STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
DUNK & BRIGHT FURNITURE CO., INC.	:	
for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period December 1, 2005 through February 29, 2008.	:	DECISION
	:	DTA NOS. 823026 AND 822710
In the Matter of the Petition	:	
of	:	
JAMES F. BRIGHT	:	
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 2005, 2006 and 2007.	:	
	:	

Petitioners, Dunk & Bright Furniture Co., Inc., and James F. Bright, filed an exception to the determination of the Administrative Law Judge issued on December 30, 2010. Petitioners appeared by Hiscock & Barclay, LLP (David G. Burch, Esq., and Kevin R. McAuliffe, Esq., of counsel). The Division of Taxation appeared by Mark Volk, Esq. (Justine Clarke Caplan, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners filed a reply brief. Oral argument, at petitioners' request, was held on November 30, 2011. The Tax Appeals Tribunal granted leave to file post-oral argument submissions, with all papers due by January 12, 2012. Petitioners and the Division of Taxation

each filed a letter brief.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether the Division of Taxation properly denied petitioners' claim for a refund of the Empire Zone enterprise credit for sales and use taxes and for real property taxes based on its determination that petitioners did not have a valid business purpose for their reorganization and that the reorganization was undertaken solely to gain Empire Zone tax benefits.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. The Administrative Law Judge's finding of fact appear below.

Petitioner Dunk & Bright Furniture Co., Inc. (D & B Furniture) operated a retail home furnishings business established in the late 1920s and located in Syracuse, New York. Petitioner James F. Bright began working for the former D & B Furniture, then owned by his father, in 1990, and thereafter acquired the business assets from his father in 1992. At the time Mr. Bright acquired the business assets, the operations of the company included retail furniture sales (including residential retail furniture sales), carpet sales, interior design services, and shop-at-home services. The company's operations remained largely unchanged from the time of Mr. Bright's acquisition of the company's assets through 1999.

In or about 1999, Mr. Bright began implementing changes in the company's operations. The first change was the August 1999 creation of JFB Warehouse Company (JFB), an entity whose function was to lease warehouse space and sublet that leased space to D & B Furniture, as

well as to approximately 10 additional subtenants. The space leased, and in turn subleased, by JFB was spread throughout a ten-story warehouse building, which had low ceiling heights and pillars within the warehouse space. This hindered the proper storage of furniture. In addition, it was very labor intensive and expensive for D & B Furniture to carry on the furniture storage and delivery operations of its business from a multi-story facility.

The foregoing lease/sublease continued until 2004. During this time period, Mr. Bright actively sought different warehouse space to address the noted unsatisfactory aspects of D & B Furniture's arrangement with JFB and its warehouse facility. He considered several options, including leasing or acquiring existing warehouse space, and constructing and owning new warehouse space. As part of this process, Mr. Bright engaged V.I.P. Structures to provide schematic plans for two different warehouse structures to be built at the South Salina Street property where D & B Furniture's existing showroom was located. One plan involved a 50,000 square-foot stand-alone warehouse building, while the second plan involved a 50,000 square-foot addition to the existing showroom. The ultimate proposal from V.I.P. Structures contemplated a separate 56,000 to 57,000 square-foot warehouse facility to be constructed at a cost of approximately $1.4 million dollars.

In anticipation of constructing the warehouse, Mr. Bright obtained permission to subdivide the existing property into multiple lots and obtained a change in its zoning from residential to business. He also applied for a $300,000.00 grant from New York State to help defray the costs of building the warehouse. Mr. Bright applied for the grant in the name of D & B Furniture or its assigns so that he would have the flexibility to move forward with the warehouse project using an entity separate from, but related to, D & B Furniture. Mr. Bright

ultimately received $150,000.00 in grant money to use toward the purchase of equipment and the expansion of the existing D & B Furniture showroom facility to provide for, among other things, facade renovations, the separate building housing the new commercial furniture showroom and carpet warehouse display, and expanding the existing parking lot.

The subdivision and related zoning changes were undertaken so as to separate the property on which Mr. Bright intended to construct the warehouse from the property on which the furniture business was located, such that in the event the furniture company went out of business, he would still have a separate warehouse building on his own property that would be insulated from the furniture business and could be sold. In addition, this plan afforded Mr. Bright greater flexibility with respect to financing the construction of the warehouse, separated the furniture business from the warehouse business, and provided for him a separate real estate investment.

During this same time period, Mr. Bright also considered purchasing or leasing existing warehouse space and made offers to purchase or to lease on more than one property. He intended that any purchase offer or lease that came to fruition could be assigned to an entity created for the purpose of acquiring and owning or leasing the space.

One of the buildings Mr. Bright considered purchasing for warehouse space was owned by Cooper Industries. This property was available at a very low cost because it had environmental contamination. Mr. Bright was advised by legal counsel that if he purchased this property, it would be important for him to take title to the property via an entity separate from D & B Furniture in order to protect the operating business from the liabilities associated with environmental contamination.

In 2001, in addition to being the sub-landlord to D & B Furniture and the other subtenants, JFB assumed the responsibility for delivering the furniture sold by D & B Furniture. This service had previously been provided by AAK Delivery, an unrelated enterprise. JFB also provided delivery services for a furniture leasing company owned by Mr. Bright's father. Having JFB provide furniture deliveries reduced the costs and increased the efficiency and flexibility of such deliveries, providing Mr. Bright with direct control over the delivery of furniture and over resolution of customer complaints arising from damage to the furniture or to customers' homes during delivery. At the same time, Mr. Bright had concerns about liabilities such as broken down trucks, hiring drivers, damaged furniture, and accidents involving trucks and drivers in connection with JFB's assumption of furniture deliveries for D & B Furniture. In addition to these concerns, the warehouse space JFB subleased to D & B Furniture and the other subtenants was located in an old, multi-story structure, and included elevators of a design that was a potential danger to individuals lacking full knowledge of their proper use and operation. As noted, there were multiple tenants in the building, and as a result there were many individuals, both employees and non-employees of the various tenants, who moved unrestricted throughout the building. The potential liability from these circumstances was of concern to Mr. Bright, including the potential for claims that might impact the assets of D & B Furniture's operations.

