STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions

of

SION MISRAHI AND
ESTHER MISRAHI-ELTING

for the Redetermination of Deficiencies or for Refunds of New York State and New York City Personal Income Tax under Article 22 of the Tax Law and the New York City Administrative Code for the Years 2014 and 2015.

DETERMINATION
DTA NOS. 828818
AND 828822

Petitioners, Sion Misrahi and Esther Misrahi-Elting, filed petitions for the redetermination of deficiencies or for refunds of New York State personal income tax under article 22 of the Tax Law and the New York City Administrative Code for the years 2014 and 2015.

A consolidated hearing was held in New York, New York, on February 18 and 19, 2020, with all briefs to be submitted by September 17, 2020, which date began the six-month period for issuance of this determination. Petitioners appeared by Gabor & Marotta, LLC (Richard M. Gabor, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Stephanie M. Lane, Esq., of counsel). After reviewing the entire record in this matter, Nicholas A. Behuniak, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether petitioners properly classified funds received from Sushell Corporation in tax year 2014 and 2015 as "loans to shareholders" rather than cash distributions.

II. Whether the Division of Taxation properly imposed penalties upon petitioners pursuant to Tax Law § 685 (p) for the substantial understatement of liabilities.

FINDINGS OF FACT

1. Sushell Corporation (Sushell) is a New York domestic corporation that elected to be treated and taxed as a federal and New York State S corporation. Sushell files its federal and New York State tax returns on the accrual basis. Sushell owns a building located in Manhattan, New York. The building is Sushell's primary asset. The building houses 16 residential apartments and one commercial store front.

2. Petitioners, Sion Misrahi and Esther Misrahi-Elting, own 75% and 25% of Sushell respectively. Sion Misrahi and Esther Misrahi-Elting are brother and sister.

3. In April 2017, the Division of Taxation (Division) contacted Sushell to conduct a field audit of Sushell and its two shareholders, petitioners, for tax years 2014 and 2015. The Division's audit included a review of the increase in the reported "loans to shareholders," petitioners' basis in Sushell, and petitioner Sion Misrahi's tax exempt interest and New York itemized deductions. The Division's auditor also requested documentation to support the increases in both the "mortgages, notes, bonds payable in 1 year or more" and the "loans to shareholders" balances on Sushell's records.

4. During the years at issue, Sion Misrahi was a New York State and New York City resident filing New York State resident income tax returns (form IT-201).

5. During the periods at issue, Esther Misrahi-Elting was a New York State nonresident and filed New York State nonresident, part-year resident income tax returns (form IT-203).

6. Sion Misrahi is a real estate investor, real estate broker and property manager who has been in the real estate business for approximately 46 years.

7. On audit, petitioners supplied business records of Sushell including balance sheets, profit and loss statements, statements of cash flows and certain general ledgers.

8. As part of the audit, the Division requested that petitioners provide information regarding their individual basis in Sushell. Petitioners did not provide information in this regard.

9. During the audit, petitioners supplied the Division with certain documentation relating to a refinancing mortgage arrangement between Sushell and People's United Bank to support the increase in the 2015 balance of "mortgages, notes, bonds payable in 1 year or more" in Sushell's books and records.

10. On May 29, 2015, Sushell obtained a commitment letter from People's United Bank approving a loan application for $5,700,000.00 to refinance and increase an existing mortgage on Sushell's building. The May 29, 2015 commitment letter provided, in part, that: the loan would be secured by a first priority mortgage lien on Sushell's property located on Orchard Street in New York City; in the event a certain restaurant was not in full occupancy on the ground floor and not opened for business by October 1, 2015, Sion Misrahi would become personally liable for 10% of the principal balance of the loan; interest would accrue at 3% per annum; the loan would be due and payable in full after sixty months from the closing date of the loan; monthly payments on the loan would be made each month after the loan closed based upon a 30-year repayment schedule; and Sushell would be charged a $3,090.00 appraisal fee. The May 29, 2015 commitment letter also provided that the lender would accept an assignment of the existing note and mortgage for the property in question. An attachment to the May 29, 2015 commitment letter required that the mortgaged property must be covered by an insurance policy of not less than $5,700,000.00.

11. The May 29, 2015 commitment letter provided that to effectuate the loan certain documentation would need to be executed by the parties including: a loan and security agreement; a note; a mortgage; an assignment of leases and rents security agreement; and a

consolidation and modification agreement. The hearing record does not appear to contain any of the aforementioned agreements.

12. The refinancing loan agreements between Sushell and People's United Bank were executed on June 18, 2015.

13. Sushell had refinanced the mortgage on its property approximately four times in the past.

14. At the hearing, Sion Misrahi testified that in 2015, Esther Misrahi-Elting needed money to buy a partner out of another business arrangement she was involved in. He testified that the main point of the refinancing of the Sushell mortgage was so that funds could be acquired to loan to Esther Misrahi-Elting. All the funds acquired from the refinance of the mortgage were distributed to the shareholders, 75% to Sion Misrahi and 25% to Esther Misrahi-Elting. Sion Misrahi testified that he did not need the money from the loan, and he put his portion of the distribution in the bank. Petitioners testified that there was no written loan agreement for the Sushell loans to them because the transaction was between relatives and the company was wholly owned by them together. Esther Misrahi-Elting indicated to Sion Misrahi that she could not pay interest during the term of her loans so petitioners decided interest would be paid later.

