STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition of Milton & Florence Etengoff	:
	: AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision of a Determination or Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1977, 1978 & 1979.	:

State of New York :
ss.:
County of Albany :

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 23rd day of May, 1985, he served the within notice of decision by certified mail upon Milton & Florence Etengoff, the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Milton & Florence Etengoff
272 E. Treehaven Rd.
Buffalo, NY 14215

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
23rd day of May, 1985.

David Parchuck

James A. Hagelund
Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of
Milton & Florence Etengoff :

AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Personal Income
Tax under Article 22 of the Tax Law for the Years :
1977, 1978 & 1979.

State of New York :
ss.:
County of Albany :

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 23rd day of May, 1985, he served the within notice of decision by certified mail upon Joseph J. Gumkowski, the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Joseph J. Gumkowski
Lipsitz, Green, Fahringer, Roll, Schuller & James
One Niagara Square
Buffalo, NY 14202

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the representative of the petitioner herein and that the address set forth on said wrapper is the last known address of the representative of the petitioner.

Sworn to before me this
23rd day of May, 1985.

David Parchuck

Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

May 23, 1985

Milton & Florence Etengoff
272 E. Treehaven Rd.
Buffalo, NY 14215

Dear Mr. & Mrs. Etengoff:

Please take notice of the decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 690 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
Joseph J. Gumkowski
Lipsitz, Green, Fahringer, Roll, Schuller & James
One Niagara Square
Buffalo, NY 14202
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
of	:	
MILTON ETENGOFF AND FLORENCE ETENGOFF	:	DECISION
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1977, 1978 and 1979.	:	

Petitioners, Milton Etengoff and Florence Etengoff, 272 East Treehaven Road, Buffalo, New York 14215, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1977, 1978 and 1979 (File No. 36053).

A formal hearing was held before Dennis M. Galliher, Hearing Officer, at the offices of the State Tax Commission, General Donovan State Office Building, 125 Main Street, Buffalo, New York, on April 24, 1984 at 2:45 P.M., with all briefs to be submitted by July 3, 1984. Petitioners appeared by Lipsitz, Green, Fahringer, Roll, Schuller & James (Joseph L. Gumkowski, Esq., and Michael Schiavone, Esq., of counsel). The Audit Division appeared by John P. Dugan, Esq. (Deborah J. Dwyer, Esq., of counsel).

ISSUES

I. Whether certain monies transferred to petitioner Milton Etengoff from a professional corporation of which he is president and sole shareholder should be construed as constructive dividends rather than as bona fide loans.

II. Whether, pursuant to section 612(b)(7) of the Tax Law, petitioner Milton Etengoff must include in his New York adjusted gross income any portion of the contributions made by the aforementioned professional corporation to a defined benefit plan on behalf of petitioner Milton Etengoff.

FINDINGS OF FACT

1. Petitioner Milton Etengoff is a dentist employed by Milton Etengoff, D.D.S., P.C., 1241 Colvin Avenue, Kenmore, New York 14223 (hereafter referred to as "the Corporation"). Dr. Etengoff is President, sole Director and sole shareholder of the Corporation, and his wife, petitioner Florence Etengoff, who holds the title of Secretary of the Corporation, is the only other corporate officer.

2. On April 8, 1981, the Audit Division issued to petitioners a Statement of Audit Changes on which was computed additional tax due in the amounts of $11,095.24, $8,033.50, and $10,465.51 for the years 1977, 1978 and 1979, respectively.[1] The total additional tax due of $29,594.25 was based upon a field audit conducted in or about November 1980 to June 1981.

3. As reflected on the aforementioned Statement of Audit Changes, the Audit Division determined that certain monetary advances made to petitioner from the Corporation, which were treated by petitioner (and the Corporation) as loans, were actually undeclared taxable dividends for the periods in question. Furthermore, the Audit Division increased petitioner's taxable income on the basis of certain expenditures made by the Corporation pursuant to Tax Law §612(b)(7) [Pension Payments], §612(b)(8) [Social Security] and §612(b)(9) [Insurance]. The audit results may be shown, in numerical format, as follows:

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1 Petitioner Florence Etengoff's name appears solely by virtue of having filed a joint return with petitioner Milton Etengoff. Accordingly, all references to "petitioner" pertain solely to Milton Etengoff.

