DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: STEVEN A. MUSHER, Chief, Branch 6, CC:INTL

SUBJECT:

This Field Service Advice responds to your request for Field Service Advice dated December 17, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

a	=
b	=
c	=
Agency	=
Allowances	=
Authorizations	=
Corporation A	=
Corporation B	=
Corporation C	=
Corporation D	=
Costs	=
Country	=
Customers	=
Date A	=

Date B	=
Date C	=
Date D	=
Entities	=
Events	=
Individuals	=
Items	=
Owners	=
Payments	=
Permits	=
Service A	=
Service B	=
Service C	=
Service D	=
Service E	=
Status	=
Year 1	=
Year 2	=

ISSUE:

Whether a consequence of the sham transaction and assignment of income in this case is a constructive dividend from Corporation A to its shareholders, and a capital contribution from the shareholders to Corporation C.

CONCLUSION:

The assignments of income from Corporation A to Corporation C were distributions from corporate earnings that yielded direct benefits to the common shareholders of Corporation A and Corporation C. Accordingly, the payments should be classified as constructive dividends to the shareholders of Corporation A, and subsequent contributions by those shareholders to the capital of Corporation C.

FACTS:

Background

Corporation A is a domestic provider of Service A to Customers. At issue in this Field Service Advice are substantially all tax years subsequent to Year 1.

Pursuant to Authorizations and various Permits from Agency, Corporation A provided Service B to all Customers, in conjunction with Service A. If a Customer also desired Service C, he made Payments to Corporation A. Historically, Corporation A included these Payments in its gross income.

On Date A, Corporation A formed a wholly-owned Country subsidiary, Corporation B, the name of which was subsequently changed to Corporation C. On Date B, after several capital contributions by Corporation A to Corporation C, Corporation A declared a taxable dividend of one share of Corporation C stock per share of Corporation A stock, to be paid to Corporation A shareholders-of-record as of Date C. Corporation A held a minority interest in Corporation C, consisting of a% of the shares outstanding on Date D. The proportionate ownership of the individual shareholders in Corporation C was similar, but not identical, to that of the individual shareholders in Corporation A.

From time to time, Corporation A obtained from Individuals shares of Corporation C. However, in general, Corporation A later distributed such shares to Owners, thereby eliminating its ownership of Corporation C shares for each year at issue. Although the shares of Corporation C could be transferred, the right of transfer was limited. On any particular date, the shareholders of Corporation A were substantially identical to the shareholders of Corporation C, although the proportionate ownership interest of a particular shareholder in Corporation A and Corporation C would likely not be identical. Some shareholder divergence was also attributable to intra-family and charitable gifts of shares, as well as some stock redemptions by Corporation A.

During the years at issue, Corporation A had substantial earnings and profits. Thus, any distributions of property by Corporation A to its shareholders would constitute dividends for Federal income tax purposes.

Transaction

Prior to Year 1, Corporation A had obtained from Entities proposals for alternative methods of treating Payments. In order to implement one of these proposals, Corporation A formed the corporation that came to be known as Corporation C, in the manner described above.

Starting in Year 1, Corporation A decided to shift the Payments earned for Service C to Corporation C. As a means of shifting this income, Corporation A entered into a contract with an unrelated party, Corporation D, whereby the latter agreed to provide Service D to Corporation A in connection with Corporation A's performance of Services A and C to its customers. Corporation A in turn agreed to pay Corporation D the income from the Payments that were earned from Service C, net of Costs incurred by Corporation A. Corporation A then deducted the net Payments remitted to Corporation D on its income tax return.

In order to transfer the net Payments to Corporation C, Corporation D entered into a contract with Corporation C whereby the latter agreed to perform Service E for Corporation D. In exchange for this service, Corporation D paid Corporation C b% of the Payments Corporation D received from Corporation A, less certain expenses and fees charged by Corporation D. Hence, Corporation D acted merely as an intermediary for transferring the Payments, less certain expenses and fees, to Corporation C. While Corporation D and Corporation C agreed to perform Services D and E for the benefit of Corporation A, neither entity assumed Costs in connection with Events. Instead, Costs were assumed by Corporation A as Events occurred.

Under the newly-structured transaction, Corporation A attempted to avoid Federal income tax on Payments, and Corporation C accumulated investment income from those amounts in Country, without imposition of either Country tax or U.S. income tax on a current basis on Corporation A, Corporation C, or the shareholders. The restructuring was performed for the purpose of avoiding tax, and the arrangement between Corporation A, Corporation C, and Corporation D lacked economic substance and business purpose. The purpose of the arrangement with Corporation D and Corporation C was to confer tax-free benefits on the shareholders of Corporation A and Corporation C. The arrangement was a sham that involved an assignment of income from Corporation A to Corporation C. Accordingly, Corporation A is not entitled to deduct the net Payments remitted to Corporation D pursuant to their contract.