15. During the audit, petitioners supplied the Division with two single page documents both titled "Shareholder Loan Agreements." One shareholder loan agreement was between Sushell and Sion Misrahi and is dated as effective June 22, 2015. It does not provide any principal dollar amount for the debt and indicates that it is for a term of five years but is expected to be repaid before the balloon payment for the mortgage loan to Sushell is due. The loan document indicates that there are no interest payments due during the life of the loan, but the repayment amount will include all interest that accrues. The interest rate on the loan is 3%, and the interest was to accrue annually. The loan agreement was executed on January 4, 2017 by Sion Misrahi as both

the borrower and as the president of Sushell. The other shareholder loan agreement appears to have the same terms as the first loan agreement but is between Sushell and Esther Misrahi-Elting. The second loan agreement was executed on December 29, 2017 by Esther Misrahi-Elting as both the borrower and as the vice president of Sushell.

16. During the time the 2014 and 2015 loans to petitioners were originally funded, there was only an oral agreement between petitioners and Sushell.

17. Petitioners testified that the original loan agreements between Sushell and petitioners were verbal because it was a closely held company and petitioners are relatives. Sion Misrahi testified that the written loan agreements evidencing the 2014 and 2015 shareholder loans were prepared strictly for the Division's audit.

18. Petitioners testified that when they took the loans from Sushell, they believed they would have to repay the money to Sushell.

19. According to Sushell's December 31, 2014 and 2015 balance sheets provided during the audit, Sushell's long term liabilities balance increased by $1,797,378.03 while at the same time its "[d]rawings" account, listed under shareholder equity, increased from $1,523,076.55 in 2014 to $3,306,745.58 in 2015 for a $1,783,669.03 increase. Sushell's 2014 and 2015 balance sheets provided during the audit fail to show any loans to shareholders in the asset portion of the balance sheet. However, Sushell's 2014 and 2015 statement of cash flows show a cash flow for "drawings" in the equity section of the statements. For 2014, the "drawings" amount on the statement of cash flows was $241,100.00, and for 2015, the "drawings" amount was $1,783,699.03.

20. Sushell's 2014 and 2015 profit and loss statement as supplied to the Division on audit reflected the following on an "accrual basis":

Year	Mortgage Interest Expense	Interest Income
2014	$175,286.74	$18.67
2015	$211,625.39	$870.19

21. Sushell's U.S. Income Tax Returns for an S corporation, federal form 1120-S, reported:

Year	Sushell Income or (Loss)	Loans to Shareholders Beginning Balance	Loans to Shareholders Ending Balance	Increase or (Decrease) In Shareholder Loan Balance
2007	($184,140.00)	$1,100,000.00	$1,100,000.00	0
2008	$10,534.00	$1,100,000.00	$1,091,999.00	($8,001.00)
2009	($153,348.00)	$1,091,999.00	$1,069,822.00	($22,177.00)
2010	($32,177.00)	$1,069,822.00	$1,043,800.00	($26,022.00)
2011	$53,502.00	$1,043,800.00	$1,195,500.00	$151,700.00
2012	$124,119.00	$1,195,500.00	$1,267,500.00	$72,000.00
2013	($6,388.00)	$1,267,500.00	$1,267,500.00	0
2014	$241,591.00	$1,267,500.00	$1,508,600.00	$241,100.00
2015	$16,408.00	$1,508,600.00	$3,292,269.00	$1,783,699.00
2016	$148,928.00	$3,292,269.00	$3,404,269.00	$112,000.00

22. Sushell's U.S. Income Tax Returns for an S corporation, federal form 1120-S, reported:

Year	Building and other Depreciable Assets (Net of Depreciation)	Loans to Shareholders End of Year Balance	Total Assets Per 1120-S	End of year Balance of Mortgages, Notes, Bonds Payable in One Year or More
2007	$1,928,380.00	$1,100,000.00	$3,690,416.00	$4,124,282.00
2008	$1,861,161.00	$1,091,999.00	$3,625,763.00	$4,066,921.00
2009	$1,789,852.00	$1,069,822.00	$3,319,912.00	$4,006,097.00
2010	$1,718,364.00	$1,043,800.00	$3,253,288.00	$3,941,601.00
2011	$1,646,874.00	$1,195,500.00	$3,383,310.00	$4,067,300.00
2012	$1,575,386.00	$1,267,500.00	$3,437,204.00	$3,999,656.00
2013	$1,640,924.00	$1,267,500.00	$3,316,863.00	$3,928,904.00
2014	$1,562,808.00	$1,508,600.00	$3,459,817.00	$3,777,754.00
2015	$1,484,690.00	$3,292,269.00	$5,294,669.00	$5,533,767.00
2016	$1,406,573.00	$3,404,269.00	$5,313,276.00	$5,417,047.00

23. On Sushell's 1120-S tax returns from 2007 through 2016, the asset account "Land (net of any amortization)" remained a constant value of $86,000.00.