Adjustment to Petitioner's Income

	1977	1978	1979
Undeclared Dividends[2]	$21,342.78	$17,705.55	$38,049.87
Pension Payments §612(b)(7)	46,359.00	47,277.00	46,407.00
Social Security §612(b)(8)	816.75	893.85	1,163.32
Insurance §612(b)(9)	--	1,922.64	1,989.10

4. On November 30, 1981, the Audit Division issued to petitioners a Notice of Deficiency asserting additional tax due for the years 1977, 1978 and 1979 in the aggregate amount of $29,594.25, plus interest.

5. Petitioner admitted liability for additional tax due based on the adjustments made pursuant to Tax Law §612(b)(8) and §612(b)(9), but challenged both the adjustment attributable to §612(b)(7) and the characterization of the alleged loans from the Corporation as constructive dividends.

6. The auditor classified the alleged loans as constructive dividends rather than as bona fide loans based upon the assertions that the amount of the Corporation's earned surplus in each of the years at issue was in "close proximity" to the amount of loan withdrawals for that year, that no repayment schedule was set up for such loans and that a three year period was "quite a long period of time" to defer repayment.

7. Each alleged loan was unanimously authorized at a "special meeting of the sole shareholder and director", namely by Milton Etengoff in his corporate capacity as sole director, shareholder and meeting chairman, with Florence Etengoff present as Secretary. The corporate minutes of March 2, 1977 stated:

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2 The auditor determined that the alleged 1977 loan of $31,028.63 actually consisted of undeclared dividends of $21,342.78, a tax free return of capital of $800.00 and a Long Term Capital Gain of $8,885.85, based on insufficient earnings and profits in such year to treat the entire alleged loan as a dividend. In 1978 and 1979, the entire amounts of the alleged loans were treated as constructive dividends.

> "All advances made to the shareholder during any fiscal year shall, after the end of that year, be recorded in the form of a promissory note, acceptable to the corporation, bearing interest at the rate of 7½ percent per annum with repayment commencing on or after April 19, 1981, the date of Milton Etengoff's sixtieth birthday."

8. The minutes of a special meeting dated September 20, 1977 reflect the Corporation's acceptance of a promissory note for the amount of $31,028.33 plus interest at the rate of seven and one-half percent per annum duly executed by petitioner Milton Etengoff on September 20, 1977. The minutes of special meetings dated September 12, 1978 and September 14, 1979 indicate the Corporation's acceptance of similar promissory notes for advances made to petitioner during such years. Each of the three promissory notes reflected an interest rate of 7½ percent per annum with repayments to be made in semi-annual installments over a ten year period.

9. A written agreement, dated September 20, 1977, between petitioner and the Corporation, reflects petitioner's pledge of fifty shares of stock in Uptrend Co., Inc. to the Corporation as collateral security for the September 20, 1977 promissory note. Repayment of the 1977 loan[3] was not scheduled to begin until April 19, 1981 (the date of petitioner's 60th birthday), with the final payment scheduled for October 19, 1990, in order to allow petitioner to utilize his Keogh and/or corporate pension plan to make the payments. Similarly, repayment of the 1978 and 1979 loans was not scheduled to begin until April 19, 1982 and April 19, 1983, respectively, with final payments scheduled to be made on October 19, 1991 and October 19, 1992,

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3 The 1977 loan represented funds advanced during the Corporation's 1976 fiscal year. Likewise the 1978 and 1979 loans represented funds advanced in the 1977 and 1978 fiscal years, respectively.

respectively. Interest (at 7½ percent) did accrue during the 3½ year deferral period.

10. There was no lump sum distribution of the amounts at issue. Such amounts were carried on the Corporation's books as loans, with distributions made during each year reflected in a loan account composed of a series of withdrawals which, at the end of the period, were balanced out. Tuition and other personal expenses were paid by these distributions from the loan account.

11. Although petitioner's accountant, Mr. Herman Umoff, supplied the promissory notes and the corporation's minute book, balance sheet and financial statements at the hearing, none of these items were made available to the auditor at the time of the audit. According to testimony of Mr. Umoff, no direct request was made for the promissory notes or the Corporation's minutes by the auditor. The auditor testified he was not sure if he asked for these items with precise specificity.

12. Mr. Umoff did not review the minute book until the later part of 1981 or early 1982 when the Internal Revenue Service ("I.R.S.") was performing an audit of the corporation. The I.R.S. did not challenge the loans, which were listed on the Corporation's Federal Income Tax Returns as filed for each of the years in question.

13. Other than the Corporation's tax returns and (unaudited) personal and corporate financial statements (prepared for petitioner and for the Corporation's shareholder, respectively), the only document disclosing petitioner's loans that was not prepared by petitioner was a financial statement prepared by Mr. Umoff and submitted to Marine Midland Bank. This latter document was not submitted until September 1, 1981, which was after the audit had been concluded.

