

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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In the Matter of the Petitions	:	
of	:	
<b>WARD LUMBER CO., INC.</b>	:	DECISION
For Redetermination of Deficiencies or for Refund	:	DTA Nos 823209
of Corporation Franchise Tax under Article 9-A of	:	and 823163
the Tax Law for the Years 2005, 2006 and 2007.	:	

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Petitioner, Ward Lumber Co., Inc., filed an exception to the determination of the Administrative Law Judge issued on April 28, 2011. Petitioner 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. (Robert Tompkins, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a letter brief in lieu of a formal brief in opposition. Petitioner filed a reply brief. Oral argument, at petitioner's request, was heard on November 30, 2011. The Tax Appeals Tribunal granted leave to file post-oral argument submissions, with all papers due by January 12, 2012. Petitioner 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 petitioner's 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 petitioner did not have a valid business purpose for its 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, except for finding of fact “15,” which has been modified. The Administrative Law Judge’s findings of fact and the modified finding of fact are set forth below.

Petitioner, Ward Lumber Co., Inc., a Delaware corporation, is a building materials manufacturer and supplier formed in December 2001. Prior to its formation, the business presently conducted by petitioner was conducted by a different entity that was incorporated in the State of New York in 1961. The entity incorporated in the State of New York in 1961 was also named Ward Lumber Co., Inc.<sup>1</sup>

Petitioner carries on a fourth-generation family-owned business, which has operated in Jay, New York, for approximately 120 years. Although the business has always been carried on by the Ward family, it has gone through a number of intergenerational transfers over the past 120 years. The Ward family business began in 1890 when Harvey Ward, the great grandfather of its current President, Sidney John “Jay” Ward, III, started a sawmill and cut logs for area farmers. Jay Ward’s great-grandfather had six sons, including Jay Ward’s grandfather, Sidney Ward, Sr. Sidney Ward, Sr. married Agnes, who went on to become a long-time Ward Lumber employee (retiring as bookkeeper in approximately 2005). Sidney, Sr. and Agnes had four children, including two sons involved in the business, Sidney, Jr. (Jay’s father) and Bill Ward, Sr. Sidney Jr. married Janet in the early 1960s, and Janet was employed in the company performing human

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<sup>1</sup> To maintain clarity, the original Ward Lumber Co., Inc. will be referred to herein as “Ward Lumber I,” and the current Ward Lumber Co., Inc. will be referred to herein as “petitioner.”

resource functions. Upon Sidney, Sr.'s passing in 1970, and continuing through 1972, Sidney, Jr. bought out Bill Ward, Sr.'s shares. Sidney, Jr. owned and operated Ward Lumber I from 1972 through the early 1990s. Until approximately 1988, Sidney, Jr. ran the business as a sole proprietorship and made all of the business decisions.

In 1988, both Jay and his brother, Jeffrey "Jeff" Allen Ward, joined Ward Lumber I as employees. At that time, Sidney, Jr., Janet, Agnes, Jay and Jeff were the only family members involved in the business. The only shareholders in 1988 were Sidney, Jr. (64%) and Agnes (36%).

In 1988, Jay and Jeff did not have any defined titles in Ward Lumber I, but their roles quickly evolved. Jay became more involved in the building materials and retail portion of the business, while Jeff became involved in the lumber manufacturing aspect of the business. Around the end of 1988 or early 1989, Jay became vice-president of retail operations and Jeff became vice-president of lumber manufacturing.

In approximately 1990 or 1991, Ward Lumber I was separated into two divisions: the Building Material Division and the Lumber Manufacturing Division. Jay Ward also became increasingly responsible for the day-to-day administrative and executive management of the entire Ward Lumber I. Prior to 1992, as Jay Ward took on growing responsibilities, he created an informal management team comprised of longtime employees with significant responsibilities, including Ward Lumber I's chief financial officer, purchasing manager and plant manager. In 1992, Jay Ward became president of Ward Lumber I, while still managing the Building Material Division. When Jay Ward became president, Jeff Ward was elevated to senior vice-president of Ward Lumber I, with his responsibilities focused on managing the Lumber Manufacturing

Division along with Sidney Ward, Jr.