24. At the time of the hearing on this matter, February 2020, the mortgage loan was coming due in approximately six months, and Sion Misrahi indicated that Sushell planned to repay all or part of the mortgage. Sion Misrahi testified that Sushell did not have the funds to repay all or part of the mortgage when it matured. However, Sion Misrahi testified that he did have the funds in order for Sushell to repay what was necessary on the mortgage, and therefore the shareholders' loans would have to be repaid back to Sushell or face the lender foreclosing on the property.

25. Sion Misrahi testified that at the time of the hearing, the outstanding principle balance on the mortgage loan was approximately $5,700,000.00. He testified that in his opinion, banks typically will only lend 70% of the value of a property they are mortgaging against. Sion Misrahi testified that as of the date of the hearing, the mortgaged property's market value was "way under" $5,000,000.00.

26. According to petitioners, without repayment of the shareholder loans, petitioners would be insolvent and could not pay back the mortgage. Sion Misrahi paid off both the 2014 and 2015 shareholder loan balances for himself and Esther Misrahi-Elting on February 14, 2020. Sion Misrahi testified that he paid back the shareholder loans early in order to buttress his case before the Division of Tax Appeals.

27. Petitioners submitted a worksheet into evidence reflecting that the 2014 and 2015 shareholder loans in question were paid as follows:

Year	Cash Disbursements from Sushell	Amount Disbursed to Sion Misrahi (75%)	Amount Disbursed to Esther Misrahi-Elting (25%)
2014	$241,100.00	$180,825.00	$60,275.00
2015	$1,783,669.00	$1,337,752.00	$445,917.00

28. At the hearing, petitioners entered into evidence financial records, dated February 4, 2020, representing Sushell's operations for 2014 and 2015. Such statements changed the 2014 and 2015 disbursement amounts that were originally listed as "drawing" on Sushell's books and records provided to the Division during the audit and were changed to show those same amounts were now reflected as "shareholder loans." Sushell's accountant testified that he reclassified the distributions from a drawing account to the loan account on the financial statements because he had told petitioners when the disbursements were originally made that they had to be accounted for as loans because petitioners did not have sufficient basis in the company to otherwise withdraw the money. Sushell's accountant testified that the financial statements originally provided to the auditors were still subject to closing adjustments when they had been provided to the Division's auditors.

29. Sushell's accountant testified that if he used the fair market values as determined by New York City for the mortgaged property for 2014 and 2015 and accounted for the loans as cash distributions, the result would be that Sushell would be insolvent.

30. At the hearing, petitioners submitted into the record Sushell's pro-forma balance sheets for 2014 and 2015. Petitioners represented that the pro-forma balance sheets would reflect what the impact would be if the Sushell payments were accounted for as deemed cash distributions as opposed to loans:

Account	2014	2015
Current Assets/Cash	$60,581.00	$91,487.00
Other Current Assets	$96,483.00	$21,300.00
Other Assets	$58,375.00	$106,406.00
Loans to Shareholders – Reclassified as Dividends	0.00	0.00
Building at Fair Market Value	$2,335,000.00	$2,420,000.00
Total Intangible Assets	$86,970.00	$212,517.00
Total Assets	$2,637,409.00	$2,851,710.00
Current Mortgages, Notes and Bonds	$77,147.00	$118,512.00
Other Current Liabilities	$44,916.00	$18,122.00
Long-term Mortgages, Notes and Bonds	$3,777,754.00	$5,533,767.00
Other Liabilities	$57,225.00	$105,085.00
Total Liabilities	$3,957,042.00	$5,775,486.00
Shareholder's Equity		
Capital Stock	$20,343.00	$20,343.00
Retained Earnings	($517,568.00)	($1,323,568.00)
Balancing Entry FMV Less Book Value	$686,192.00	$163,118.00
Dividend Distribution	($1,508,600.00)	($1,783,669.00)
Insolvency Amount	($1,319,633.00)	($2,923,776.00)
Liabilities and Equity	$2,637,409.00	$2,851,710.00

31. On the pro-forma balance sheets, the fair market value of the mortgaged property was determined by reference to relevant New York City Department of Finance notices of property valuations for 2014 and 2015 for the mortgaged property.

32. In 2019, the New York City Department of Finance conducted a desk audit of Sushell for the tax year 2016. The result of the audit was that the New York City Department of Finance allowed Sushell to treat the subject 2014 and 2015 shareholder disbursements as loans. During its desk audit, the New York City Department of Finance did not request any documents from Sushell.

33. Petitioners submitted into the hearing record Sushell's balance sheet for December 31, 2019, which reflected shareholder loans as an asset with a value of $3,585,745.58, a building with a value of $2,139,894.53, less improvements of $889,504.60, plus land with a value of $86,000.00. The December 31, 2019 balance sheet also reflected the liability of a mortgage payable of $5,158,112.04.