14. The loans were not being repaid at the time of the audit since the repayment schedule was deferred, as noted. However, several payments were made after the audit according to the aforementioned schedules for repayment, with such repayment ongoing at present. None of the amounts at issue have been forgiven or otherwise cancelled as debts owed by petitioner to the Corporation. Furthermore, although interest accrued during the deferral period, both petitioner and the Corporation use the cash method of accounting (as opposed to the accrual method); thus, the Corporation did not recognize interest income during the noted deferral period nor did petitioner recognize a corresponding deduction for interest expense.[4]

15. The Audit Division asserts that the alleged loans constitute constructive dividends from petitioner's professional corporation based upon the irregular amounts of the loans used to pay personal expenses; the lack of presentation of copies of the promissory notes or repayment schedules during the audit; no evidence of repayment during the audit period; and the accountant's inability to either produce or state the existence of the corporate minutes during the audit period.

16. Petitioner did not personally appear and give testimony at the hearing.

17. As a result of the audit, petitioner's New York adjusted gross income was increased pursuant to Tax Law §612(b)(7) on the basis of certain expenditures made by the corporation in contributing to a corporate retirement plan on behalf of petitioner. This modification of petitioner's income was

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4 All interest as accrued during the deferral period appears to have been paid on the date and as part of the first payment due from petitioner on each of the loans.

based on an actuarial determination (by petitioner's actuary) of the amount available to petitioner as a defined benefit Keogh contribution.[5]

18. At the pre-hearing conference, the Audit Division reduced the asserted deficiency from $29,594.25 to $28,368.35, in recognition of the fact that petitioner's pension program was a defined benefit plan as opposed to a defined contribution plan.

19. Petitioner maintains that no portion of the contributions made by a professional corporation to a defined benefit plan should be included in a taxpayer-shareholder's New York adjusted gross income and thus the entire portion of the deficiency related to section 612(b)(7) should be eliminated.

CONCLUSIONS OF LAW

A. That the Internal Revenue Code does not define what constitutes a loan. One common thread appearing in the repeated decisions, however, is that there must be an intent to repay the advance at the time it is made. Genito et al v. U.S., 80-2 USTC ¶9771 (1980). The question of whether advances from a corporation to its shareholder(s) constitute dividends rather than loans is one of fact. Wiese v. Commissioner, 93 F.2d 921 (1938).

B. That criteria in determining whether a withdrawal of corporate funds by a sole stockholder constitutes dividends or loans include treatment of the withdrawals as loans or receivables on the corporate books, execution of notes evidencing the loans, availability of sufficient earned surplus to cover the withdrawals, evidence of some repayments, financial ability of the borrower to repay the withdrawals and personal guarantees or collateralization of the

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5 Letters of April 8, 1982 by LeRoy T. Watkins and October 7, 1982 by petitioner's counsel.

loans. Frederick Purdy v. Commissioner, 26 TCM 1967-82 (1967). Additional criteria include the control of the corporation, its dividend history, size of the advances, whether the corporation imposed a ceiling on the amounts that might be borrowed and attempts to force repayment. Dolese et al v. US, 79-2 USTC ¶9540, Cert den., 100 S.Ct. 1648 (1979). Where, as here, a sole shareholder entirely controls the corporation, close scrutiny of the situation is warranted [Elliott J. Roschuni, 29 T.C. 1193 (1958), aff'd per curium 271 F.2d 267 (C.A.5, 1959)].

C. That surface examination of the documentary evidence tends to indicate the existence of a debtor-creditor relationship between petitioner and the Corporation. The amounts alleged as loans were carried as receivables by the Corporation and were reflected as loans to the shareholder on its tax returns. In addition, petitioner executed interest-bearing promissory notes for the aggregate amounts advanced over each year, accrued interest during periods of deferral, collateralized one of the loans, and has made repayments as due under the schedule of repayments as established.

D. That, however, there are other facts indicating that the amounts withdrawn constituted dividends to petitioner. More specifically, the alleged loans were comprised of a series of withdrawals of varying amounts over the course of each year, rather than lump-sum amounts as might be expected in a true loan situation. Furthermore, the amounts withdrawn were used to pay a variety of petitioner's personal expenses of an ongoing nature. The corporate minutes reflect simply a general authorization whereby "...all advances to [petitioner] during any fiscal year..." were to be recorded at year's end in

the form of a promissory note payable by petitioner (see Finding of Fact "7"). There is no evidence or allegation of any corporate purpose being served by making loans to petitioner.