Commencing in approximately 1993 or 1994, Agnes Ward, while remaining an employee, began gifting her shares in Ward Lumber I as part of her estate planning. Rick Rolands, Esq., an estate planning attorney, worked with Agnes Ward until approximately 1996 to accomplish her estate goals. Mr. Rolands, and later his associate, Patricia Chevy, Esq., also advised Sidney Ward, Jr. and Janet Ward regarding their estate plans starting in 1996 and through to the present day.

Sidney Ward, Jr. retired in early 1996 and Janet Ward retired later in the same year. At the time of their respective retirements, Sidney Ward, Jr. and Janet Ward remained the majority shareholders of Ward Lumber I. At that time, Jay Ward and Jeff Ward were minority shareholders of less than 25 percent each. As part of their retirement plans, Sidney Ward, Jr. and Janet Ward began periodically transferring shares to Jay and Jeff Ward, equally in all cases.

Also in 1996, Jay Ward formally created a senior management team, which held regular meetings. The team consisted of all Ward Lumber I's shareholders, the chief financial officer, the purchasing manager, the plant manager and the forester. The shareholders also continued to hold meetings on approximately a quarterly basis. Such meetings were fairly informal, and the goal of the shareholders was generally to reach a consensus decision on all issues.

Beginning in 1996, Ward Lumber I began to rapidly grow through acquisitions and expansions of retail locations. In 1996, Ward Lumber I acquired the former Grossman's in Plattsburgh, New York, and hired most of Grossman's former employees. Grossman's had an existing client base already in place, which, it was hoped, would continue to patronize the store after Ward Lumber I acquired it. The decision-making process to purchase the Grossman's

location was very abbreviated compared to most of the shareholders' business decisions.

In 1998, Ward Lumber I acquired another existing company known as Mountain Log Homes, a manufacturer of log home packages. In 1999, Ward Lumber I acquired yet another existing business known as M.E. Pratt Lumber in New Russia, New York. M.E. Pratt Lumber was a saw mill, and was purchased so that Ward Lumber I could capture M.E. Pratt Lumber's log supply and prevent a competitor from doing so.

In 2000, Ward Lumber I began the process of opening a new retail building supply store in Malone, New York. This process required Ward Lumber I to acquire vacant farm land, obtain municipal approvals, excavate and prepare the site for construction, construct the store, outfit the store with necessary fixtures, hire new employees and recruit customers. Unlike Ward Lumber I's purchase of the existing Grossman's location in Plattsburgh, the construction of a new store in Malone came with significant challenges, including the need to hire all new employees, some with no experience in a retail building supply business, to market to new customers and to determine the appropriate mix of products for that market.

At this time, Ward Lumber I's shareholders consisted of Sidney Ward, Jr., Janet Ward, Jay Ward and Jeff Ward. The ownership percentages were such that Jay and Jeff Ward owned slightly less than 50 percent combined, with the remaining shares owned by Sidney Ward, Jr. and Janet Ward.

Despite its long history, Ward Lumber I was struggling financially prior to its merger into petitioner. While it realized steady profits from 1994 to 1999, Ward Lumber I experienced a rather drastic change in financial condition during the years 2000 and 2001, when it incurred operating losses of approximately \$1.4 million.

Several factors contributed to Ward Lumber I's economic downturn and unstable financial condition. Primarily, these factors were: economic distress in the lumber and building supply industry; mounting competition from Canadian companies; inefficient and outdated equipment in the lumber mill, prompting an urgent need to modernize; high employee turnover; rapid rise in production of industrial grade lumber in the mill, which was sold for a loss; and rapid growth and expansion over a five-year period.

We modify finding of fact "15," to read as follows:

As financial losses mounted between 2000 and 2001, Ward Lumber I struggled to make its debt service payments with its primary financial lender, NBT Bank, N.A. (NBT). The bank's regulators downgraded Ward Lumber I's loan credit rating from an "A" to a "C." Accordingly, NBT, through its account representative and vice president, and other senior officials, attended frequent meetings with Ward Lumber I to discuss the bank's concerns with the company's financial viability and various options to return the company to profitability. One option frequently suggested by NBT was closing down the mill and liquidating its assets.<sup>2</sup>

To avoid closure of the mill, Ward Lumber I attempted to address NBT's concerns by scrutinizing expenses, reducing senior management salaries by eleven percent, eliminating Ward Lumber I's 401(k) matching contributions for employees, changing health insurance plans to lower costs, downsizing staff and reducing hours of operation.