34. On April 23, 2018, the Division issued a notice of deficiency to petitioner Sion Misrahi, notice no. L-047953804, assessing tax, penalty pursuant to Tax Law § 685 (p), and interest.

35. On April 23, 2018, the Division issued a notice of deficiency to petitioner Esther Misrahi-Elting, notice no. L-047953775, assessing tax, penalty pursuant to Tax Law § 685 (p), and interest.

SUMMARY OF THE PARTIES' POSITIONS

36. The Division asserts the notices were issued to petitioners because there were no bona fide debts between Sushell and petitioners; instead the subject transactions should be deemed cash distributions from Sushell constituting distributions in excess of petitioners' stock basis in

Sushell.[1] The Division also asserts petitioners should be liable for penalties pursuant to Tax Law § 685 (p) for the substantial understatement of their New York tax liabilities.

37. Petitioners assert that the 2014 and 2015 distributions from Sushell were bona fide loans. Petitioners claim that if the loans were deemed cash distributions, Sushell would be insolvent and thus such distributions would be illegal and not possible.

CONCLUSIONS OF LAW

A. When the Division issues a notice of deficiency to a taxpayer, a presumption of correctness attaches to the notice, and the burden of proof is on the taxpayer to demonstrate, by clear and convincing evidence, that the asserted deficiency is erroneous (***see Matter of O'Reilly***, Tax Appeals Tribunal, May 17, 2014; ***see also Matter of Leogrande v Tax Appeals Trib.***, 187 AD2d 768 [3d Dept 1992], ***lv denied*** 81 NY2d 704 [1993]; ***Matter of Tavolacci v State Tax Commn.***, 77 AD2d 759 [3d Dept 1980]; Tax Law § 689 [e]).

B. The issue of whether amounts paid to shareholders are dividends or loans is a factual issue and depends upon the intent of the shareholders to repay the amounts received and the intent of the corporation to require repayment (***see Williams v Commissioner***, 627 F.2d 1032 [10th Cir 1980]); ***Miele v Commr. of Internal Revenue***, 56 T.C. 556 [1971], ***affd sub nom. Miele v Commissioner***, 474 F2d 1338 [3d Cir 1973])

C. The U.S. Tax Court has noted:

> "Because a genuine loan is accompanied by an obligation to repay, loan proceeds do not constitute income to the taxpayer. ***Commissioner v. Tufts***, 461 U.S. 300, 307, 103 S.Ct. 1826, 75 L.Ed.2d 863 (1983). For this rule to apply, however, the obligation to repay 'must be unconditional and not contingent upon some future event.' ***Frierdich v. Commissioner***, 925 F.2d 180, 185 (7th Cir. 1991) (citing ***United States v. Henderson***, 375 F.2d 36, 39 (5th Cir. 1967)), aff'g T.C. Memo.

[1] The Division's assessments included two additional ancillary issues; however, petitioners do not challenge such issues in their petitions, nor are they addressed in any manner by petitioners elsewhere in these proceedings. Petitioners' brief states that the only issue is the classification of the subject withdrawals as loans or dividends. The additional ancillary issues asserted by the Division are deemed conceded by petitioners.

> 1989-393. As the Fifth Circuit stated in ***Henderson***, 375 F.2d at 39: 'Perhaps the most important underlying principle is that no valid debt exists unless there is an unconditional obligation of another to pay * * * a definite sum of money.'
>
> Where an obligation to pay arises only upon the occurrence of a future event, we have consistently held that a valid debt does not exist for Federal tax purposes" (***Novoselsky v Commissioner***, T.C. Memo 2020-68 [2020]).

D. In making the determination of whether amounts paid to shareholders constitute dividends, or loans to shareholders, multiple factors may be considered; however, there does not appear to be one master list of all the factors to consider (***see Illinois Tool Works Inc. v Commissioner***, T.C. Memo 2018-121 [2018] [providing a list of fourteen items to consider based upon eight factors considered in ***Busch v Commissioner***, 728 F.2d 945 (7th Cir. 1984) and supplementing such with six additional factors considered in ***Dixie Dairies Corp. v Commissioner***, 74 T.C. 476 (1980)]; ***see also Novoselsky v Commissioner*** [noting that fourteen factors were utilized by the court in ***Illinois Tool Works Inc. v Commissioner***, but that other courts have "applied somewhat different multi-factor tests to determine whether an advance should be treated as a loan as opposed to a dividend or a capital contribution"]). Ultimately it is an analysis that depends upon the facts of each case.

