X produces and exports fiber for sale on the world market, but due to monetary restrictions, X has had difficulty in securing dollars needed to pay refunds to foreign customers and to pay travel expenses of its employees outside country M. P, therefore, formed Y, a wholly owned foreign corporation incorporated in country T to act on behalf of X to receive part of the sales price charged by X and to pay certain expenses of X. Thereafter, some of these dollars accumulated by Y were used to pay the above-mentioned refunds and expenses, as well as certain promotion expenses in connection with the fiber sales. The funds diverted from X to Y were in excess of the amounts necessary to provide Y with reasonable compensation for its services to X and to reimburse Y for the expenses it incurred on behalf of X.

A distribution to a shareholder need not be formally declared and paid but may take the form of a constructive dividend. A constructive dividend is paid when a corporation diverts property, directly or indirectly, to the use of a shareholder without expectation of repayment, even though no formal dividend has been declared.

Where property is transferred from one affiliate to a sister corporation without adequate consideration, there is a constructive distribution to the common parent whether or not the motive for the transfer was an attempt improperly to allocate income or deductions between the corporations. However, any amount diverted to Y for disbursements on behalf of X, or as reasonable compensation for services rendered to X, would not be considered as constructive dividend income to P. Accordingly, the income of X diverted to Y in excess of the disbursements on behalf of X and reasonable compensation for services of Y will be treated as a distribution taxable as a dividend to P to the extent of the earnings and profits of X, and a capital contribution by P to Y.