Mr. Bright and his financial advisor, James E. Kane, had discussed the foregoing concerns about liability, and Mr. Kane recommended the possibility of separating the operations of JFB into separate entities so as to segregate the liabilities associated with the subleasing of warehouse space and the liabilities associated with the furniture delivery from the furniture business itself. Mr. Bright had considered reorganizing into various entities in connection with

the issue of segregating potential liabilities and with his desire to expand his business.

JFB provided furniture delivery services for D & B Furniture from 2001 through March 2002. At that point, Mr. Bright had a comprehensive understanding of the furniture delivery business, and recognized that he could make greater profit if furniture deliveries were directly handled through D & B Furniture. Mr. Bright worked directly with his insurance advisors to guard against the noted liability concerns he continued to have with respect to the delivery business, and his insurance advisors convinced Mr. Bright that he could substantially mitigate the risk associated with the delivery business more easily if it were part of D & B Furniture. While D & B Furniture thereafter undertook the furniture delivery operations, JFB continued, until 2004, to provide furniture delivery services to the furniture rental company owned by Mr. Bright's father.

Ultimately, in 2004, Mr. Bright located modern, cost-effective warehouse space on Steelway Boulevard South, Liverpool, New York, offering warehouse space on one level and having ceilings of sufficient height to allow for adequate racking to be installed for proper furniture storage. The warehouse owner was willing to lease the space directly to D & B Furniture without need of a personal guarantee from Mr. Bright. In contrast, however, if the tenant was to be an entity other than D & B Furniture, the owner would require Mr. Bright to sign a personal guarantee of the lease. Mr. Bright determined that since, unlike his existing warehouse space, there would be no subtenants under this new lease, he could address his liability concerns via proper insurance coverage and risk-management procedures. Accordingly, he decided that D & B Furniture would lease the property as tenant, thereby eliminating the need for Mr. Bright to personally guarantee the lease.

Throughout the late 1990s and early 2000s, Mr. Bright pursued other business opportunities toward his business expansion goal. He modernized and expanded his existing commercial and retail carpet operation, including the acquisition of a separate software system to serve the carpet operation. He also began a commercial furniture operation for which he purchased a separate software system that allowed the designers on staff to prepare three-dimensional design renderings such as those depicting a collection of workstations. The employees who worked in the carpet operations and the commercial furniture operations were located in a different building from the retail furniture operations, and their compensation was handled independently from that of the retail furniture operation's employees.

Mr. Bright and Mr. Kane also discussed creating separate entities with respect to the carpet operations and the commercial furniture operations, in consideration of the desire to segregate the liabilities of the various operations, as well as to isolate the profits of each of the operations from the others. In this latter regard, the incentives and rewards used to encourage employees to improve their performance could be simplified, in that only those profits attributable to the particular operation in which a given employee worked would be considered for additional incentive or reward remuneration. Further, creating separate entities for the different operations would provide separate businesses that could be acquired by Mr. Bright's children or sold (separately) to third parties. Mr. Bright and Mr. Kane also discussed other advantages of having separate entities, including the ability to mortgage different assets without the necessity of guaranteeing such mortgages with the assets of an operating company, the ability to sell assets independently of each other, and the ability to segregate certain liabilities such as tort and environmental liabilities associated with real property ownership or leasing.

Notwithstanding the foregoing considerations in favor of separating the various business operations into separate entities, it was equally important to Mr. Bright that the operations be structured such that financial statements and tax returns could be filed on a consolidated basis, and all the income from all the entities would be included in one report, so that lenders would be able to understand the whole of Mr. Bright's business operations. This consideration led to discussions centering on having the separate entities under one parent entity, or holding company.

In 2002, Mr. Bright's legal counsel, Ronald Berger, proposed a plan of reorganization (the Plan), described as a "tax planning idea," which included establishing a holding company that would provide flexibility to restructure the existing business operations, segregate the liabilities associated with such operations, and allow for the realization of additional economic incentives available under the New York State Empire Zones Program.

On June 21, 2002, pursuant to the foregoing Plan, Dunk & Bright Holdings, Inc. (D & B Holdings) was formed. Thereafter, on December 31, 2002, D & B Holdings acquired the assets of D & B Furniture in a tax-free reorganization pursuant to Internal Revenue Code (IRC) § 368(a)(1)(c). On January 29, 2003, D & B Holdings filed an official name change amendment, changing its name to Dunk & Bright Furniture Co., Inc.[1]

Mr. Berger serves as the corporate secretary of D & B Holdings, with responsibility for preparing the minutes of the meetings of its board of directors (Board Minutes). Mr. Berger also prepares the official minutes of the annual D & B Holdings shareholder meeting (Shareholder

[1] In result, D & B Holdings effectively assumed the original company name Dunk & Bright Furniture Co., Inc. Herein, to preserve clarity, the post-reorganization petitioner shall be referred to as either "petitioner, D & B Furniture" or "D & B Holdings."

Minutes). Mr. Bright is the sole shareholder and no formal shareholder meetings are held. However, Shareholder Minutes are prepared, since Mr. Bright's lenders require annual audited financial statements, which, in turn, require annual shareholder minutes. Mr. Bright gives the Shareholder Minutes, prepared by Mr. Berger, only a cursory review. Mr. Berger has (and had) no operating, management or decision making authority or responsibility with respect to D & B Holdings. Rather, all decision-making and day-to-day operational authority for D & B Holdings rests with Mr. Bright and with Dawnmarie Raymond (with direct oversight from Mr. Bright). Mr. Bright, as the sole shareholder, has no obligation to demonstrate to anyone any actions he plans to take in connection with his business operations, nor has he ever been requested to provide a written business plan when seeking financing, and accordingly, he does not create written business plans. In similar fashion, there is no evidence that the Plan of reorganization as proposed by Mr. Berger to Mr. Bright is embodied or was presented in written form.