E. The Internal Revenue Service (IRS) Market Segment Specialization Program Guideline for Shareholder Loans provides a list of twelve factors to consider when attempting to determine whether a disbursement is a loan or a dividend including the following: (1) the extent to which the shareholder controls the corporation; (2) whether security was given; (3) was the shareholder in a position to repay the loan; (4) were there adequate earnings and profits; (5) was there a certificate of indebtedness given to the corporation; (6) was there a repayment schedule or attempt to repay; (7) was there a set maturity date; (8) did the corporation charge interest; (9) whether the corporation made systematic efforts to obtain repayment; (10) the magnitude of

advances; (11) whether a ceiling exists to limit the amount the corporation can advance; and (12) the dividend history of the corporation (***see IRS Market Segment Specialization Program Guideline for Shareholder Loans*** [June 2001], 2001 WL 1763433). In addition to the factors noted in the IRS Market Segment Specialization Program Guideline for Shareholder Loans, courts have considered other factors including: the taxpayer's statement of intent to repay; the treatment of advances in the corporate records; the taxpayer's use of funds; the borrower's participation in management as a result of advancing funds; the status of advances relative to other debt; the risk involved in making the advances; and the ability of the borrower to obtain loans from outside sources (***see Illinois Tool Works Inc. v Commissioner***). Many of the factors considered by the IRS and the courts may not be of great utility in the case at hand because the record here is not as extensive as the record in some of the federal cases or the factors simply do not provide any help in the analysis of this case because of the particular circumstances.

F. The U.S. Tax Court has recognized:

> "'[N]o single factor is controlling' when employing these tests. ***Busch***, 728 F.2d at 948. Indeed, '[m]ulti-factor tests are not "talismans of magical power, and the most that can be said is that they prove a source of helpful guidance."' ***MoneyGram Int'l, Inc. & Subs. v. Commissioner***, 153 T.C. ——, —— (slip op. at 51) (Dec. 3, 2019) (quoting ***Dillin v. United States***, 433 F.2d 1097, 1100 (5th Cir. 1970)). At bottom we must decide whether 'there [was] a genuine intention to create a debt, with a reasonable expectation of repayment.' ***Litton Bus. Sys., Inc. v. Commissioner***, 61 T.C. 367, 377 (1973). This determination is 'purely a question of fact.' ***Busch***, 728 F.2d at 949" (***Novoselsky v Commissioner***; ***see also Illinois Tool Works Inc. v Commissioner*** [noting that no single factor is dispositive of the determination that a transaction is a loan or a dividend]).

G. The starting point of the analysis for this case is the recognition that there can be "especially strong support" for finding corporate advances to be dividends when the purported borrower is the sole shareholder of the purported lender (***see Illinois Tool Works Inc. v Commissioner***, citing ***Busch v Commissioner***). The fact that the recipients of the disbursements,

Sion Misrahi and Esther Misrahi-Elting, together own 100% of the stock of Sushell triggers this concern. This 100% ownership scenario creates "obvious difficulties to thinking of the shareholder and corporation as debtor and creditor" (***Illinois Tool Works v Commissioner***, quoting ***Alterman Foods, Inc. v United States***, 611 F.2d 866 [Ct. Cl. 1979]).

H. When analyzing the intent of the parties, courts consider the parties' actual intent at the time the advances were made (***see Illinois Tool Works Inc. v Commissioner***, citing ***Busch v Commissioner***). As noted above, the aim is to determine whether the parties intended to create a "definite obligation, repayable in any event" (***Illinois Tool Works Inc. v Commissioner***, citing ***Hewlett-Pakard v Commissioner***, T.C. Memo 2012-135 [2014], ***affd sub nom. Hewlett-Packard Co. v Commissioner***, 875 F3d 494 [9th Cir 2017]

I. Petitioners' actions in this case suggest that they did not intend to create the kind of definite obligation that was repayable in any event that is necessary to find the disbursements were loans. This conclusion is based upon several facts. The funds for the 2014 disbursements were derived from the earnings and profits of Sushell for that year. Sushell's 2014 income was $241,591.00, and the related disbursements to petitioners were $241,100.00. The disbursements were allocated in direct proportion to each shareholder's stock ownership interest, 75% to Sion Misrahi and 25% to Esther Misrahi-Elting. "The statutory concept of dividend is a distribution out of earnings and profits, and normally it is proportionate to shares" (***see Casner v Commissioner***, 450 F2d 379, 387 [5th Cir 1971], quoting ***Zenz v Quinlivan***, 213 F.2d 914, 917 [6th Cir 1954]).

J. The funds for the 2015 disbursements were derived from the refinancing and increase in the outstanding mortgage debt associated with the key asset of the corporation. This debt had been refinanced approximately four other times in the past. An examination of the balance

