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Constructive Dividends and Personal Expenses

Cross References

- *Hee,* T.C. Memo. 2026-53

The taxpayer incorporated Waimana Enterprises, Inc. in 1988 and was its sole shareholder and president during tax years 2003 through 2012, the tax years at issue in this case. Waimana was a C corporation, and its primary business was as a holding company for its affiliates. Waimana pursued new business opportunities, provided management services, and supported each of its affiliates' businesses. Waimana affiliates during the tax years at issue include Sandwich Isles Communications, Inc., Clearcom, Inc., and Ho'opa'a Insurance Co., each of which were C corporations.

To pay expenses, the taxpayer routinely used his personal credit cards. The taxpayer personally paid the balances of the credit cards each month, then sought reimbursement of certain expenses related to the appropriate business.

On the credit cards' itemized monthly statements, the taxpayer would direct his assistant to categorize charges as personal or business related, record the general category of the charges (such as travel, meals/entertainment, or office expense), and allocate the charges to the subsidiaries. A request for reimbursement form was then prepared and a reimbursement check from each business would then be issued to the taxpayer.

Waimana and the subsidiaries routinely reimbursed employees for company travel. The travel reimbursement process (for things such as rental cars, hotels, and other travel expenses) required filling out a form, providing a receipt, stating the purpose of the travel, and identifying what parts of the travel were personal versus business. However, the taxpayer did not always follow this same procedure for reimbursing his own expenses.

The taxpayer used a certified public accountant (CPA) to prepare Forms 1120, *U.S. Corporation Income Tax Return,* for tax years 2003 through 2008. The CPA relied upon the check registers' account classifications for preparing the tax returns, and QuickBooks entries in later years. In addition to tax preparation, the CPA provided other accounting services, including payroll, bookkeeping, and preparing calculations and trial balances. The CPA was also responsible for certified audits of Waimana's financial statements.

An LLP was engaged to prepare Forms 1120 for tax years 2009 through 2012. These tax returns were filed for Waimana on a consolidated basis with those of its subsidiaries. The LLP prepared workpapers based on the information provided by Waimana. In addition to preparing tax returns, Waimana engaged the LLP to assist with the IRS audit.

Beginning in 2008, the IRS selected the taxpayer's joint personal and corporate returns for examination. Initially, the CPA represented the taxpayer and Waimana in the audit. However, in 2009, because of a criminal referral by the IRS, Waimana retained the LLP.

The taxpayer was found guilty by a jury in 2016 on seven counts: One count of corrupt interference with the administration of Internal Revenue Laws and six counts of filing false tax returns. The judge found that the taxpayer's testimony during the trial was false, material, and willful, and she imposed a 46-month prison sentence and criminal monetary penalties, including a restitution order of $431,793 and a fine of $10,000.

In 2022, the IRS issued a Notice of Deficiency based on the taxpayer's Forms 1040 with respect to deficiencies in income tax and penalties for tax years 2004 through 2012. The IRS also issued a Notice of Deficiency to Waimana that was based on its Forms 1120 for tax years 2003, 2004, and 2006 through 2008. The IRS determined that the taxpayer received constructive dividends from Waimana for each year at issue on the basis of the disallowance of certain business deductions. In the alternative, the IRS determined that the taxpayer received additional wages for services equal to the disallowance of certain business deductions claimed.

During the Tax Court trial, the IRS primarily relied on information produced by the government in the taxpayer's criminal trial.

The taxpayer argued that the statute of limitations had expired. The taxpayer also disputed the applicability of the fraud penalties. IRC section 6501(a) provides that the amount of any tax must be assessed within three years of the filing of a return. The Notices of Deficiency in these cases were issued more than three years after the relevant returns were filed. Therefore, the periods of limitation for the tax years at issue have expired and assessment is barred unless an exception to the general period applies.

IRC section 6501(c)(1) provides that, where a taxpayer has filed a false or fraudulent return with the intent to evade tax, there is no period of limitations, and the tax may be assessed at any time." Fraud for this purpose is defined as intentional wrongdoing by the taxpayer with the specific purpose of avoiding tax believed to be owed.