The Board Minutes for the 2002 board meeting state that the reorganization was undertaken "to maximize tax benefits." The corporate tax returns for 2002 included an attached statement that "[t]he purpose for the [reorganization] was to provide the corporate structure the flexibility to take advantage of certain New York State incentives. The details and transactions that took place in order for the reorganization to take place are included in the attached agreement." A Statement of Business Purpose, prepared by Mr. Bright and his professional advisors in connection with the subject audit and in response to questions raised therein, signed by Mr. Bright on July 18, 2007, includes a history of Mr. Bright's business and its operations, and in conjunction therewith sets forth reasons, in addition to the maximization of tax benefits, for the reorganization as noted above (i.e., segregation of liabilities, isolation of profits of the

various business operations and financing considerations).

Ultimately, Mr. Bright did not create separate entities to own and carry on each of the different business operations, as described above. In this respect, the commercial furniture operation did not generate the anticipated rate of return, and Mr. Bright decided to cease this operation. This operation and the carpet operation had been located in a different building from the retail furniture operation. Mr. Bright agreed to lease the building that housed the carpet and commercial furniture operations to Syracuse University, in connection with which he downsized the carpet operation and relocated it within the retail furniture showroom space. No separate entity was created to hold the lease of the separate building with Syracuse University.

The Division of Taxation (Division) commenced an income tax audit of petitioner James F. Bright for the years 2005, 2006 and 2007. In connection with this audit, the Division, via a series of letters, requested information concerning the business purposes for the reorganization, including details as to the general business activities of the transferor (D & B Furniture) and transferee (D & B Holdings), how the use of assets changed, whether the principal business activity had changed with respect to the transferor after the transfer of assets pursuant to the reorganization, and explanations as to concerns about potential liability in the trucking (furniture delivery) operation. Pursuant to these letters, the Division sought various documents, including internal memos, e-mails, correspondence with consultants, representatives, and outside third parties, a list of the boards of directors for the transferor and transferee, copies of board minutes pertaining to the creation of the holding company, correspondence with the Empire State Development Corporation (ESDC), and an explanation as to why JFB Warehouse, Inc. was not moved into D & B Holdings, as was D & B Furniture. The Division also requested any

documents explaining why "Holdings" was a more suitable tenant than "Warehouse," and an explanation of the tax benefits to which the board of directors referred to in the December 2002 Shareholder Minutes.

In response to these letter requests for information and documentation, petitioners (by Mr. Kane) included a statement of business purpose, a statement that no written documentation existed to detail the liability concerns associated with the operation of the warehouse or the furniture delivery business, a statement that no written business plan existed relative to the reorganization, and an explanation that "Mr. Bright and Mr. Berger stated that the reference to tax benefits referred to the Empire Zone credits that would be available to the corporation if they registered and were approved as a Zone Certified Business."[2]

In addition to the income tax audit, the Division also conducted a sales tax audit of petitioner D & B Furniture (i.e., D & B Holdings) for the period spanning December 1, 2004 through February 29, 2008. The Division concluded, as is relevant to these proceedings and upon the information supplied and conclusions reached in the income tax audit, that this petitioner did not meet the "valid business purpose test" in connection with the reorganization of D & B Furniture into D & B Holdings and, as a result, was not entitled to the Empire Zones tax credit for sales tax purposes.[3]

On September 22, 2008, the Division issued to petitioner James F. Bright and Cynthia

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[2] In this case, and prior cases, the parties have used many terms to refer to the tax credits provided under the Empire Zones Program. As such, we refer to as these credits generally as the Empire Zones benefit or Empire Zones tax credit.

[3] To the extent the sales tax audit resulted in disallowance of Dunk & Bright Holding's claimed QEZE based sales tax exemption the same is premised, essentially, on the income tax audit investigation and the conclusions arrived at as result thereof, without further significant sales tax audit investigation.

Bright three Notices of Deficiency asserting additional personal income tax due in the amounts of $67,621.02 for 2005, $69,952.19 for 2006 and $77,622.32 for 2007, plus interest, based upon the disallowance of Empire Zone tax credits for real property claimed for each of such years.[4] On February 2, 2009, the Division issued to petitioner Dunk & Bright Furniture Co., Inc. (i.e, D & B Holdings) a Notice of Determination assessing sales and use tax due for the period spanning December 1, 2005 through February 29, 2008 in the amount of $41,030.53, plus interest, based upon disallowance of the company's Empire Zone benefits based on sales taxes.[5]

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge reviewed the relevant history of the Empire Zones Program and "shirt changing," a practice whereby existing businesses reorganize to acquire Empire Zone benefits. The Administrative Law Judge noted that the Legislature acted several times to close this perceived loophole. Herein, the Administrative Law Judge found that petitioners had zero employees in their base period and were established and entitled to receive Empire Zone benefits prior to August 1, 2002 and, therefore, are subject to Tax Law § 14 (b) (1). As such, the Administrative Law Judge held that, in order for petitioners to retain the Empire Zone benefits, they had to satisfy the test provided in Tax Law § 14 (j) (4) (B).

The Administrative Law Judge observed that Tax Law § 14 (j) (4) (B) provides that, for the purposes of the Empire Zones Program, a corporation may not be considered a new business

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[4] Cynthia Bright's name appears solely by virtue of having filed joint personal income tax returns with petitioner James F. Bright for each of the years in issue.

[5] The Division also concluded that D & B Holdings owed additional sales tax in the amount of $28,531.82. The Notice of Determination issued with respect to this amount of tax has been paid and is not contested. While the Notice of Determination premised upon the Division's disallowance of QEZE based sales tax exemption has likewise been paid, it remains at issue and is contested herein.

unless it establishes that it was not formed solely to gain Empire Zone benefits and that it was formed for a "valid business purpose," as defined under Tax Law § 208 (9) (o) (1) (D). The Administrative Law Judge construed this language as imposing a dual requirement, such that a taxpayer seeking the new business designation must prove both that a valid business purpose motivated the formation of the business, and that the sole purpose was not to acquire Empire Zone benefits.