sheets reflected on Sushell's 1120-S tax returns from 2007 through 2015 indicates that Sushell appears to have been using mortgage debt to finance disbursements to petitioners for several years. The financials show that Sushell's primary assets were the "loans to shareholders" and the book value of the mortgaged property; in contrast, Sushell's primary liability during this period was the mortgage that was being refinanced repeatedly. From 2007 through 2015, the shareholders (petitioners) had not made substantial payments to reduce the balance of the shareholder loans on Sushell's books. Sion Misrahi testified that because the value of the mortgaged property had dropped by the due date of the mortgage loan, 2020, Sushell could not refinance the mortgage for the amount it had been refinanced in 2015, $5,700,000.00, so he would have to make up the difference between what could be refinanced and the total due in 2020. Sion Misrahi indicated that otherwise Sushell would "lose the building." This arrangement appears to be more akin to shareholder draws and additional contributions of capital than formal loan arrangements. It appears that repayments of the 2014 and 2015 disbursements are contingent on whether the mortgaged property will hold, or appreciate, in value by the due date of the mortgage. If the mortgaged property value does hold or appreciate in value, it appears Sushell will refinance the mortgage when due; in that case, the shareholders will not have to repay the 2014 and 2015 disbursements when the mortgage is refinanced. The notes executed by petitioners support this conclusion. Although legally it may not be necessary to have formal notes with a closely held business (***see Busch v Commissioner*** [acknowledging that debtor/creditor relationships may exist even where there are no notes, no repayment and no collateral]), when petitioners did formally execute notes, the notes did not list any amount of principle as debt on the notes. It appears petitioners intentionally left their options completely open. If they don't want to repay the disbursements (if say the mortgaged property appreciated

in value), then they didn't have to; however, if Sushell actually needed funds to cover the maturing mortgage, then the shareholders would pay back to Sushell what was needed. In this case, the amounts of the 2014 and 2015 disbursements were paid back in full, in advance of the due date, to apparently show the Division that petitioners would repay the debts. However, that fact does not establish that there were true unconditionally repayable debts at the time the disbursements were initially made. It appears subsequent circumstances including the decrease in the mortgaged property's value and the ongoing scrutiny of the arrangement by the State made the payments prudent and necessary (***see Miele v Commissioner*** [repayment of loans before a tax audit has begun is more persuasive evidence of a loan than repayment made after the tax audit has begun]).

K. The proportion of the disbursements and the rationale for the disbursements also point to the conclusion that they were more akin to draws than loans. The original need for the 2015 withdraws was that Esther Misrahi-Elting needed funds to address a separate business venture she was involved in. Thus, according to petitioners, it was agreed that when Sushell completed its refinancing of the mortgage, funds could be lent to Esther Misrahi-Elting for her other business needs. Sion Misrahi testified he did not need the share of the disbursement he received (***see Illinois Tool Works Inc. v Commissioner*** [shareholder using funds for "purely personal purposes" supports finding that withdrawals were distributions]). Nevertheless, when the mortgage refinancing went through in 2015, the additional money received from the refinancing was distributed to petitioners in direct proportion to their ownership interest in Sushell, whether petitioners needed funds or not.

L. There did not appear to be any business need for Sion Misrahi to borrow money from Sushell. Apparently, it was convenient to take his share of the profits from 2014 and his share of

the additional mortgage borrowings from 2015. When circumstances were such that it was either necessary or prudent to repay the 2014 and 2015 distributions, Sion Misrahi paid back the total amounts due for both himself and Esther Misrahi-Elting. The fact that Sion Misrahi repaid Esther Misrahi-Elting's loans supports the conclusion that she may not have been in a position to repay the disbursements herself (***see Illinois Tool Works Inc. v Commissioner*** [examining borrowers' "adequacy of capitalization" to determine if borrowers could actually repay debts when first loaned]). It also is noted that the 2014 withdrawals had nothing to do with the 2015 refinancing, but rather they were funded directly by the 2014 profits of Sushell. As noted, the 2014 disbursements were also in exact proportion to petitioners' ownership percentages.

M. The terms of the loans also are reason for pause (***see Illinois Tool Works Inc. v Commissioner*** [reviewing debtor's ability to obtain the same debt from an independent party]). The secured mortgage loan charged 3% interest, and the unsecured shareholder disbursements charged the exact same interest rate. Unsecured debt is a higher risk endeavor for the lender as compared to secured debt. Typically, one would expect a higher interest rate charged on unsecured debt to reflect the increased risk the lender is assuming. Conversely, it also seems unlikely that a business entity would incur debt at a set interest rate and then immediately loan out that money at the exact same interest rate. There is no profit to be made in such a transaction. The majority shareholder of Sushell, Sion Misrahi, testified that the major point of the refinancing of the Sushell mortgage was to acquire funds that could be loaned to Esther Misrahi-Elting. This transaction may be understandable from a closely-held, brother and sister shareholder perspective, but from an objective business perspective, the arrangement lacks a credible business purpose.

N. The treatment of advances in the corporate records is also a factor for consideration. In this case, the Sushell financial statements provided during the audit treated the subject disbursements as "drawings" in the equity section of Sushell's balance sheet, not as shareholder loans. This classification was changed on the balance sheet submitted into the record at the hearing where the disbursements were then classified as loans to shareholders. The fact that they were originally classified as equity drawings is indicative of the original intent of the parties. It is noted that petitioners' and Sushell's accountant testified that the disbursements were meant to be loans, and the reclassification of such on the corporate balance sheet submitted at the hearing was the accountant's later refinement of Sushell's books and records which were subject to the accountant's closing adjustments. But this point, along with the fact that the disbursements were always classified as shareholder loans on Sushell's federal income tax returns, does not completely negate the disclosures made in the original financial statements and other elements of this case.