Ward Lumber I also considered the option of relocating to the Plattsburgh Air Force Base Park or moving operations outside the State of New York. Moreover, Ward Lumber I actively sought assistance from other organizations and agencies, including the Essex County Industrial Development Agency (Essex County IDA), the Empire State Development Corporation (ESDC) and New York State Energy Research and Development Authority (NYSERDA), as potential

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<sup>2</sup> We modify this finding of fact to more accurately reflect the record.

funding sources.

Because of Ward Lumber I's status as a closely-held family business and its key position as one of the largest employers and business enterprises in Essex County, ESDC, through its regional director, Gregory Caito, became actively involved in efforts to save the company from closing, and maintaining Ward Lumber I's presence in the northern New York region. Mr. Caito, together with Allen Dunham of the Essex County IDA, adopted a comprehensive approach to alleviate Ward Lumber I's financial crisis and assembled a group of agencies to develop viable alternatives.

One option contemplated by the agencies was the separation of the Building Material Division and Lumber Manufacturing Division into separate legal entities with separate management. From a family perspective, the separation was appealing to Jay and Jeff Ward because it would reduce significant family tensions resulting from their differences in opinion as to the management of each division. Another potential benefit of separation was the possibility of dividing up Ward Lumber I's debt among different lenders. Initially, NBT promoted the separation of the divisions because Charter One Bank had expressed an interest in financing the manufacturing division, and NBT was more comfortable in financing the building material division. However, due to underwriting concerns, NBT ultimately determined that any separation would require cross-guarantees, cross-collateralization and cross-default provisions for both entities. As a result, each entity would have to guarantee the debt of the other entity, but neither would have control over the management and operations of the other entity. Moreover, Ward Lumber I's accountant advised against the separation due to the enormous tax liability associated with the severance of the divisions, as well as the increased overhead and

administrative costs that would result from running two stand-alone companies. Ultimately, for the foregoing reasons, Ward Lumber I rejected the separation of the divisions into two separate entities.

Another option contemplated in 2000 by Ward Lumber I, ESDC and the Essex County IDA was a \$10 million project consisting of construction of a new sawmill and acquisition of new equipment to improve the mill's efficiency and profitability. Although Charter One Bank had expressed an interest in financing this project with participation from the Essex County IDA, Ward Lumber I ultimately rejected moving forward with the project due to its unwillingness to take on a new \$10 million loan in addition to its existing debt of over \$6 million, as well as Ward Lumber I's inability to provide the necessary 20 to 30 percent equity injection into the project.

In 2000, the Essex County IDA invited Ward Lumber I to attend a certain Empire Zones Program Informational Seminar (Empire Zones Seminar) held on October 17, 2000, at the Moriah Business Park in Mineville, New York. At the Empire Zones Seminar, speakers Fred DiMaggio, Director of the Empire Zones Program for Empire State Development, Lois Ketzer from New York State Department of Taxation and Finance, and Marcy Neville, Coordinator for the Moriah, Port Henry, Essex Empire Zone, discussed generally the Empire Zones Program, and how both new businesses and existing businesses became eligible for Empire Zone benefits. Among the items discussed, Mr. DiMaggio stated that an existing business would have to attain a new tax identification number and form a new entity in order to qualify for the benefits available through the Empire Zones Program. Jay Ward attended the Empire Zones Seminar on behalf of Ward Lumber I.

Subsequent to the Empire Zones Seminar, Ward Lumber I was strongly encouraged by



ESDC and the Essex County IDA at several meetings to pursue the possibility of qualifying for Empire Zone benefits as one of the initiatives to offset Ward Lumber I's continuing financial difficulties.

When contemplating the option of moving operations to the Plattsburgh Air Force Base Park in or around 2000, City of Plattsburgh Economic Development representative Rosemarie Schoonmaker set up a meeting for Ward Lumber I with Mr. McAuliffe on January 5, 2001, to discuss the Empire Zones Program in more detail, and the steps necessary to become certified as an Empire Zone enterprise. Immediately upon leaving that meeting with Ms. Schoonmaker and Mr. McAuliffe, Jay Ward set up a January 12, 2001 meeting at the offices of Ward Lumber I's accountant, Arthur Place & Company, in Albany, New York.