The Administrative Law Judge determined that petitioners failed to meet their burden of proving either requirement under Tax Law§ 14 (j) (4) (B). The Administrative Law Judge held that this inquiry required considering the entire timeline of events prior to and after the reorganization of the business. The Administrative Law Judge noted that documentation contemporaneous with the reorganization indicated that these steps were being taken in order to accrue additional tax benefits. The Administrative Law Judge noted that petitioners proffered several after-the-fact business rationales for the reorganizations; however, these purposes were not consistent with the post-reorganization conduct of the business. Rather, the Administrative Law Judge determined that the reorganization was motivated solely by the pursuit of Empire Zone tax credits and failed to meaningfully change petitioners' economic position. Accordingly, the Administrative Law Judge concluded that petitioners failed to prove either prong of Tax Law § 14 (j) (4) (B).

The Administrative Law Judge also rejected petitioners' interpretation of Tax Law§ 14 (j) (4) (B). Petitioners submitted that this statute allowed tax benefits upon a showing that a taxpayer reorganized for a valid business purpose or that the reorganization was not motivated solely by Empire Zone benefits. The Administrative Law Judge rejected this interpretation

because it failed to give effect to all of the words in the statute. In addition, the Administrative Law Judge noted that petitioners' interpretation contradicts statutory maxims by shifting the burden onto the Division.

ARGUMENTS ON EXCEPTION

In their exception, petitioners argue that the determination should be reversed because the Administrative Law Judge misapprehended facts and applied the incorrect legal standard. As a new argument, petitioners argue that we should consider the constitutionality of Tax Law § 14 (b) (1) and Tax Law§ 14 (j) (4) (B) as-applied because, as petitioners contend, these statutes are being applied retroactively.

Petitioners contend that the Administrative Law Judge incorrectly concluded that there was no valid business purpose for the reorganization and that the reorganization was motivated solely to acquire Empire Zone benefits. Petitioners cite to the record and contend that they reorganized their business in order to better segregate liabilities. They argue that these purposes were never realized because changes in the business climate ultimately obviated the need for the holding company. Petitioners contend that these factors establish that the reorganization was undertaken for purposes beyond "maximizing tax benefits," mentioned within the 2002 Board Minutes. Petitioners argue that the Administrative Law Judge erroneously rejected these arguments.

Petitioners also contend that the Administrative Law Judge erroneously rejected their interpretation of Tax Law§ 14 (j) (4) (B). They do not dispute that there are two parts to the test under this statute. Rather, petitioners condense the language and argue that the test under Tax Law § 14 (j) (4) (B) should be whether a taxpayer has established that a reasonable business

purpose existed at the time of the reorganization, in addition to the existence of the Empire Zone benefits. Under petitioners' interpretation, a taxpayer may be considered a new business if it meets either the valid business purpose test or shows that the reorganization was motivated by something other than Empire Zone benefits. Petitioners argue that the interpretation adopted by the Administrative Law Judge lacks clarity and establishes a standard that is incongruous with the meaning of the statute.

At oral argument and in their post-oral argument submission, petitioners argue that a different standard of review should apply to this case. Relying primarily on ***James Sq. Assoc. LP v Mullen*** (91 AD3d 164 [2011]), petitioners make two contentions. Petitioners contend that the burden of proof should be lowered because Empire Zone benefits resemble contracts, as opposed to typical exemptions from taxation. Additionally, petitioners analogize the instant facts to ***James Sq.***, and contend that Tax Law § 14 (b) (1) and Tax Law§ 14 (j) (4) (B) were unconstitutionally applied to them.

The Division argues that the Administrative Law Judge properly determined that petitioners failed both elements of Tax Law § 14 (j) (4) (B). In support of its position, the Division cites to the purpose of this statute, which is to curb the abuse of the Empire Zones Program through the practice of "shirt changing."

The Division argues that the record fully supports the determination of the Administrative Law Judge. It argues that none of the contemporaneous documentation introduced by petitioner indicates a business purpose other than acquiring Empire Zone tax benefits. The Division also contends that the business purposes proffered by petitioners lack merit because they are inconsistent with the record and petitioners' conduct. Specifically, the Division notes that, prior

to the reorganization, petitioners had already segregated certain liabilities because the warehousing and furniture sales functions were performed by two separate entities. The Division argues that the conduct in this matter resembles the type of abuse that the Legislature sought to curb by enacting Tax Law § 14 (j) (4) (B), and that the Administrative Law Judge properly resolved this matter.

The Division argues that the Administrative Law Judge properly rejected petitioners' interpretation of Tax Law § 14 (j) (4) (B). The Division contends that this statute does impose a two-part test wherein a taxpayer must meet both prongs in order to qualify as a new business for the purposes of the Empire Zones Program. The Division notes that this interpretation is consistent with the legislative intent of eliminating "shirt changing." The Division further argues that petitioners cannot meet their burden of proof by offering a different interpretation of Tax Law § 14 (j) (4) (B).

In its post-oral argument brief, the Division argues that petitioners misplace their reliance on ***James Sq.*** The Division contends that it would be improper to consider whether the statute is retroactive as-applied because the new business and valid business purpose test are being applied prospectively from their enactments. The Division argues that petitioners had ample notice of both of these enactments, which invalidates petitioners' arguments to the contrary. The Division reiterates that petitioners have offered no statutes or jurisprudence that would permit modification to the burden of proof. As such, the Division contends that the determination of the Administrative Law Judge should be affirmed.

