

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition

of

PAUL H. NELSON and FLORENCE E. NELSON

DECISION

for Redetermination of a Deficiency or for
Refund of Personal Income Tax under Article 22
of the Tax Law for the Years 1980 and 1981.

Petitioners, Paul H. Nelson and Florence E. Nelson, 396 Highland Drive, Schenectady, New York 12303, filed a petition for a redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1980 and 1981 (File No. 51942).

A hearing was held before Brian L. Friedman, Hearing Officer, at the offices of the State Tax Commission, Building #9, State Office Campus, Albany, New York on November 22, 1985 at 10:45 A.M. Petitioners appeared pro se. The Audit Division appeared by John P. Dugan, **Esq.** (Thomas Sacca, Esq., of counsel).

ISSUE

Whether amounts reported as loans to officers on the books of a corporation of which petitioner Paul H. Nelson is an officer and 50 percent stockholder were properly classified as loans or whether said amounts were dividends paid and were, therefore, taxable to petitioners.

FINDINGS OF FACT

1. Paul H. Nelson and Florence E. Nelson (hereinafter "petitioners") filed New York State Income Tax Resident Returns under filing status "married filing separately on one return" for the year 1980 and under filing status "married filing joint return" for the year 1981.

2. For the years at issue, petitioner Paul H. Nelson and Joseph Painter were the sole officers and stockholders of Upstate Petrol, Inc. (hereinafter "the corporation"). On its Corporation Franchise Tax Report for the taxable period October 1, 1979 through September 30, 1980, the corporation claimed compensation paid to officers in the amount of \$12,000.00, \$6,000.00 to petitioner Paul H. Nelson and \$6,000.00 to Joseph Painter. At the hearing held herein, petitioner Paul Nelson conceded that 9/12 of the \$6,000.00 paid to him by the corporation for the period ending September 30, 1980, or the amount of \$4,500.00, had not previously been reported by him on his 1980 New York State Income Tax Resident Return and further conceded liability for the tax thereon. Therefore, the only remaining issue is whether the amounts reported by the corporation as loans to officers were loans or were dividends which were taxable to petitioners.

3. A field audit of the corporation was performed in 1982. On the books of the corporation for the fiscal year ending September 30, 1980, the corporation initially listed management fees paid to petitioner Paul Nelson and to Joseph Painter in the amounts of \$15,000.00 to each, a total of \$30,000.00. The accountant for the corporation subsequently made an adjusted entry to the corporate books which reclassified \$18,000.00 of the aforesaid \$30,000.00 as loan repayments to Paul H. Nelson and Joseph Painter, with the balance of \$12,000.00, \$6,000.00 (the amount conceded by petitioner Paul Nelson as being taxable income as indicated in Finding of Fact "2", supra) to each, remaining as management fees. The Audit Division allowed \$5,907.00 as loan repayments and disallowed as loans to officers the sum of \$12,093.00. For the fiscal year ending September 30, 1981, the corporate books originally contained an entry listing \$17,400 to petitioner Paul H. Nelson and 18,200 to Joseph Painter as

management fees and a subsequent adjusted entry charged the total thereof, or \$35,600.00, as loans to officers. Therefore, the Audit Division disallowed loans to officers in the amount of \$35,600.00. The Audit Division computed taxable income to petitioner Paul H. Nelson as follows:

	<u>Total Taxable Income to Officers</u>	<u>Taxable Income to Nels</u>
<u>1980</u>		
Period 1/1 - 9/30/80	\$12,093.00	\$ 6,046.00
10/1 - 12/31/80	--	--
35,600.00 x 3/12	8,900.00	4,450.00
Taxable Income	\$20,993.00	\$10,496.00
Taxable as Dividends-Earnings 9/30/80	8,518.00	4,259.00
Balance	\$12,475.00	\$ 6,237.00
Retained Earnings	-0-	-0-
Return of Capital	(350.00)	(175.00)
Taxable as Capital Gain	\$12,125.00	\$ 6,062.00
<u>1981</u>		
Loans to Officers (35,600.00 x 9/12)	26,700.00	13,350.00
Taxable as Dividends-Earnings 9/30/81	1,988.00	994.00
Taxable as Capital Gain	\$24,712.00	\$12,356.00

4. On November 7, 1983, the Audit Division issued to petitioners a

Statement of Personal Income Tax Audit Changes which contained the following explanation:

	<u>"1980 HUSBAND</u>	<u>1980 WIFE</u>	<u>1981 JOINT</u>	<u>TOTAL</u>
Total Adjustment	\$11,709.00	\$12,078.00	\$ 7,172.00	
New York Income Reported for 1980, your return has been recomputed to arrive at a lesser tax.	8,328.00	--	--	
Itemized Deductions	(8,156.00)	(866.00)		
Exemptions	(2,250.00)	(1,500.00)		
Net Adjustment			7,172.00	
Taxable Income Previously Stated			12,997.00	
Taxable Income Adjusted	9,712.00	9,712.00	20,169.00	
Tax on Corrected Taxable Income	429.84	429.84	1,420.28	