LAW AND ANALYSIS:

The correct characterization of excessive payments between corporations under common ownership arises in several contexts, including I.R.C. §§ 61, 162, and

482.[1] To date, the courts have not articulated a single rule to govern the classification of such payments in all cases. Rather, the facts in each case must be examined in order to determine the correct characterization of the payments.

Section 316(a) of the Code provides that any distribution of property made by a corporation to its shareholders out of earnings and profits (accumulated after February 28, 1913) is a dividend. In general, a distribution by a corporation, or a payment by a corporation for the benefit of a shareholder, whether or not it is formally declared as a distribution, will, in the absence of a corporate business purpose, constitute a constructive dividend to the shareholder.

An undeclared distribution by a corporation may be treated as a constructive dividend to the shareholder if it is made for the shareholder's direct benefit. In such cases, the distribution need not be made directly to the shareholder, but may be made to another party. Rapid Electric Co. v. Commissioner, 61 T.C. 232, 239 (1973).

In Rev. Rul. 69-630, 1969-2 C.B. 112, the Service treated an excessive payment between brother-sister corporations as a dividend to the common shareholders, and a capital contribution by the shareholders to the related corporation that received the excessive payment. In the revenue ruling, individual A caused his wholly-owned corporation, X, to sell certain assets at a less than arm's length price to another corporation wholly-owned by him, Y. A principal purpose of the sale was the avoidance of Federal income tax. The Commissioner made an allocation of income pursuant to section 482, in order to reflect an arm's length price. The effect of this allocation was to increase X's income and Y's basis in the transferred assets. This increase was treated as a distribution to A with respect to his X stock, and a capital contribution by A to Y.

Rev. Rul. 78-83, 1978-1 C.B. 79, held that if property is transferred from brother corporation to a sister corporation without adequate consideration, a constructive distribution has been made to the common parent, regardless of whether a motive existed for improper allocation of income or deductions between the corporations.

Some courts have applied a "demonstrable business interest" theory. For example, in Knipe v. Commissioner, T.C. Memo. 1965-131, aff'd per curiam sub nom. Equitable Publishing Co. v. Commissioner, 356 F.2d 514 (3rd Cir. 1966), cert. denied, 385 U.S. 822 (1966), the Tax Court held that where payments by a brother

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[1] Because the arrangement was a sham and an assignment of income, we need not consider how section 482 might apply.

to a sister corporation, purportedly for services, lacked a valid transferor business purpose, they constituted constructive dividends to the common shareholders.

Courts often require a showing of direct benefit as a prerequisite for finding a constructive dividend to the common shareholder(s). For example, in Rushing v. Commissioner, 52 T.C. 888 (1969), aff'd, 441 F.2d 593 (5th Cir. 1971), the Service argued that a transfer of cash between brother-sister corporations was a constructive dividend to the common shareholder, and a contribution of capital to the transferee corporation. Because the Tax Court viewed the benefit to the common shareholder to be merely derivative, it held there was no constructive dividend. Rushing, 52 T.C. at 894.

In White Tool v. Commissioner, T.C. Memo. 1980-443, aff'd, 677 F.2d 528 (6th Cir. 1982), cert. denied, 459 U.S. 907 (1982), a profitable brother corporation made excessive payments to its loss sister corporation for rental of four motor vehicles and an airplane. The Commissioner determined an arm's length rent, allocated the excessive rent from the loss corporation to the profitable corporation, and classified the greater than arm's length amount as a constructive dividend to the common shareholders of the two corporations. Although the Tax Court upheld the primary allocation of income pursuant to section 482, it viewed the benefits to the shareholders as derivative in nature, and declined to find a constructive dividend. See also R.T. French Co. v. Commissioner, 60 T.C. 836, 855-56 (1973) (shareholder benefit was derivative; no constructive dividend to common parent of brother-sister corporations that engaged in non-arm's-length transaction where parent never received the income, and where actual dividends paid to parent exceeded amount of asserted constructive dividends); Gulf Oil Corp. v. Commissioner, 89 T.C. 1010, 1028 (1987), aff'd on this issue, 914 F.2d 396, 413 (3rd Cir. 1990) (payments from affiliates to parent, although not deductible as insurance premiums, were not constructive dividends because they benefited the affiliates).

