Welle v. Commissioner, 140 T. C. No. 19 (U. S. Tax Court 2013)

In Welle v. Commissioner, the U. S. Tax Court ruled that Terry Welle did not receive a constructive dividend from his corporation, Terry Welle Construction, Inc. , when it provided services at cost for his lakefront home construction. The court held that the corporation's decision not to charge its customary profit margin did not constitute a distribution of earnings and profits. This decision clarifies that services provided at cost by a corporation to its shareholder, without diverting corporate assets, do not trigger constructive dividend taxation.

Parties

Terry J. Welle and Chrisse J. Welle, as petitioners, challenged the Commissioner of Internal Revenue, as respondent, in the United States Tax Court regarding the tax year 2006. Terry J. Welle was the sole shareholder of Terry Welle Construction, Inc. (TWC), a subchapter C corporation.

Facts

Terry J. Welle, as the sole shareholder and president of TWC, a construction company specializing in multifamily housing projects, used the corporation to facilitate the construction of his lakefront home in Detroit Lakes, Minnesota. TWC maintained a "cost plus" job account on its books to track the construction costs. However, Welle and his wife personally hired subcontractors and ordered building supplies, which TWC paid for directly. The Welles reimbursed TWC for all costs, including overhead, but did not pay TWC's customary profit margin of 6% to 7%. The Commissioner determined that Welle received a constructive dividend equal to the forgone profit.

Procedural History

The Commissioner issued a notice of deficiency to the Welles for the tax year 2006, asserting a deficiency of $10,620 and an accuracy-related penalty of $2,124 under section 6662(a). The Welles petitioned the U. S. Tax Court to contest the deficiency determination. The Tax Court heard the case, and the standard of review applied was de novo, given that the issue involved factual determinations and legal interpretations.

Issue(s)

Whether Terry J. Welle received a constructive dividend from TWC equal to the forgone profit margin when TWC provided services for the construction of his lakefront home at cost?

Rule(s) of Law

Under section 61(a)(7) of the Internal Revenue Code, dividends are included in a

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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 the expectation of repayment. However, not every corporate expenditure that incidentally confers an economic benefit on a shareholder is a constructive dividend.

Holding

The Tax Court held that Terry J. Welle did not receive a constructive dividend from TWC equal to its forgone profit margin. The court determined that TWC's provision of services at cost to Welle did not result in the distribution of current or accumulated earnings and profits, as required by section 316(a).

Reasoning

The court's reasoning focused on the distinction between the provision of services at cost and the distribution of corporate earnings and profits. The court cited cases such as Magnon v. Commissioner and Benes v. Commissioner, where the provision of services at cost did not include an amount corresponding to forgone profit as part of a constructive dividend. The court emphasized that for a constructive dividend to be recognized, there must be a diversion of corporate assets to the shareholder, which reduces the corporation's earnings and profits. In this case, TWC's decision not to charge its customary profit margin did not divert corporate assets or distribute earnings and profits to Welle. The court distinguished this scenario from cases involving the bargain sale of property or the use of corporate property, where the fair market value of the benefit conferred is typically included in the constructive dividend. The court concluded that Welle's use of TWC was incidental to the corporation's business purposes, and the arrangement did not operate as a vehicle for distributing earnings and profits.

Disposition

The Tax Court entered a decision in favor of the petitioners, Terry J. Welle and Chrisse J. Welle, and did not sustain the Commissioner's deficiency determination. The court did not address the issue of the accuracy-related penalty under section 6662(a) due to the ruling on the constructive dividend issue.

Significance/Impact

Welle v. Commissioner clarifies the scope of constructive dividends in the context of corporate services provided at cost to shareholders. The decision underscores that a corporation's decision not to charge its customary profit margin for services provided at cost does not necessarily result in a constructive dividend, as it does not constitute a distribution of earnings and profits. This ruling has implications for

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corporate-shareholder transactions and may influence how corporations structure services provided to shareholders without triggering unintended tax consequences. Subsequent courts and legal practitioners will likely reference this decision when analyzing similar scenarios involving the provision of corporate services at cost.

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