OPINION

The instant matter presents the question of whether petitioner, D & B Furniture, was

entitled to Empire Zone tax credits for the period at issue. This dispute between petitioners and the Division revolves around whether petitioners' reorganization was a "shirt change," a practice by which businesses reorganize to create the illusion of creating jobs, or "phantom jobs," and take advantage of benefits provided under the Empire Zones Program (***see*** NY Assembly, Record of Proceedings, March 31, 2005).

In 1986, the Legislature enacted the Empire Zones Program[6] "to stimulate private investment, private business development and job creation" in economically impoverished areas (General Municipal Law § 956). To that end, the Empire Zones Program provides tax credits to businesses that are certified as a Qualified Empire Zone Enterprise (QEZE). Subsequent to the program's enactment, the Legislature identified the practice of "shirt changing" as inconsistent with the purposes of the Empire Zones Program and acted to curb these abuses.

In order to remediate this problem, the Legislature passed legislation amending the existing "new business" test, which was originally implemented in 2002 (***see*** Chapter 85, Laws of 2002; Tax Law § 14 [b] [1]). These amendments defined a new business as one that was created for a valid business purpose and was not created solely to acquire Empire Zone benefits (Tax Law § 14 [j] [4] [B]). It is clear that the Legislature intended these amendments to cure the problem of "shirt changing." The application of these amendments is at the core of determining whether petitioners are entitled to tax credits under the Empire Zones Program.

Having reviewed the legislative intent, we now turn to the language of the subject statutes. In chapter 161 of the Laws of 2005, the Legislature amended Tax Law § 14 (b) (1) to

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[6] Originally enacted as Economic Development Zone Program, this Act was amended by the chapter 63 of the Laws of 2000, which renamed it the Empire Zones Program, and includes the current system of acquiring Empire Zone benefits.

provide the following:

> "For entities first certified prior to August first, two thousand two, if the entity had a base period of zero years or zero employment in the base period, then the employment test will be met only if the enterprise qualifies as a new business under subdivision (j) of this section."

On June 21, 2002, D & B Holdings was created via reorganization. This entity had essentially the same ownership and the same operations as its immediate predecessor, D & B Furniture, and, on December 31, 2002, it amended its name to Dunk & Bright Furniture Co. Prior to August 1, 2002, this entity became entitled to receive Empire Zone benefits and had zero employees in its base period. These facts are not in dispute. We conclude that petitioner D & B Furniture is subject to Tax Law § 14 (b) (1). Therefore, in order to retain the subject Empire Zone benefits, petitioners must meet the new business test.

Interpretation of Tax Law § 14 (j) (4) (B)

The instant controversy revolves around a component of the new business test found in Tax Law§ 14 (j) (4) (B). This statute provides the following:

> "[an entity] shall not be deemed a new business if it was not formed for a valid business purpose, as such term is defined in clause (D) of subparagraph one of paragraph (o) of subdivision nine of section two hundred eight of this chapter *and* was formed solely to gain empire zone benefits" (emphasis added).

The Administrative Law Judge determined that the Division correctly construed Tax Law § 14 (j) (4) (B) as imposing both a requirement and a restriction on entities seeking the new business designation. In order to qualify as a new business, the statute requires an entity to establish that it was formed for valid business purposes. Additionally, the statute denies the new business designation to an entity that was formed solely to acquire Empire Zone benefits. As interpreted by the Administrative Law Judge, an entity that fails either aspect of the test under

Tax Law§ 14 (j) (4) (B) may not be considered a new business and would be ineligible for Empire Zone benefits.

Petitioners argue that the Administrative Law Judge's interpretation is so narrow that it defeats the purpose of the Empire Zone tax credits. Petitioners contend that, when properly construed, Tax Law§ 14 (j) (4) (B) provides that the new business designation shall not be granted when an entity does not meet both prongs. This interpretation would permit petitioner, D & B Furniture, to retain its new business designation if it established either that it reorganized for a valid business purpose or that Empire Zone benefits were not the sole motivation for the reorganization.

We note that a taxpayer challenging the statutory interpretation of an administrative agency bears a heavy burden of proof.

> "As a general rule, 'the construction given statutes . . . by the agency responsible for their administration, if not irrational or unreasonable, should be upheld'" (citations omitted) (***Matter of Brooklyn Assembly Halls of Jehovah's Witnesses, Inc. v Department of Envtl. Protection of City of N.Y.***, 11 NY3d 327, 334 [2008]).

Therefore, in order to prevail, petitioners must establish either that the Division's interpretation is unreasonable or that their interpretation is the only reasonable one (***see e.g. Matter of County of Albany v Hudson River-Black Riv. Regulating Dist***., 2012 NY Slip Op 03698 [2012]; ***see also Samiento v World Yacht Inc.***, 10 NY3d 70 [2008]).

We conclude that petitioners have failed to establish that the Division unreasonably interpreted this statute. The parties' interpretations differ based on the meaning of the term "and" within Tax Law§ 14 (j) (4) (B). The Division has interpreted this term as creating a twofold requirement, where a new business designation may not be granted either in the absence

of a valid business purpose or if Empire Zone benefits are the sole desire for formation. Petitioners failed to adduce any evidence proving that the Division's interpretation was unreasonable, given the Legislature's strong desire to eliminate "shirt changing" (***see*** NY Assembly, Record of Proceedings, March 31, 2005). Further, we note that in light of the legislative history, petitioners' interpretation leads to results that are "out of harmony with or inconsistent with the plain meaning of the statutory language" (***Matter of Trump-Equitable Fifth Ave. Co. v Gliedman***, 57 NY2d 588, 595 [1982]).[7] Accordingly, we reject petitioners' interpretation of Tax Law§ 14 (j) (4) (B).

We hold that, in order to satisfy the test under Tax Law§ 14 (j) (4) (B), an entity must establish that:

> (1) the subject entity was formed for a valid business purpose, as defined under Tax Law § 208 (9) (o) (1) (D) (***see infra***); and,
>
> (2) its formation was not motivated solely to acquire Empire Zone benefits.

