

New York Tribunal Says Siblings Received Distributions, Not Loans

Posted on Mar. 4, 2022

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By Andrea Muse

The New York Tax Appeals Tribunal has held that funds shareholders received from an S corporation were cash distributions, and not loans, for state personal income tax purposes.

The New York Tax Appeals Tribunal ruled February 24 in [Matter of Misrahi](#) that the withdrawals did not constitute unconditionally repayable debts when they were initially made, affirming an administrative law judge's [March 2021 determination](#) that the funds received from the corporation [were cash distributions](#).

Timothy Noonan of Hodgson Russ LLP told *Tax Notes* March 3 that the reclassification of loans as taxable dividends is not all that common an issue in New York tax cases, adding that this case is an example of the New York Division of Taxation applying and enforcing federal tax law. "Over the past decade, we have seen tax department auditors raise sophisticated federal tax concepts in their audits, and not limit their review to issues specific to New York tax law or to the specific computation of taxable income under New York's rules," he said.

"Perhaps this is because the federal government has been lax in its enforcement efforts, but whatever the case, since the starting point for New York taxable income in most cases is based on federal taxable income, taxpayers should expect to see tax department auditors continue to raise federal tax issues in their enforcement efforts," Noonan added.

Siblings Sion Misrahi and Esther Misrahi-Elting received cash disbursements from Sushell Corp. totaling roughly \$250,000 in 2014. Misrahi received 75 percent and Misrahi-Elting received 25 percent of the funds, matching their ownership percentages of the corporation.

In 2015 the corporation received a bank loan of \$5.7 million to refinance and increase an existing mortgage on a building, which was required to be paid in full in five years. The funds from the refinance of the mortgage — \$1.8 million — were distributed to the siblings based on their ownership interests in the company. Financial records of the corporation originally listed the disbursements to the siblings as "drawings," but the corporation's accountant testified they were reclassified as "shareholder loans" after he told the siblings that they did not have sufficient basis in the company when the disbursements were originally made to otherwise withdraw the money.

The New York Division of Taxation conducted an audit of the corporation in April 2017 and,

concluding that the disbursements should be deemed cash distributions, issued notices of deficiencies to the siblings in 2018.

New York Division of Tax Appeals ALJ Nicholas A. Behuniak held that the siblings had not shown that the disbursements were loans that required timely repayments, noting that there was no formal arrangement to pay the funds back and that the disbursements were based on the earnings and profits of the corporation and were issued in proportion to each sibling's share in the corporation.

Noting that Misrahi testified that the major reason for the refinance of the corporation's mortgage was to acquire funds that could be loaned to his sister and that there didn't seem to be a business need for Misrahi to receive funds for the corporation, Behuniak concluded that the arrangement lacked a credible business purpose. He also rejected the siblings' argument that the division's classification of the disbursements as cash distributions would make the company insolvent and was therefore illegal under section 510 of New York's Business Corporation Law.

On appeal to the tribunal, the siblings argued that the division reclassified the withdrawals as cash distributions using the economic substance doctrine and, under IRC provisions, the burden of proof shifted to the division to adequately support the reclassification. But the tribunal ruled that New York law places the burden of proof on the petitioner in cases before the Division of Tax Appeals, adding that the siblings had cited no authority for their argument that the IRC burden of proof provisions are applicable in New York tax proceedings.

The tribunal stated that the controlling factor determining if the withdrawals are treated as loans or taxable distributions is whether there was a debtor-creditor relationship between the siblings and the corporation.

"If repayment was intended at the time of the transfers, the amounts are generally loans," the tribunal added. "On the other hand, if no repayment was intended at the time of the transfers, or if repayment was conditional or contingent on some future event, the amounts are generally dividends."

The tribunal stated that it was mindful that this case involves a closely held corporation, which requires special scrutiny given the "unfettered control exercised by a limited number of shareholders," but it noted that the siblings did not establish the purpose for the 2014 purported loans and that the alleged purpose of the 2015 loans was for Misrahi-Elting's personal use in connection with an unrelated business venture.

Misrahi paid off the loans early, and the siblings argued that the early payment was the best evidence that they intended for the withdrawals to be repaid. The tribunal disagreed, noting that Misrahi paid both his and his sister's loans off — supporting a conclusion that she could not afford to repay the advances herself — and that he did so after the division made the determination that the withdrawals were cash distributions.

The taxpayers in *Matter of Misrahi* (DTA Nos. 828818, 828822) were represented by attorneys from Gabor & Marotta LLC.