O. Finally, Sushell's profit and loss statement covering 2014 and 2015 indicate substantial mortgage interest expenses accrued for those two years (***see*** finding of fact 20); however, interest income, which presumably would have included the interest associated with shareholder loans, accrued for those two years, $18.67 and $870.19 respectively, is minimal at best. A loan payoff schedule submitted into evidence by petitioners at the hearing calculated the respective annual interest on the shareholder loans to be $7,233.00 ($5,424.75 + $1,808.25) for 2014 and $53,509.51 ($40,132.56 + $13,377.51) for 2015. These material discrepancies do not support the accounting of an actual debt.

Petitioners failed to meet their burden of proof that the disbursements at issue were actual loans with required timely repayments regardless of future events.

New York City Audit

P. As proof that the distributions were shareholder loans, petitioners point to an audit performed by New York City regarding Sushell's 2016 tax year, wherein the City did not challenge Sushell's classification of the subject distributions as shareholder loans. It is noted that the City audit was a "desk audit," and the City did not request any relevant records of the transactions at issue in this case. The record is silent as to why the City made the determination it did, and as a result, it is impossible to consider the reasoning that may have been employed. Moreover, it is clear that the Division of Tax Appeals is not required to defer to the judgments of other jurisdictions such as New York City (***see e.g. Matter of Dutton and Conlon***, Tax Appeals Tribunal, April 6, 1995; ***Matter of DeGroat***, Tax Appeals Tribunal, October 23, 2008). The results of the New York City audit are of utility in the analysis of this case; however, based upon an independent review of the transactions at issue, a conclusion differing from that found by the City has been reached.

Business Corporation Law § 510

Q. Petitioners argue that Business Corporation Law (BCL) § 510 prevents the subject disbursements from being classified as anything other than a loan.

Specifically, BCL § 510 provides in relevant part:

> "(a) A corporation may declare and pay dividends or make other distributions in cash or its bonds or its property, including the shares or bonds of other corporations, on its outstanding shares, except when currently the corporation is insolvent or would thereby be made insolvent, or when the declaration, payment or distribution would be contrary to any restrictions contained in the certificate of incorporation.
>
> (b) Dividends may be declared or paid and other distributions may be made either (1) out of surplus, so that the net assets of the corporation remaining after such declaration, payment or distribution shall at least equal the amount of its stated capital, or (2) in case there shall be no such surplus, out of its net profits for the

fiscal year in which the dividend is declared and/or the preceding fiscal year" (BCL § 510).

For proof of this point, petitioners submitted pro-forma Sushell balance sheets as though the subject distributions had been accounted for as cash distributions (***see*** finding of fact 30). These balance sheets reflected the fair market value of the mortgaged property based upon New York City tax billing property valuation assessments for those years. As a starting point in reviewing petitioners' analysis, the pro-forma Sushell balance sheets treat the entire balance of the shareholders' loans, including those made before 2014, as dividends. This adjustment does not comport with the record in which the Division only adjusted the disbursements for 2014 and 2015 as dividends. Furthermore, there are balances such as the "balancing entry FMV less book value" which petitioners do not adequately explain and are thus problematic in determining the accuracy of the conclusions which may be drawn from the statements. Most importantly though is that the fair market value that the pro-forma statements utilize for the mortgaged property is a market value as determined by the New York City Department of Finance.

As noted above, BCL § 510 (b) permits dividends to be paid from either surplus or current year and prior year net profits. The calculation of a corporation's surplus available to pay dividends is based upon the actual value, not the book value, of the distributing corporation's assets (***see McKinney's Consolidated Laws of NY***, Business Corporation Law § 510, Notes of Decisions, ¶ 4 Determination of Surplus; citing ***Vowteras v Argo Compressor Serv. Corp.***, 83 AD2d 834 [2d Dept 1981]). It is noted that "[t]he fact that the corporation has not the ready funds sufficient to pay the dividend, and therefore borrows money with which to pay the dividend, does not render the declaration and payment illegal" (***Cox v Leahy***, 209 App Div 313, 315 [3d Dept 1924], citing ***Gilbert Paper Co. v Prankard***, 204 App Div 83 [1923]).

Notably, the New York City Department of Finance determined the market values of the mortgaged property was $2,335,000.00 and $2,420,000.00 for 2014 and 2015 respectively. These valuations appear suspect given that in 2015 Sushell obtained a mortgage loan for $5,700,000.00 that was secured by the value of the property. The undersigned recognizes that mortgage loan amounts by themselves may not be the most accurate method to determine the value of a property; however, in this case the commitment letter provided that Sushell was to pay for an appraisal associated with the 2015 mortgage refinancing. No appraisal was offered for proof of the accurate market valuation of the property at the time of the refinancing. Moreover, the terms of the commitment letter required that Sushell obtain insurance for the mortgaged property in an amount of at least $5,700,000.00. It is highly unlikely that the bank would require, and Sushell would be able to obtain, property insurance on the subject property that was significantly greater than the value of the underlying property itself. Sion Misrahi himself, a person with many years of valuable experience in the real estate industry, testified that typically a financial institution will only loan up to 70% of a property's market value. In this case, the financial institution loaned $5,700,000.00 against the value of the mortgaged property. Nothing was presented into the record that supports that somehow the 2015 financing arrangement was tainted and should not be given appropriate weight. The evidence supports the conclusion that the mortgaged property's fair market value in 2015, the time of the refinancing and 2015 distributions, was much more likely to be closer to the amount of the mortgage financing of $5,700,000.00, than the significantly lower value New York City attributed to the property for property tax purposes. The use of the more likely and accurate market valuation of the mortgaged property in the pro-forma balance sheets would appear to cure petitioners' claim that classification of the subject disbursements as dividends would violate BCL § 510.