This construction gives effect to the clear terms of the statute, and is consistent with the legislative intent of curbing "shirt changing." Having determined the proper interpretation of Tax Law§ 14 (j) (4) (B), we now turn to the issue of whether petitioners have met the foregoing test.

Valid Business Purpose

Tax Law§ 14 (j) (4) (B) requires that an entity establish that it was formed for a valid business purpose. For the purposes of the new business test, the definition of a valid business

[7] Petitioners' interpretation seeks to strip the valid business purpose requirement from Tax Law § 14 (j) (4) (B). This construction would permit an entity to be considered a new business if it was not formed solely to acquire Empire Zone benefits, but lacked a valid business purpose. This result is clearly incompatible with both the statutory language and legislative intent of curbing the "shirt-changing" abuse of the Empire Zones Program.

purpose is found in Tax Law § 208 (9) (o) (1) (D), which states:

> "A valid business purpose is one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for some business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer, or the entry by the taxpayer into new business markets."

Under this statute, a taxpayer meets its burden of showing a "valid business purpose" when it establishes the following:

> (1) that a non-tax business purpose, or a variety of business purposes together, serves as the "primary motivation" for the subject business activity; and,
>
> (2) that the subject activity "meaningfully changes" the taxpayer's economic position in some non-tax manner.

We have previously determined that Tax Law § 208 (9) (o) (1) (D) codifies the subjective prong of the sham transaction analysis, or the economic substance doctrine[8] (***Matter of Graphite Metallized Holdings***, Tax Appeals Tribunal, July 7, 2011). Accordingly, we find it appropriate to consider the relevant jurisprudence.

In part, the valid business purpose inquiry "involves a subjective analysis of the taxpayer's intent" at the time of the subject business activity (***Winn-Dixie Stores v Commissioner***, 113 TC 254, 280 [1999], ***affirmed*** 254 F3d 1313 [2001], ***cert denied*** 535 US 986 [2002]; ***Gregory v Helvering***, 293 US 465 [1935]). In cases addressing valid business purpose, "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended" (***Gregory***, 293 US 465, 469; ***see also In re CM***

[8] We note, as did the District Court in ***Long Term Capital Holdings v U.S.*** (330 F Supp 2d 122 [2004], ***affd*** 150 Fed Appx 40 [2005]), that the name of the test is not critical so long as the analysis focuses on the taxpayer's subjective business purpose for engaging in the transaction and the transaction's objective economic substance.

Holdings, 301 F3d 96 [2002]). We agree with the opinion expressed by the Third Circuit in ***In re CM Holdings*** (301 F3d 96, 106 [2002]):

> "If Congress intends to encourage an activity, and to use taxpayers' desire to avoid taxes as a means to do it, then a subjective motive of tax avoidance is permissible. But to engage in an activity solely for the purpose of avoiding taxes where that is not the statute's goal is to conduct an *economic sham*" (emphasis added).

While subjective in nature, this test measures the validity of a taxpayer's alleged business rationale in light of objective facts contemporaneous with the business activity (***Coltec Indus., Inc. v U.S.***, 454 F3d 1340 [2006], ***cert denied*** 549 US 1206 [2007]). Accordingly, it is appropriate to place great weight on evidence that is contemporaneous with the subject business activity.

As defined under Tax Law § 208 (9) (o) (1) (D), the valid business purpose test is not a strict standard, but rather a flexible test. As stated by the United States Supreme Court, this test is whether:

> "Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find?" (***Gregory v. Helvering,*** 293 US 465, 469 [1935]).

We note that the consideration of tax consequences in business activities is permissible under Tax Law § 208 (9) (o) (1) (D). However, this statute provides that such consideration cannot serve as the primary motivation for such business activities. Bearing these principles in mind, we first turn to the question of whether petitioners established a non-tax primary motivation for the subject reorganization.

Petitioners offer various permutations of segregating liabilities as the primary motivation for their reorganization. At the hearing, petitioners offered testimony regarding the furniture business, its growth, and the considerations leading up to and after the reorganization.

Petitioners acknowledge that tax considerations influenced the decision to reorganize, but contend that this was not their primary motivation. However, the record lacks contemporaneous documentation showing that the segregation of liabilities served as the primary purpose for the reorganization. The record does not contain a business plan, correspondence, or minutes indicating that the segregation of liabilities was even a significant motivator for this reorganization. Rather, the record provides a different picture.

Our review of the record confirms the conclusion that the reorganization was purely motivated by tax considerations. The record shows that Mr. Bright's counsel introduced the reorganization under the holding company strategy as a "tax planning idea." The December 30, 2002, minutes of the board of directors' meeting clearly identifies the primary motivation for the reorganization as the acquisition of certain tax benefits. The 2002 corporate tax return, signed by petitioner, James Bright, contained an attached statement indicating one rationale for the reorganization: taking advantage of certain New York State incentives. A letter from petitioners' accountant identifies these tax benefits and incentives as those provided under the Empire Zones Program. The record simply lacks clear and convincing evidence of a non-tax business purpose that is contemporaneous with the reorganization (***c.f. Matter of Graphite Metallized Holdings***, Tax Appeals Tribunal, July 7, 2011 [record indicated economic hardship and consideration of reorganization prior to the emergence of Empire Zones benefits]).

We conclude that petitioners failed to establish that a non-tax business purpose served as the "primary motivation" for the reorganization of its furniture building through D & B Holdings. Absent clear and convincing contemporaneous evidence, we cannot accept petitioners' rationalizations for the reorganization. This is particularly true herein, where petitioners' post-

reorganization conduct and the contemporaneous documentation establish that tax considerations strongly influenced the decision to reorganize and form D & B Holdings, which is now petitioner, D & B Furniture. Accordingly, petitioners failed the "primary motivation" component of the valid business purpose test under Tax Law § 208 (9) (o) (1) (D).