In AOD 1982-077, the Service declined to acquiesce in White Tool, and stated that in its view the existence of a constructive dividend should be determined, not based on whether a direct benefit accrues to the shareholder, but based on "whether the intercorporate transfer serves a demonstrable, legitimate business interest of the transferor" (emphasis added). In this connection, an earlier decision, Gilbert v. Commissioner, 74 T.C. 60 (1980), held that a valid business purpose for the payment, although not controlling, is a significant factor under the direct benefit test.

A court might conclude, based on White Tool and Rushing, that the tax avoidance benefits to the shareholders in this case are nevertheless only "derivative," rather than "direct," such that no constructive dividends resulted to them. Although this case is arguably distinguishable in that the tax avoidance was egregious, it is uncertain whether that distinction would compel a different outcome on the constructive dividend issue. Regardless of whether the demonstrable business interest or the shareholder direct benefit test applies, the result in this case is in our view the same, namely a constructive dividend to the shareholders, followed by the shareholders' contribution to the capital of Corporation C.[2]

We have considered and eliminated for now, the potential alternative characterizations of the excessive payments attributable to the assignments of income in this case as either loans or as non-shareholder contributions by Corporation A to Corporation C. Excessive payments (or other transfers of funds) between commonly-controlled corporations generally will not be characterized as debt unless the economic substance of the transaction indicates that the parties intended to create indebtedness. Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973) (critical inquiry is whether there was "a genuine intention to create a debt, with a reasonable expectation of repayment, and [whether] that intention comport[ed] with the economic reality of creating a debtor-creditor relationship."); Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3rd Cir. 1968) (court must determine whether investment, analyzed in terms of economic reality, is "risk capital subject to the fortunes of the corporate venture . . . or represents a strict debtor-creditor relationship."); see also Geftman v. Commissioner, 154 F.3d 61 (3rd Cir. 1998). In particular, a debt will not be found unless there is an unconditional obligation, either express or implied, to repay the funds in question. Fin Hay Realty, 398 F.2d at 696.

In Altama Delta v. Commissioner, 104 T.C. 424 (1995), the Service imputed interest on certain intercorporate payments pursuant to section 482, and argued that the amounts should be treated as debt. The IRS prevailed on that theory, primarily because the taxpayer failed to carry his burden of showing that the amounts in question were not debt. In the instant case there is no evidence, direct or indirect, whether in terms of writings, course of conduct of the parties, or otherwise, of a debt obligation. The transfers to Corporation C occurred at regular intervals over a period of c years without any repayment, demand for repayment, or other evidence that a repayment obligation existed.

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[2] Since, as noted above, section 482 need not be applied in this case, we do not address the separate analysis of secondary adjustments to conform accounts to reflect primary adjustments under section 482, pursuant to the regulations and applicable revenue procedures. See generally Treas. Reg. § 1.482-1(g)(3); Rev. Proc. 99-32, 1999-34 I.R.B. 296, superseding Rev. Proc. 65-17, 1965-1 C.B. 833.

Similarly, the facts known to date do not support characterizing the excessive payments attributable to the assignments of income as non-shareholder contributions by Corporation A to Corporation C. The legislative history of I.R.C. § 118 recognizes that contributions to capital may be made by persons other than shareholders: "Section [118] deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services." S. Rep. No. 1622, 83d Cong., 2d Sess. (1954). For example, a developer, local government, or business organization may contribute property to a corporation in order to obtain a specific benefit, such as the location of a business in a particular locality. E.g., May Department Stores v. Commissioner, T.C. Memo. 1974-253, aff'd, 519 F.2d 1154 (8th Cir. 1975). In determining whether payments are capital contributions, courts generally look to the intent of the transferor. Among the factors indicating that a transfer is a contribution to capital are bargaining with respect to the amount contributed and a likelihood that the contribution will result in additional income for the transferor. While courts have found capital contributions where unrelated parties made payments to induce some action by the corporation, or where shareholders made payments to their corporation, no decision has found a capital contribution where excessive payments were made between brother-sister corporations.

Further, Corporation C's assets include the net amount of Payments remitted by Corporation A to Corporation D that were subsequently transferred to Corporation C. As discussed above, the consequences of the determination that the income belongs to Corporation A were constructive dividends to the shareholders, followed by deemed contributions by the shareholders of the constructive dividend proceeds to the capital of Corporation C. The capital contributions thus belong to Corporation C.