On the basis of the taxpayer's prior criminal conviction of underpayments of tax and the filing of false tax returns, the Tax Court stated they were convinced that the IRS had established by clear and convincing evidence that underpayments of tax existed.

The taxpayer contested the amounts of the deficiencies regarding the underpayments. The IRS argued that the taxpayer received unreported income in the form of constructive dividends from Waimana and that Waimana incorrectly deducted payments.

A constructive dividend is an economic benefit without expectation of repayment, conferred upon a shareholder of a corporation. The determination of constructive dividend income received by the taxpayer is a determination of unreported income. The amount of the constructive dividend is equal to the fair market value of the benefit received.

If a distributing corporation has sufficient earnings and profits (E&P), the distribution is a dividend that the shareholder must include in gross income. If the distribution exceeds the corporation's E&P, the excess represents a nontaxable return of capital or capital gain. The taxpayer bears the burden of proving that the corporation lacks sufficient E&P to support dividend treatment at the shareholder level. If neither party presents evidence as to the distributing corporation's E&P, the taxpayer has not met his burden of proof.

The taxpayer in this case did not present evidence as to Waimana's and the subsidiaries' accumulated E&P for the tax years at issue. Waimana made one cash distribution of $1 million to the taxpayer as a shareholder in 2012, but Waimana did not report any distribution of cash, stock, or property from 2005 through 2011. Accordingly, the court concluded both Waimana and the subsidiaries had sufficient E&P in the tax years at issue to justify dividend treatment.

Corporate expenditures constitute constructive dividends only if (1) the expenditures do not give rise to a deduction on behalf of the corporation, and (2) the expenditures create economic gain, benefit, or income to the owner-taxpayer.

Deductions for all ordinary and necessary business expenses paid or incurred in carrying on a trade or business are allowed. An ordinary expense is one that is common and acceptable in the particular business. A necessary expense is an expense that is appropriate and helpful in carrying on the trade or business. No deduction is allowed for personal, living, or family expenses.

A taxpayer's general statement that expenses were paid in the pursuit of a trade or business is insufficient to establish that the expenses had a reasonably direct relationship to any such trade or business. Taxpayers are required to keep adequate records to substantiate these deductions.

Examples of deductions disallowed by the IRS in this case (and considered personal rather than business) include:

- Massages that were part of a holistic approach that were successful in treating the taxpayer's asthma. The court noted these payments were personal in nature.
- Tuition paid for the taxpayer's eldest daughter to attend the Massachusetts Institute of Technology (MIT) for a degree in a field that bears no relationship to the work that Waimana performed.
- Salaries and employee benefits to the children of the taxpayer were not deductible. The court found it unlikely that the children worked a sufficient number of hours to receive such compensation. Some children were attending school but Waimana did not document the type of work these children performed.
- Salaries and employee benefits to the wife of the taxpayer were not deductible. The court noted the wife's role at Waimana was unclear. She never had an office, and her testimony was uncorroborated. The taxpayer could not provide any evidence of the type of work she performed for Waimana on a regular basis.
- Travel expenses were not deductible. Waimana deducted costs of multiple flights for the children from their colleges back home at various times each year, including around the holidays. The only documentation for such travel expenses were the credit card statements. The court stated this was insufficient to comply with the heightened documentation standards under IRC section 274.
- A 2008 trip to France and Switzerland was not deductible. The taxpayer acknowledged that the deduction of the Switzerland portion of the trip was a mistake. The court also stated the taxpayer failed to present evidence of a business purpose for the trip to France. The taxpayer tried to argue that the purpose was to visit a factory, but the court noted it aligned with one of the children's college spring break, and such child was not

an employee of Clearcom or Waimana at the time. The trip costs also failed to meet the heightened substantiation standards under IRC section 274.

