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Corporate Opportunity Doctrine Raises Tax, Ethical Issues

by Robert W. Wood • San Francisco

The corporate opportunity doctrine, a feature of state corporate law, provides that there are some business opportunities that properly belong to the corporation rather than to any individual officer, director, shareholder, or entity any of them may control. It has accounted for careful

Continued on Page 2

ALSO IN THIS ISSUE:

CORPORATE OPPORTUNITY Continued From Page 1

corporate minutes in cases where the corporation declines to pursue a project (*e.g.*, an acquisition), but someone else connected with the company is given the green light to pursue the opportunity.

From a corporate perspective, the problems and pitfalls seem relatively straightforward. The key is typically disclosure, with disinterested board approval.

On the surface, there would appear to be no tax issues raised by this relatively common scenario. But, can an officer's or director's pursuit of a corporate opportunity result in a deemed dividend to the individual recipient?

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What is a Corporate Opportunity?

The answer depends on how one defines a corporate opportunity. In *McCabe Packing Co. v. U.S.*, 809 F. Supp. 614 (DC Ill., 1992), a family-owned corporation operated a slaughterhouse. It had once unsuccessfully tried to develop calf blood as a marketable by-product of its packing operations, but eventually abandoned the efforts. Later, it was approached by a drug company desiring to purchase the blood and use it for research.

Although the company declined the offer, it permitted one of its shareholder-officers (a member of the controlling family) to pursue the venture. The officer operated the blood business on his own time for several years, using processing equipment provided to him by the drug company. During these years, he reported the income personally. Eventually, the corporation took over the blood business.

The Service asserted that even during the early years, the income belonged to the corporation, and thus, constituted a constructive dividend to the officer-shareholder. When the matter reached the district court, the company argued that it had legitimately declined the business opportunity, and therefore, no corporate asset had been distributed to the shareholder.

Constructive Dividends

Distributions of corporate property to shareholders can easily be deemed constructive dividends. Common examples of constructive dividends include the following:

- Below-market purchases of corporate property by shareholders.
- Excessive payments to shareholders to purchase or lease their property.
- Corporate payments of expenses, or purchases of property, for the benefit of shareholders.

The question in *McCabe*, of course, was whether the blood was really corporate property any more. The blood itself was a worthless by-product to the corporation. Likewise, under applicable state law, a corporate director or agent could take a business

Continued on Page 7

CORPORATE OPPORTUNITY Continued From Page 2

opportunity personally as long as there was full disclosure of the opportunity to the corporation, and the corporation rejected it, was not in a position to accept it, or had tried without success to obtain it.

The full disclosure that occurred in *McCabe*, coupled with the company's decision not to get involved, precluded the application of the corporate opportunity doctrine, prevented the existence of a constructive dividend, and resulted in a taxpayer victory.

Semantic Victory

Nonetheless, if a corporate opportunity *has* been usurped, the possibility of constructive dividend treatment based on an assumed value for the opportunity certainly could arise. While the risk does not appear to be a serious one (given that good corporate practice would require thorough documentation of the corporation's decline of the opportunity), the constructive dividend possibility can pop up to make a bad situation worse. ■