This conclusion would be the same even if it were determined that the deemed transfers constituted non-shareholder contributions by Corporation A to the capital of sister Corporation C, rather than deemed contributions by the shareholders to the capital of Corporation C. Under either characterization, from the perspective of Corporation C, the transfers were capital contributions, and the resulting assets belonged to Corporation C.

We note that, with respect to the basis of the Corporation C stock in the hands of the shareholders, all taxable years prior to Year 2 are now closed for most individual shareholders. To the extent that the shareholders failed to report income on account of the constructive dividends received from Corporation A in the closed years, the duty of consistency would bar them from claiming a step-up in the basis of their stock in Corporation C as a result of the deemed contributions of capital to Corporation C.

The duty of consistency doctrine prevents a taxpayer, after taking a position in one year that is to his advantage, and once an adjustment with respect to that year is barred, from adopting a contrary position in a subsequent year. Johnston v. United States, 605 F. Supp. 26, 28 (D. Mont. 1984). Thus, for example, a taxpayer who benefited from a representation in one tax year may not reduce his tax in a subsequent tax year by arguing, after the statute of limitations has run on the earlier year, that his original representation was incorrect, and that more tax was due in the now-closed year. See Herrington v. Commissioner, 854 F.2d 755, 758 (5th Cir. 1988), cert. denied, 490 U.S. 1065 (1989); Estate of Letts v. Commissioner, 109 T.C. 290 (1997). Thus, the duty of consistency prevents a taxpayer from obtaining a permanent exclusion of income that is taxable, or from deducting the same expense in multiple taxable years. Letts, 109 T.C. at 296.

The duty of consistency has three elements: (1) the taxpayer represented a fact or reported an item for Federal income tax purposes for a particular year; (2) the Service acquiesced in or relied upon the representation of fact or the reported item for that year; and (3) the taxpayer attempts to change the representation or reporting in a subsequent year, after expiration of the period of limitation, and the change is detrimental to the Service. Herrington, 854 F.2d at 757; and Cluck v. Commissioner, 105 T.C. 324, 332 (1995).

A taxpayer's inclusion or omission of a particular item on a tax return can be a representation that the facts are consistent with how the item is reported. Thus, failure to report a particular item of income may be an implied representation of fact with respect to that item, which the taxpayer cannot repudiate at a later date. Letts, 109 T.C. at 300; Wentworth v. Commissioner, 244 F.2d 874, 875 (9th Cir. 1957) (failure to report receipt of funds on an income tax return was a representation that the funds were a loan repayment).

When the duty of consistency applies, the Commissioner may proceed as if the original representation on which he relied continues to be true, even if it is not, and the taxpayer is estopped from advancing a contrary position. Cleo Perfume, Inc. v. Commissioner, T.C. Memo. 1998-155.

The duty of consistency does not apply to a mutual mistake of law, provided that both the taxpayer and the Commissioner had knowledge of, or equal access to, facts that would have alerted them to the mistake. Herrington v. Commissioner, 854

F.2d at 758; Letts, 109 T.C. at 302; LeFever v. Commissioner, 100 F.3d 778, 788 (10th Cir. 1996); Estate of Ashman v. Commissioner, T.C. Memo. 1998-145; Ross v. Commissioner, 169 F.2d 483, 496 (1st Cir. 1948) (taxpayer was entitled to change position in second return to report constructive receipt of salary in an earlier year because this was a question of law, not fact).

If the shareholders in the instant case failed to report dividend income in the years prior to Year 2, they implicitly represented that the assignments of income from Corporation A to Corporation C did not result in constructive dividends. This position might have been reasonable if, for example, (under different facts) the transfers had a valid business purpose, or if the shareholders did not directly benefit from the transfers. On the facts of this case, however, the duty of consistency bars the shareholders from disavowing the original representation.

Although the mistake in this case was legal in nature, the Commissioner did not have equal access to the facts for the years that are now closed. In effect, the Commissioner was led to rely on the belief that the transaction between Corporation A and Corporation C constituted legitimate Service E, whereas in reality it was a sham transaction and an assignment of income from Corporation A to Corporation C, motivated by tax-avoidance considerations. The Commissioner failed to advance the constructive-dividend theory in the intervening years because he was unaware of the true nature of the transaction. Under these circumstances, the shareholders cannot assert the "question of law" exception to the duty of consistency. Thus, the shareholders would be precluded from arguing that they had dividend income in the closed years, and that they are entitled to a corresponding step-up in the basis of their stock in Corporation C.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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[redacted]

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If you have any questions, please call (202) 874-1318.

STEVEN A. MUSHER
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