On January 12, 2001, representatives of Ward Lumber I attended the aforementioned meeting with its accountant, Mr. Place, Mr. Rolands and Mr. McAuliffe to discuss, among other things, the formation of a new entity. Due to Ward Lumber I's struggle with financial losses and the family dynamics among its shareholders, Ward Lumber I's accountants and attorneys advised Ward Lumber I of the benefits of incorporating in Delaware. One benefit of incorporating in Delaware included the limited liability afforded shareholders for unpaid wages to employees (as opposed to shareholder personal liability for payroll in New York). Another benefit of incorporating in Delaware discussed at the meeting included "simple majority" voting requirements (as opposed to "super-majority" voting requirements in New York) to foster easier decision-making for management. Moreover, the subject of transition of ownership for estate planning purposes was also generally discussed. Jay Ward's testimony at the hearing generally was consistent with the position that petitioner was formed, among other reasons, to take

advantage of a Delaware entity's flexibility in management and estate planning issues and to avail itself of limited shareholder liability for unpaid wages and benefits afforded by Delaware law.

Mr. Ward added as part of his direct testimony that, "part of our bank loaning us more money and sticking with us and going through this whole process was because we were going to get Empire Zone benefits, and those benefits would help pay for some of the debt service." Mr. Ward further clarified on cross examination that financial stability as a business purpose for the new entity meant that NBT was looking to the cash from the Empire Zone credits as part of financial stability to justify further lending.

In or around early 2001, and at the urging of various professional advisors, Jay Ward began his pursuit of Empire Zone benefits. Jay Ward and Ward Lumber I's accounting manager, Cathy Murray, began the process by collaborating with the Essex County IDA and the Moriah-Port Henry Economic Development Zone office to obtain the necessary boundary revision to include Ward Lumber I's building footprint within the Essex County/Moriah-Port Henry Empire Zone. After locating the business within the Zone, and effectuating the merger of the business into a Delaware corporation, petitioner submitted its application for Empire Zone certification, obtained approval of its application from the local board, and ultimately obtained the necessary approval from the New York State Empire Development Office. Petitioner became zone-certified in Essex and Franklin Counties, and received Empire Zone benefits for tax years 2002, 2003 and 2004.

Additional recommendations made at an Essex County IDA task force meeting held on May 16, 2001 included pursuit of grants available through ESDC; NYSEDA Energy Smart

Loan Fund approval; and credits available under the Empire Zones program. ESDC was able to provide Ward Lumber I with some grant assistance, and Ward Lumber I was approved for a \$350,000.00 NYSERDA Energy Smart Loan on July 24, 2001. Both the ESDC and NYSERDA funds were used to induce NBT to extend additional financing in the amount of \$550,000.00 for a much-needed head rig band saw (Band Saw Loan) to reduce energy consumption in 2001.

Despite Ward Lumber I's attempts to cut costs, increase cash flow and seek alternative funding sources, Ward Lumber I defaulted on its loan covenants. Although Ward Lumber I was current with its payments, Ward Lumber I failed to meet minimum financial requirements respecting its profitability, stockholder equity and debt service coverage ratio.

Rather than immediately triggering an acceleration of payments under its loan terms, NBT continued to work with Ward Lumber I and waived Ward Lumber I's noncompliance for fiscal years ended December 31, 2000 and 2001. However, NBT's willingness to continue its lending relationship with Ward Lumber I resulted in increased restrictions and fees. For instance, NBT required unlimited personal guarantees of Jay and Jeff Ward in March 2001, and increased the interest rate on Ward Lumber I's \$3.3 million line of credit from prime minus a quarter to prime plus a quarter. Furthermore, NBT declined to re-amortize the Band Saw Loan over a ten-year period due to a lack of available unencumbered real estate for additional collateral.