Corrected Tax Due	429.84	429.84	1,420.28	
Tax Previously Computed	95.19	95.19	645.00	
Total Additional Tax Due	334.65	334.65	775.28	
Interest	103.63	103.63	144.00	
Total	438.28	438.28	919.28	\$1,795.8

The total adjustments were further explained as follows:

	1980 <u>HUSBAND</u>	1981 <u>JOINT</u>
Compensation paid by Upstate Petrol, Inc. for the year 10/80 Not previously reported \$0.00 x 9/12	\$ 4,500.00	--
Dividends from Upstate Petrol, Inc. considered dividends on capital gains. Taxable as dividends 10/80 - 8,518.00 10/81 - 1,988.00	4,259.00	\$ 994
Capital Gain	\$6,062.00 <u>3,637.00</u>	\$12,356.00 <u>7,414.00</u>
Net Capital Gain	<u>2,425.00</u>	<u>4,942</u>
Balance	\$11,184.00	\$5,936
New York modification Capital Gain - 20%	<u>606.00</u>	<u>1,236</u>
Total Adjustment	<u>\$11,790.00</u>	<u>\$7,172</u>

Accordingly, on February 2, 1984, the Audit Division issued Notices of Deficiency for the year 1980, to each of the petitioners asserting additional tax due in the amount of \$334.65 plus interest of \$113.35 for a total amount due from each of \$448.00 and also issued a Notice of Deficiency to petitioner Paul H. Nelson, for the year 1981, asserting additional tax due in the amount of \$775.28 plus interest of \$164.39 for a total amount due of \$939.67. Petitioners do not contest the formula utilized by the Audit Division in taxing portions of the disallowed loans as dividends and remaining portions thereof as taxable capital gain.

5. At the time of the audit of the corporation, no notes were presented to the auditor to substantiate the existence of loans made to the corporation by petitioner Paul H. Nelson or by Joseph Painter. The corporate books of the corporation contained no entry of interest expense for the alleged loans.

6. On November 10, 1982, a date subsequent to the audit of the corporation, petitioner Paul H. Nelson and Joseph Painter each repaid \$10,000.00 to the corporation.

7. At the hearing held herein, petitioner Paul H. Nelson introduced copies of 17 on demand notes, allegedly executed by him during the period April 1, 1980 through December 3, 1981, to evidence loans made by the corporation to him and also introduced copies of 27 on demand notes, allegedly executed by Joseph Painter during the period April 10, 1980 through December 1, 1981, to evidence loans made by the corporation to Joseph Painter.

9. Petitioner Paul H. Nelson contends that no interest was charged on the notes because he and Joseph Painter could not compute the proper amounts to be charged.

CONCLUSIONS OF LAW

A. That in deciding the issue of whether cash withdrawals from closely held corporations are taxable dividends or bona fide loans, the U.S. Court of Appeals, 10th Circuit, in Dolese v. United States, 605 F.2d 1145,1153, stated:

"The courts have looked to a number of test factors in deciding the question. Such factors have included the control of the corporation, its dividend history, the size of the advances, whether the corporation imposed a ceiling on the amounts that might be borrowed, whether there were definite maturity dates, attempts to force repayment, intention or attempts to repay, and the shareholder's ability to liquidate the loan."

B. That withdrawals by officer-shareholders of several close corporations

to repay existed and where notes evidencing the withdrawals were executed only after notice of an audit was received. C.F. Williams, 80-2 USTC ¶9550.

C. That, at the time of the audit of the corporation, the corporate books contained entries which categorized the amounts in issue as management fees paid to petitioner Paul H. Nelson and to Joseph Painter, the sole officers and shareholders of the corporation, which entities were later adjusted to reclassify said amounts as loans. In addition, at the time of this audit, no notes were presented to evidence the existence of the alleged loans. Petitioner Paul H. Nelson offered no independent evidence, other than his own self-serving testimony to substantiate that the notes presented at the hearing held herein had been executed by Painter and himself at the time at which the corporation advanced funds to each. No interest on the alleged loans was charged by the corporation or paid by Nelson or Painter to the corporation. No ceiling was imposed by the corporation on the amount of the advances to Nelson and Painter, no maturity date was set on the notes and no repayments of the amounts advanced by the corporation to Nelson and Painter were made until after the audit was completed.


D. That petitioners have failed to sustain their burden of proof required by section 689(e) of the Tax Law to show that the Audit Division improperly classified as dividends, amounts reported as loans to officers on the books of the corporation.

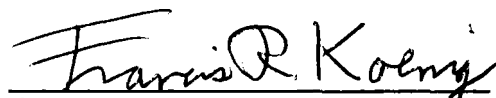
E. That the petition of Paul H. Nelson and Florence E. Nelson is denied and the Notices of Deficiency dated February 2, 1984 are sustained, together with such additional interest as may be lawfully owing.


DATED: Albany, New York

STATE TAX COMMISSION

APR 28 1986


PRESIDENT


COMMISSIONER


COMMISSIONER