We next address the question of whether the reorganization "meaningfully changed" petitioners' economic position apart from tax considerations. Prior to the reorganization, D & B Furniture was a healthy, expanding business. Petitioners contend that this growth required the segregation of liabilities, which led to the reorganization under the holding company strategy. However, the alleged liability concerns were never addressed, as JFB was never brought within the holding company, and no separate entity was created to hold the lease of the building that used to house carpets for Syracuse University. While the liabilities were not addressed, the record shows that within eight months of its formation, D & B Holdings assumed all of the assets, liabilities, and the name of D & B Furniture, essentially returning the business to its exact state prior to the reorganization.

Petitioners failed to establish that their reorganization of D & B Furniture "meaningfully changed" their economic position. The time line of events and the lack of contemporaneous evidence regarding segregating liabilities make it extraordinarily difficult, if not impossible, to accept that petitioners' proffered plan had a non-tax objective. There is simply no evidence from the time of the reorganization indicating that this activity was designed to affect petitioners' business in any way apart from accruing Empire Zone benefits. In fact, the record supports the opposite conclusion (i.e. that the reorganization was undertaken to acquire Empire Zone benefits) because, at the conclusion of the reorganization, the furniture business was left in essentially the

exact same position as prior to the reorganization in all respects, except for the acquisition of Empire Zone benefits.

We conclude that petitioners did not meet either prong of the valid business purpose test under Tax Law § 208 (9) (o) (1) (D). The record simply does not support any of petitioners' other rationalizations for the reorganization. Petitioners failed to establish a non-tax business purpose that motivated the reorganization of their business. They also failed to establish that the reorganization meaningfully changed their economic position. As, petitioners failed the valid business purpose test under Tax Law § 208 (9) (o) (1) (D), we conclude that petitioners failed the new business test under Tax Law§ 14 (j) (4) (B) because they did not establish that D & B Furniture (D & B Holdings) was formed for a valid business purpose.

Sole Purpose

Although petitioners' failure to establish a valid business purpose is fatal to their claim, we note that record supports the conclusion that petitioners' reorganization was motivated solely by the acquisition of Empire Zone benefits. As such, we will address the sole purpose prong of Tax Law§ 14 (j) (4) (B) as well.

The record supports the Administrative Law Judge's conclusion that petitioners' conduct appears to be consistent with the regular, ongoing growth efforts of a healthy business. The record lacks evidence of a contemporaneous business plan for the reorganization of D & B Furniture through D & B Holdings. The documentation in the record and petitioners' conduct support the conclusion that Empire Zone tax credits motivated the reorganization. The other alleged motivations, including the desire to segregate liabilities, simply lack credible support. Further, the record shows no indication of how the formation of D & B Holdings and its

absorption of D & B Furniture materially altered the original business' economic position. Therefore, we do not disturb the Administrative Law Judge's conclusion that the acquisition of Empire Zone benefits was the sole motivation for the reorganization.

Challenges Based on ***James Sq.***

On exception, petitioners raise additional challenges based on the recent Appellate Division, Fourth Department decision in ***James Sq. Assoc. LP v Mullen*** (91 AD3d 164 [2011]).

James Sq. involved a different set of amendments to the Empire Zones Program. These amendments were passed in 2009 and permitted the revocation of Empire Zone status based on a failing of either the "shirt changing" test or a cost-benefit analysis (General Municipal Law § 959 [a]; L 2009, ch 57, part S-1, §§ 11-22). The Court found that, consistent with the legislative mandate and intent of these amendments, the Commissioner of the New York State Department of Economic Development revoked the challenging taxpayers' QEZE status, effective January 1, 2008, thereby depriving them of carried-over tax credits.

The taxpayers commenced suit over the subject credits, resulting in the decision relied upon by petitioners.[9] Therein, the Appellate Division held that the subject statutes were not retroactive tax statutes because they did not impose a new tax or increase an existing tax (***James Sq. Assoc. LP v Mullen***, 91 AD3d 164, 172-173). However, the Court found it proper to determine the constitutionality of those amendments because they "altered [the taxpayers'] eligibility for tax credits" (***id.***, 91 AD3d 173). The Appellate Division found the amendments unconstitutional as-applied because it found that the taxpayers reasonably relied upon the law

[9] It should be noted that the Court of Appeals has stated, "one who objects to the act of an administrative agency must exhaust available administrative remedies before being permitted to litigate in a court of law" (***Watergate II Apts. v Buffalo Sewer Auth.***, 46 NY2d 52, 57 [1978]).

and could not have foreseen the changes to the Empire Zones Program, which would have altered their behavior.

Relying on ***James Sq.***, petitioners raise two arguments. First, they contend that this Tribunal should apply a different burden of proof in this case because the Appellate Division allegedly applied a lower standard for the Empire Zone tax credits. Second, petitioners contend that a constitutional as-applied analysis is appropriate because Tax Law § 14 (j) (4) (B) is being retroactively applied to petitioner, D & B Furniture.

Burden of Proof

A taxpayer generally bears the burden of proof because it seeks to claim a tax credit (***see e.g. Matter of Golub Serv. Sta. v Tax Appeals Trib. of State of N.Y.***, 181 AD2d 216 [1992]). Tax credits, such as those at issue, are a particularized species of exemption from taxation (***Matter of Marriott Family Rests. v Tax Appeals Trib. of State of N.Y.***, 174 AD2d 805 [1991], ***lv denied*** 78 NY2d 863 [1991]). "Statutes creating tax exemptions must be construed against the taxpayer" (***Matter of Federal Deposit Ins. Corp. v Commissioner of Taxation & Fin.***, 83 N.Y.2d 44, 49 [1993] [internal quotation marks and citation omitted]; ***Matter of Grace v New York State Tax Commn.***, 37 NY2d 193 [1975], ***rearg denied*** 37 NY2d 816 [1975], ***lv denied*** 37 NY2d 708 [1975]).

