Terry J. Welle and Chrisse J. Welle v. Commissioner of Internal Revenue, 140 T. C. 420 (U. S. Tax Ct. 2013)

In a significant ruling on corporate taxation, the U. S. Tax Court held that Terry J. Welle did not receive a constructive dividend from his company, Terry Welle Construction, Inc. , despite the company not charging him its customary profit margin for services rendered during the construction of his lakefront home. The court clarified that a corporation's decision not to profit on services provided at cost to a shareholder does not constitute a distribution of earnings and profits, impacting how corporations and shareholders structure service arrangements.

Parties

Terry J. Welle and Chrisse J. Welle, as petitioners, sought relief from the Commissioner of Internal Revenue, the respondent, regarding a tax deficiency and penalty determination for the year 2006.

Facts

Terry J. Welle, the sole shareholder of Terry Welle Construction, Inc. (TWC), a subchapter C corporation specializing in multifamily housing, utilized the corporation's resources to assist in building his lakefront home. TWC maintained a 'cost plus' job account for tracking construction costs. Although TWC's framing crew worked on the home and TWC paid subcontractors and vendors directly, Welle personally hired these subcontractors and ordered supplies in TWC's name. Welle reimbursed TWC for all costs incurred, including overhead, but did not pay the customary 6% to 7% profit margin typically charged by TWC to its other clients. The Commissioner of Internal Revenue determined that Welle received a constructive dividend from TWC equal to the forgone profit margin, resulting in a deficiency and penalty for 2006.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency of $10,620 and an accuracy-related penalty of $2,124 against the Welles for the tax year 2006, asserting that Terry J. Welle received a constructive dividend of $48,275 from TWC. The Welles petitioned the U. S. Tax Court for review. The Tax Court reviewed the case de novo, as is customary in tax deficiency disputes.

Issue(s)

Whether Terry J. Welle received a constructive dividend from Terry Welle Construction, Inc. , when the corporation provided services at cost without charging its customary profit margin during the construction of Welle's lakefront home?

Rule(s) of Law

Section 61(a)(7) of the Internal Revenue Code includes dividends in a taxpayer's gross income. Section 316(a) defines a dividend as any distribution of property made by a corporation to its shareholders out of its earnings and profits. Section 317(a) defines property as money, securities, and any other property except stock in the distributing corporation. A constructive dividend arises when a corporation confers an economic benefit on a shareholder without expectation of repayment, as stated in *Hood v. Commissioner*, 115 T. C. 172, 179 (2000). However, not every corporate expenditure that incidentally confers an economic benefit on a shareholder constitutes a constructive dividend, as noted in *Loftin & Woodard, Inc. v. United States*, 577 F. 2d 1206, 1215 (5th Cir. 1978).

Holding

The U. S. Tax Court held that Terry J. Welle did not receive a constructive dividend from Terry Welle Construction, Inc. , when the corporation provided services at cost during the construction of his lakefront home. The court determined that the transactions did not result in the distribution of current or accumulated earnings and profits as defined under Section 316(a) of the Internal Revenue Code.

Reasoning

The court's reasoning was based on the interpretation of the statutory definition of a dividend and the concept of constructive dividends. The court emphasized that for a constructive dividend to be recognized, there must be a distribution of property that reduces the corporation's earnings and profits, which was not the case here. TWC did not divert corporate assets or distribute earnings and profits when it provided services at cost to Welle, as Welle fully reimbursed TWC for all costs, including overhead. The court distinguished this scenario from cases where a corporation sells property to a shareholder at a discount or provides corporate property for personal use without full reimbursement, which could result in a constructive dividend. The court also noted that TWC's decision not to profit on services provided at cost to Welle was not an implement for the distribution of corporate earnings and profits, citing *Palmer v. Commissioner*, 302 U. S. 63, 70 (1937). The court's analysis relied on statutory interpretation, precedential analysis, and the distinction between incidental benefits and actual distributions of earnings and profits.

Disposition

The court entered a decision for the petitioners, Terry J. Welle and Chrisse J. Welle, rejecting the Commissioner's deficiency and penalty determinations.

Significance/Impact

The *Welle* decision clarifies the criteria for recognizing constructive dividends, particularly in scenarios where a corporation provides services to a shareholder at cost. It establishes that a corporation's forgone profit on such services does not constitute a distribution of earnings and profits under Section 316(a) of the Internal Revenue Code. This ruling has significant implications for how corporations and shareholders structure service arrangements, potentially affecting tax planning and compliance strategies. Subsequent courts have cited *Welle* in similar cases, reinforcing its doctrinal importance in the area of corporate taxation and constructive dividends.