In 2001, Ward Lumber I's shareholders determined to reorganize into a new Delaware corporation. The shareholders formed a corporation in Delaware known as "Glen Road Lumber, Inc.," which later changed its name to "Ward Lumber Company, Inc." upon the dissolution of Ward Lumber I in New York. Procedurally, the following events took place to create petitioner, and to allow petitioner to carry on Ward Lumber I's business:

- a. On December 14, 2001, the Certificate of Incorporation of petitioner under the original name, Glen Road Lumber, Inc., was filed with the Secretary of State of Delaware.
- b. On December 21, 2001, the Application for Authority of Glen Road Lumber, Inc., to do business in the State of New York as a foreign corporation was filed with the New York State Department of State.
- c. On December 26, 2001, the Certificate of Ownership and Merger of Ward Lumber I (a New York corporation) into Glen Road Lumber, Inc. (a Delaware corporation) pursuant to sections 253 and 103 of the Delaware General Corporation Law was filed with the Secretary of State of the State of Delaware to actualize the merger of Ward Lumber I and petitioner, effective December 31, 2001, as set forth in a Plan of Merger and Reorganization of the aforementioned entities adopted pursuant to sections 905 and 907(c) of the New York Business Corporation Law, and authorized by unanimous written consent of the board of directors and all shareholders of Ward Lumber I and petitioner on December 4, 2001.
- d. On December 31, 2001, a similar Certificate of Merger of Ward Lumber I (a New York corporation) into Glen Road Lumber, Inc. (a Delaware corporation), pursuant to section 907 of the New York Business Corporation was filed with the New York State Department of State.
- e. On January 10, 2002, a Certificate of Amendment of the Application for Authority of Glen Road Lumber, Inc., was filed with the New York State Department of State to amend the name of the corporation stated in paragraph 1 to “Ward Lumber Company, Inc.,” as effectuated by the change of the true corporate name under the laws of the State

of Delaware on December 31, 2001.

f. On January 15, 2002, a Certificate of Assumed Name of Ward Lumber Company, Inc., was filed with the New York State Department of State to allow the corporation to operate under the assumed name of “Ward Lumber” in the counties of Clinton, Essex and Franklin.

The shareholders of Ward Lumber I and petitioner were the same before and after the merger, and each maintained their percentages of ownership.

Thereafter, petitioner was certified under Article 18-B of the General Municipal Law as a Qualified Empire Zone Enterprise (QEZE) in Essex County on March 2, 2002, and in Franklin County on December 30, 2003.

In 2001, petitioner, in the name of “Glen Road Lumber, Inc.,” had filed a general business corporation franchise tax return, Form CT-4, and a U.S. corporation short-form income tax return, Form 1120-A. The affirmation attached to Form 1120-A included a statement given under penalty of perjury and signed by Jeff Ward that stated:

The purpose of the reorganization was to create a new corporation which would be eligible for economic development incentives and benefits under state law as a certified business in a local economic development zone. These economic development incentives and benefits are of substantial economic and business value to the corporation.

The Form CT-4, Form 1120-A and the attached affirmation were prepared by petitioner’s accountant, Arthur Place & Company, P.C., and signed by Jeff Ward. In general, Jay Ward is the company officer who typically reviews and signs tax returns on behalf of petitioner, but he relies heavily on petitioner’s accountant to prepare all tax returns.

Prior to the merger in December 2001, Ward Lumber I had an overall loss of at least \$700,000.00. After the merger in 2002, the yield from the band saw installation increased from

approximately two to three percent to twelve percent, contributing to petitioner's reduction of its overall loss to \$350,000.00. Petitioner began to turn its financial condition around and realized a \$127,000.00 profit in 2003, and an \$829,000.00 profit in 2004. The increase in profits after the merger and the closure of petitioner's component plant afforded the start-up of a livestock equipment company.

Due to positive improvements in petitioner's financial condition, NBT continued the extension of petitioner's \$3.3 million revolving line of credit, including a temporary increase of \$300,000.00 until August 31, 2002. The temporary increase of the line of credit to \$3.6 million required personal limited guarantees of retired shareholders Sidney Ward, Jr. and Janet Ward up to \$500,000.00. Such guarantees were released after petitioner was able to pay off an additional \$500,000.00 in the summer of 2002. Other contributing factors to petitioner's improved financial condition after the merger included cost-reducing initiatives taken by management to address NBT's concerns, as well as receipt of Empire Zone benefits in the amount of \$180,000.00 over a three-year period, from 2002 to 2004.<sup>3</sup>