Accounting for the Disbursements

R. Petitioners vigorously challenge whether the distributions at issue should be classified as loans to shareholders or dividend distributions to shareholders. However, petitioners do not challenge the Division's computations of the tax deficiencies themselves if the determination is made that the distributions were deemed cash distributions.

Typically, the starting point when analyzing a constructive dividend of an S corporation is to determine if any of the payment should be construed as compensation.

> "If the entity making the advances is an S corporation, before determining whether the debt is bona fide, it must be determined: Did the S corporation reasonably compensate the shareholder who received the advances? If not, the examining agent must evaluate whether all or part of the advances should be reclassified as compensation, subject to employment taxes" (***see IRS Market Segment Specialization Program Guideline for Shareholder Loans*** [June 2001], 2001 WL 1763433).

In the case at hand, neither party has asserted that the constructive dividend should be classified in whole or part as compensation.

S. The tax treatment of constructive dividends depends upon a corporation's ability to pay those amounts. As the Tax Appeals Tribunal noted:

> " 'Because dividends can only be distributed to the extent of a corporation's earnings and profits under IRC § 316, a court can only find a constructive dividend to be taxable as ordinary income to the extent of the corporation's earnings and profits. "Otherwise, a distribution to a stockholder is merely a recovery from his basis in his shares to the extent that he has such a basis; to the extent that the payments exceed the basis, the payments amount to a gain." See [Estate of DeNiro v. Commissioner, 746 F2d 327, 331 (1984)]. § § 316(a), 301 (c)' (***Hagaman v Commissioner***, 958 F2d 684, 694 [1992])" (***Matter of Babel***, Tax Appeals Tribunal, March 18, 2014).

Since petitioners did not provide any information regarding their respective basis in Sushell, the Division utilized a basis of zero for both petitioners. Treating the loans as cash distributions, the Division first accounted for Sushell's reported income in 2014 and 2015 as increases to each shareholders' basis in the company. The Division then utilized the amount of

the deemed cash distributions to reduce the ordinary business losses taken by each petitioner in each respective year. The Division then reduced prior years' ordinary business losses taken by the shareholders in those years. In 2015, after the adjustments noted, there remained an additional balance of the deemed cash distributions that were then accounted for as capital gains derived from excess shareholder distributions over their stock basis. As noted above, petitioners do not challenge the Division's computations in this regard.

Penalties

T. Penalties were imposed upon petitioners pursuant to Tax Law § 685 (p). Pursuant to Tax Law § 685 (p), a penalty may be imposed for the substantial understatement of liability if the understatement in the taxable year "exceeds the greater of ten percent of the tax required to be shown on the return for the taxable year, or two thousand dollars" (Tax Law § 685 [p]). Penalties imposed under Tax Law § 685 (p) must be waived if petitioners show reasonable cause for the substantial understatement and that they acted in good faith (***see Matter Biggar***, Tax Appeals Tribunal, December 24, 2019). The Tax Appeals Tribunal has held that a careful weighing of facts and circumstances is necessary to determine whether "a taxpayer acted with ordinary business care and prudence in attempting to ascertain his tax liability and that penalties should be abated" (***id.***, citing ***Matter of McGaughey***, Tax Appeals Tribunal, March 19, 1998, ***confirmed*** 268 AD2d 802 [3d Dept 2000]).

The relevant tax returns have always disclosed the subject disbursements as loans. In its audit of Sushell, the New York City Department of Finance permitted the disbursements to be accounted for as loans. The withdrawals were repaid, with interest, when the mortgage debt was coming due and petitioners determined that the property value had decreased, and repayment of the loans was necessary to pay the maturing mortgage debt. Mr. Misrahi testified that the

withdrawals were repaid early in an attempt to appease the State, but it appears Mr. Misrahi planned on repaying Sushell to cover the mortgage coming due on property that had decreased in value. For these reasons it is concluded that petitioners acted in good faith and with reasonable cause in their understatement of taxes. Accordingly, the penalties are cancelled.

U. The petitions are granted to the extent indicated in conclusion of law T but otherwise are denied, the Division is directed to revise the notices of deficiency in accordance with conclusion of law T, and the notices of deficiency, as recalculated, are sustained.

DATED: Albany, New York
March 11, 2021

/s/ Nicholas A. Behuniak
ADMINISTRATIVE LAW JUDGE