In order to meet its burden, the taxpayer must demonstrate through clear and convincing evidence that the exemption applies and that it is entitled to it (***see Matter of Lake Grove Entertainment, LLC v Megna***, 81 AD3d 1191 [2011]; ***Matter of Blue Spruce Farms v New York State Tax Commn.***, 99 AD2d 867 [1984], ***affd*** 64 NY2d 682 [1984]). We note that in matters of statutory interpretation, our cardinal function is to effectuate the intent of the

Legislature (***see Matter of Yellow Book of N.Y., Inc. v Commissioner of Taxation & Fin.***, 75 AD3d 931 [2011], ***lv denied*** 16 NY3d 704 [2011]). The statutory language is the clearest indicator of legislative intent (***Matter of Lewis Family Farm, Inc. v New York State Adirondack Park Agency***, 64 AD3d 1009 [2009]).

We find that the decision in ***James Sq.*** does not stand for the proposition that cases involving Empire Zone tax credits call for a different burden of proof. Contrary to petitioners' position, the Court did not sua sponte modify the standard of review for entitlement to Empire Zone tax credits. Rather, in ***James Sq.***, the Appellate Division applied a "balancing of the equities" test in order to decide whether the relevant 2009 amendments to the Empire Zones Program were constitutional as-applied to the taxpayers (***James Sq. Assoc. LP v Mullen***, 91 AD3d 164, 173 [2011]). This was not a diminution of the burden of proof for a taxpayer seeking to claim Empire Zone tax credits. Accordingly, we reject petitioners' challenge to the applicable burden of proof based on the decision of ***James Sq.***

Constitutionality As-Applied

We now address petitioners' challenges to the constitutionality of Tax Law § 14 (j) (4) (B) as-applied based on the theory that it is a retroactive statute. Initially, we note that it is within our authority to consider whether tax statutes are constitutional as-applied (***Matter of Hazan***, Tax Appeals Tribunal, April 21, 1989, ***confirmed sub nom Matter of David Hazan, Inc. v Tax Appeals Trib. of State of N.Y.***, 152 AD2d 765 [1989], ***affd*** 75 NY2d 989 [1990]).

Petitioners bear the burden of proving that the application of Tax Law § 14 (j) (4) (B) was retroactive because they are challenging the constitutionality of the statute (***Amazon.com, LLC v New York State Dept. of Taxation & Fin.***, 81 AD3d 138 [2010]). As stated by the Appellate

Division:

> "Retroactive statutes are those which impair vested rights or alter past transactions or considerations. . . 'A statute is not retroactive. . . when made to apply to future transactions, merely because such transactions relate to and are founded upon antecedent events'" (citations omitted) (***Matter of Allied Grocers Coop. v Tax Appeals Trib.***, 162 AD2d 791, 792 [1990]).

As the challenging party, petitioners must prove that the changes to Tax Law § 14 (b) (1) and Tax Law § 14 (j) (4) (B) were retroactively applied to them.

Petitioners failed to establish that the application of these statues was, in fact, retroactive. Herein, the subject amendments to the statute were passed in April 2005. The periods at issue are December 1, 2005 through February 29, 2008, which are subsequent to the subject amendments to the Empire Zones Program. Contrary to petitioners' position, a statute may not be construed as retroactive because it conditions future benefits upon past events. Herein, the amendments to the Empire Zones Program may not be considered retroactive on the grounds that they condition the receipt of *prospective* Empire Zone benefits based on purposes for which petitioner, D & B Furniture, was formed.

We emphasize that petitioners have also failed to show that they were deprived of a "vested right." Contrary to petitioners' assertions, they do not possess any entitlement to the Empire Zone tax credits as a matter of right. As stated by the Court of Appeals, "This is because an exemption is not a matter of right, but is allowed only as a matter of legislative grace" (***Matter of Grace v New York State Tax Commn.***, 37 NY2d 193, 196 [1975], ***rearg denied*** 37 NY2d 816 [1975], ***lv denied*** 37 NY2d 708 [1975]; ***Matter of Royal Indem. Co. v Tax Appeals Trib.***, 75 NY2d 75 [1989]). This is particularly true where a taxpayer engages in an activity to avoid taxation without accomplishing the statutory goal (***see e.g. In re CM Holdings***, 301 F2d 96, 106

[2002]). Petitioners could not be entitled to the subject credits as a matter of right.

Under these facts, a constitutional as-applied analysis would be inappropriate under petitioners' theory of retroactivity. This is not a situation where the taxing authority, the State of New York, is impermissibly reaching back to divest petitioners of an actual, vested right (***c.f. Matter of Replan Dev. v Dept. of Hous. Preserv. & Dev. of City of N.Y.***, 70 NY2d 451, 456 [1987], ***app dismissed*** 485 US 950 [1988] [discussing retroactive real property tax laws]). Rather, this is a situation where the Legislature identified a systemic abuse of the tax system, "shirt changing," and acted to prospectively stop entities from acquiring Empire Zone benefits when they did not provide the desired benefits to New York State (***see*** NY Assembly, Record of Proceedings, May 31, 2005). As these tax advantages are provided solely out of legislative grace, it was well within the Legislature's providence to amend the Empire Zones Program, particularly for the public purpose of curbing abuses of the program.

We conclude that petitioners failed to meet their burden of proving that the application of Tax Law § 14 (b) (1) and Tax Law § 14 (j) (4) (B) was retroactive.

We find petitioners' remaining arguments to be without merit or were properly disposed of by the Administrative Law Judge.

Accordingly, it is ORDERED, ADJUDGED, and DECREED that:

1. The exceptions of Dunk & Bright Furniture Co., Inc., and James F. Bright are denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petitions of Dunk & Bright Furniture Co., Inc., and James F. Bright are denied;

4. The Notice of Determination dated February 2, 2009 and the Notices of Deficiency dated September 22, 2008 are sustained.

DATED: Albany, NY
June 28, 2012

/s/ James H. Tully, Jr.
James H. Tully, Jr.
President

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner