be treated as constructive dividends to the common shareholder if the transfer primarily benefits the shareholder personally and lacks a genuine business purpose at the corporate level, especially when the transfer is not a bona fide loan.

Summary

Gilbert L. Gilbert, sole shareholder of Jetrol, Inc., and 50% shareholder of G&H Realty Corp., sought to redeem his brother's 50% stake in Realty. Realty lacked funds, so Jetrol borrowed $20,000 and transferred it to Realty, which then redeemed the brother's shares. The Tax Court determined this transfer was not a bona fide loan but a constructive dividend to Gilbert because it primarily benefited him by giving him sole ownership of Realty, using Jetrol's funds, without a legitimate business purpose for Jetrol. The court emphasized the lack of loan terms, Realty's inability to repay, and the direct personal benefit to Gilbert.

Facts

Gilbert L. Gilbert was the sole shareholder of Jetrol, Inc., a manufacturing company, and a 50% shareholder of G&H Realty Corp. (Realty), which owned the building Jetrol leased. Gilbert's brother, Henry Gilbert, owned the other 50% of Realty and wanted to retire. Realty lacked the funds to redeem Henry's shares. To facilitate the redemption, Jetrol borrowed $20,000 from a bank, with Gilbert personally guaranteeing the loan. Jetrol then transferred the $20,000 to Realty, recorded as a loan receivable. Realty used these funds to redeem Henry's stock. No formal loan documents, interest rate, or repayment schedule existed between Jetrol and Realty. Years later, to sell Jetrol, Gilbert repaid the $20,000 to Jetrol using his own funds.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Gilbert's income tax, arguing the transfer was a constructive dividend. Gilbert petitioned the Tax Court to contest this determination.

Issue(s)

1. Whether the $20,000 transfer from Jetrol to Realty constituted a bona fide loan.
2. If the transfer was not a bona fide loan, whether it constituted a constructive dividend to Gilbert, the common shareholder.

Holding

1. No, the transfer was not a bona fide loan because it lacked objective indicia of debt, such as a formal note, interest, fixed repayment terms, and a realistic

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expectation of repayment by Realty.
2. Yes, the transfer constituted a constructive dividend to Gilbert because it primarily benefited him personally by allowing him to gain sole control of Realty, using Jetrol's funds, and lacked a sufficient business purpose for Jetrol.

Court's Reasoning

The court reasoned that for a transfer to be considered a bona fide loan, there must be a genuine intention to create debt, evidenced by objective factors. Here, several factors indicated the absence of a true loan: no promissory note, no stated interest, no fixed repayment schedule, and Realty's questionable ability to repay. The court noted, "Such allegedly objective economic indicia of debt such as consistent bookkeeping and consistent financial reporting on balance sheets are in our opinion little more than additional declarations of intent, without any accompanying objective economic indicia of debt."

The court found no legitimate business purpose for Jetrol to make the transfer. Gilbert's argument that it was to secure Jetrol's tenancy was weak, as the cost of relocation was minimal. The primary purpose was to benefit Gilbert personally by enabling him to acquire full ownership of Realty. The court stated, "It is Gilbert's use of Jetrol's earnings and profits for a primarily personal and noncorporate motive of Jetrol that is critical and causes such use to be a constructive dividend to him." Even though Gilbert personally guaranteed Jetrol's bank loan, the court deemed this contingent liability insufficient to offset the constructive dividend because the bank primarily looked to Jetrol for repayment, not Gilbert's guarantee as the primary security.

Practical Implications

Gilbert v. Commissioner clarifies that intercompany transfers, especially between closely held corporations, are scrutinized for their true nature. Labeling a transfer as a "loan" is insufficient if it lacks the objective characteristics of debt and primarily benefits the common shareholder. This case highlights that:

- Bookkeeping entries alone do not establish a bona fide loan if not supported by economic reality.
- Absence of formal loan terms (note, interest, repayment schedule) weakens the argument for a true loan.
- Transfers lacking a demonstrable business purpose at the corporate level and directly benefiting a shareholder are highly susceptible to being classified as constructive dividends.
- Personal guarantees by shareholders may not offset constructive dividend treatment if the primary obligor is the corporation and the guarantee is merely supportive.

Attorneys advising clients on intercompany transactions must ensure these transfers

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are structured with clear loan terms, justifiable business purposes for the transferring corporation, and demonstrable intent and capacity for repayment to avoid constructive dividend implications for shareholders. This case is frequently cited in constructive dividend cases involving related corporations and shareholder benefits.

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