Finally, even absent a direct request therefor by the auditor, it remains unexplained as to why such obvious documentary evidence of the questioned loans (i.e. specifically the promissory notes and corporate minutes) was not presented during the course of the audit, thus raising a question as to whether such items were in existence at that time. Petitioner, in turn, as the creator of and signatory to such documents, has provided no testimony on the subject.

E. That the obvious advantage to petitioner in having corporate distributions treated as loans rather than as dividends is that tax otherwise due thereon may be deferred almost indefinitely (or even ultimately avoided) while petitioner still enjoys the use of the funds. Given the facts and circumstances presented, petitioner has not sustained the burden of proving that a bona fide debtor-creditor relationship was intended and created and was the primary purpose in mind at the times the various advances were made [see Katherine R. Lane, 28 T.C.M. 890].

F. That section 612(b) of the Tax Law contains certain "add-back" modifications increasing an individual's federal adjusted gross income in order to arrive at his New York adjusted gross income. Specifically, §612(b)(7), as in effect during the years at issue, required a taxpayer who was a shareholder in a professional service corporation to add back the amount deductible by such corporation under section 404(a)(1), (2) or (3) of the Internal Revenue Code (Pension Trusts, Employees' Annuities and Stock Bonus and Profit Sharing Trusts) for the professional service corporation's taxable year ending in or

with such taxpayer's taxable year for contributions paid on behalf of such taxpayer minus the maximum amount which would be deductible for Federal income tax purposes by such taxpayer under section 62(7) of the Internal Revenue Code (Self Employed Retirement Plans) if such taxpayer were a self-employed individual.

G. That the Employee Retirement Income Security Act of 1974 (ERISA) added a new provision to the Internal Revenue Code, IRC §401(j), which for the first time made defined benefit Keogh plans available to self-employed individuals. Of relevance here is the fact that the limitation as to the maximum amount deductible, as established by IRC §404(e),[6] was made inapplicable [by IRC §401(j)(6)] to defined benefit plans. Instead, such limitation was to be determined in accordance with IRC §§401(j), 404(a) and 412, which determination required the use of certain actuarial assumptions. The use of such actuarial assumptions can result in differences in deduction limitations between self-employed persons utilizing defined benefit plans and those utilizing defined contribution plans, since the latter limitation is not based on actuarial assumptions but rather is the specified dollar amount or percentage of earned income.

H. That Tax Law section 612(b)(7) was amended by L. 1981, C. 358, whereby the "add-back" modification for either a defined contribution plan or a defined benefit plan was to be equal to the deduction allowed to the professional service corporation minus the lesser of $7,500.00 (later increased to

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6 Originally this limitation was the lesser of $2,500.00 or 10 percent of the earned income "from the trade or business with respect to which the plan is established"; subsequent amendments raised this limitation to $7,500.00 or 15 percent, and later to $15,000.00 or 15 percent.

$15,000.00; L. 1981, C. 1043) or 15 percent of the earned income from such corporation. Petitioner maintains that such amendment, enacted because the "add-back" modification computations had become "unworkable" in situations involving defined benefit plans (and rectifying such situations by providing an easily ascertainable add-back amount), means that the add-back provision [§612(b)(7)] did not apply in situations involving defined benefit plans prior to the effective date of the amendment.

I. That although prior to the aforementioned 1981 amendment, computation of the section 612(b)(7) add-back amount in a defined benefit plan situation may have been cumbersome (involving two sets of computations: one for the plan and one for each individual thereunder, assuming he were self-employed), it was not incapable of being performed. Petitioner's submission of such computation by his own actuary (see Finding of Fact "17", footnote "4") supports this conclusion. Moreover, while the actuarial computations necessarily involve, as noted, certain assumptions, there is no challenge raised by the Audit Division as to the reasonableness of the assumptions inherent in the computations made by petitioner's actuary. Accordingly, it does not follow that shareholders in professional service corporations in general, or petitioner in particular, were outside of the ambit of section 612(b)(7) by virtue of their being in situations involving a defined benefit plan as opposed to a defined contribution plan, and petitioner's assertions in this regard are rejected.

J. That the petition of Milton Etengoff and Florence Etengoff is hereby denied, and the Notice of Deficiency dated November 30, 1981 is sustained.

DATED: Albany, New York

MAY 23 1985

STATE TAX COMMISSION

PRESIDENT

COMMISSIONER

COMMISSIONER