- Travel expenses for a 2009 Presidential Inauguration trip also failed to meet the heightened substantiation standards under IRC section 274.
- Travel expenses for a 2010 trip to Tahiti failed to meet the deductible standard because more time was spent on personal activities than on business activities. Under IRS regulations, if the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination.
- Travel expenses for a 2010 Trip to Walt Disney World for the taxpayer's children were not deductible because they were not employees of Waimana at the time.
- Travel expenses for a 2011 trip to Mauna Lani for the taxpayer and his entire family were not deductible because the taxpayer classified the trip as a stockholder's meeting. At the time of the trip, the taxpayer was the only shareholder of Waimana. The taxpayer testified that the purpose of the trip was succession planning, but no other family member could recall any business succession planning meetings during the trip. No documentation, such as meeting minutes or agendas, was presented to the court to substantiate such a claim.
- A sport coat purchased for the taxpayer was classified as an office expense. The court stated it is well established that the costs of purchasing and maintaining ordinary street attire are not deductible merely because those clothes are worn to the office.
- Various meal and entertainment expenses for the taxpayer and members of his family were not deductible because no documentation regarding the purpose of the expenses were provided to the court.
- Payments to the Santa Clara University bookstore in 2008 were not deductible as educational expenses because no receipts were provided to substantiate the purpose of the payments.
- Deductions classified as office expenses were not deductible because they were found to be for clothing and furniture and other non-office related expenses of a personal nature.
- Deductions related to the purchase of the Santa Clara property were determined to be non-deductible. The taxpayer argued that the Santa Clara property served many purposes, including providing a place for the taxpayer and Waimana employees to stay when checking on a subsidiary and for his children to learn property management. The taxpayer, however, provided no evidence that employees stayed in the house. Instead, it was the home of the taxpayer's children throughout their time at Santa Clara University, which was a five-to-ten-minute walk from the house. The children never paid rent, but they rented the spare rooms to other tenants and collected rent. These payments collected were not transferred to Waimana, but instead used by the children to pay maintenance expenses, including items such as toilet paper and paper towels. The court also stated that Waimana's purchase of the Santa Clara property for the taxpayer's children to practice management skills is not an ordinary and necessary business expense for the type of business that Waimana was engaged in.
- The taxpayer made multiple cash withdrawals on his Amex Optima card that were reimbursed by Waimana. The reimbursement requests did not specify what the cash was used for on the trips or whether the taxpayer used the entire amount withdrawn.

- The taxpayer argued some distributions from Waimana were shareholder loans. (1) The taxpayer did not execute formal loan documents with respect to the distributions. (2) Waimana did not accrue interest on an annual basis for such loans. (3) There was no evidence that Waimana established a repayment schedule or required any specific repayments. (4) The taxpayer offered no collateral to secure repayment to Waimana. (5) Two repayments of a portion of the loan favor the taxpayer in finding a shareholder loan, but the repayments did not total the outstanding balance of the loan. (6) There was little evidence to show that the taxpayer had a reasonable prospect of repaying the distributions at the time they were made because of financial difficulty. (7) There was no evidence showing that Waimana and the taxpayer conducted themselves in a manner that indicated the distributions were shareholder loans.

Based an all of the above factors, the court concluded that the distributions were constructive dividends.

The court concluded that there were underpayments for the tax years at issue as to the taxpayer and to Waimana.

The court also determined that the fraud penalty should apply. There were six factors that support the finding of fraud as to the taxpayer.
- Understating income,
- Maintaining inadequate records,
- Giving implausible or inconsistent explanations,
- Supplying incomplete or misleading information to a tax return preparer,
- Lack of credibility of the taxpayer's testimony, and
- Filing false documents.

The two factors that did not favor a finding a fraud were failing to file tax returns and dealing in cash. Accordingly, the court ruled that the IRS had established by clear and convincing evidence that the underpayments of tax for years 2004 through 2012 were attributable to fraud. Therefore, tax years 2004 through 2012 remain open and are not subject to the statute of limitations. The court ruled in favor of the IRS' determination of tax deficiencies and for civil fraud penalties.