For each of the applicable tax years 2005, 2006 and 2007, petitioner filed a Form CT-3, general business corporation franchise tax return. The returns were prepared by petitioner's accountant, Arthur Place & Company, P.C. Included with the returns were claims for Empire Zone tax reduction credits, Form CT-604, and claims for Empire Zone real property tax credits, Form CT-606. For the applicable tax years, petitioner claimed the following amounts as Empire Zone tax reduction credits: \$312.00 in 2005; \$538.00 in 2006; and \$138.00 in 2007. For the

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<sup>3</sup> 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 these credits generally as the Empire Zone benefits or Empire Zone tax credits.

applicable tax years, petitioner claimed the following amounts as Empire Zone real property tax credits: \$61,408.00 in 2005; \$69,502.00 in 2006; and \$65,681.00 in 2007.

Attached to the CT-604 and CT-606 forms for tax years 2005, 2006 and 2007 was a Schedule G Statement outlining, in general, the multiple reasons claimed for the formation of petitioner in 2001, and asserting that petitioner “was formed for valid business purposes” and “was not formed solely to gain Empire Zone benefits.”

The Schedule G Statement filed for the years 2005, 2006 and 2007 stated that Ward Lumber I had lost approximately \$1,500,000.00 in 2000 and 2001, due in part to competition and outdated equipment. The statement indicated that Ward Lumber I’s lending institution had raised the possibility of shutting down the saw mill and liquidating the operations. Ward Lumber I was in breach of covenants under the loan documents, and the risk level with respect to the loans had drawn review and oversight by the bank’s credit committee and the U.S. Office of the Comptroller of the Currency. According to the statement, Ward Lumber I was faced with three choices: shut down and lay off its employees; build a new mill for over \$10,000,000.00; or develop a plan acceptable to the bank (from which forbearance and additional funds would be needed) to retool the existing facility over time to enable it to compete with the Canadian mills.

The statement further explained that the ESDC, the Essex and Franklin County IDAs and NBT developed a plan that would enable Ward Lumber I to survive and continue its employment, including a staged upgrade of the facility. According to the statement:

ESDC proposed economic development benefits to assist with the re-tooling of the facility, including a grant for the acquisition of a band saw and certain Empire Zone benefits. These Empire Zone benefits would provide needed cash flow to convince forbearance by the bank and additional lending by the bank. In order to remain in business, the business needed an extension of credit from the bank in the approximate amount of \$500,000 to maintain working capital. The

bank was willing to lend this money in the event that additional cash flow was made available by reason of the merger into Ward Lumber Company, Inc. Because of the merger into Ward Lumber Company, Inc., and in reliance on ESDC's recommendations, the bank extended an additional \$500,000 on a line of credit to keep the business operating, helped finance (together with an ESDC grant) the acquisition of the band saw, and financed subsequent upgrades. These improvements have increased the facility's yield by 12% and have allowed the facility to remain in operation. Without the merger, these funds would not have been available and the business would have shut down.

Based upon this recommended course of action from ESDC, the use of a merger into a new corporation was examined by the business. At that time, the business was in the midst of succession planning. Because of the advantages of Delaware law with respect to management, franchise taxes and the elimination of certain liabilities if a merger into a Delaware corporation occurred, a decision was made to merge the Predecessor Corporation [Ward Lumber I], a New York corporation, into a new Delaware corporation, Ward Lumber Company, Inc. [petitioner]. Delaware law afforded a better legal structure for the relationship of the shareholders and management through a transition in ownership and management personnel, and allowed for the isolation of certain liabilities.

Because of the merger into Ward Lumber Company, Inc. [petitioner], the business has returned to modest profitability, avoided a shutdown and liquidation by its lender, and maintained its employment of over 100 employees. Ward Lumber Company, Inc. [petitioner], was formed, based upon advice and guidance from ESDC, to reassure the bank of the future prospects of the business, provide additional cash flow available to a lender, and to obtain needed funds from the bank for an upgrade of the facilities. Ward Lumber Company, Inc. [petitioner] was not formed solely to obtain Empire Zone benefits.

The Schedule G Statement was signed by Jay Ward.

The Division of Taxation (Division) initially undertook a desk audit of petitioner for the tax year 2005. The auditor sent a letter, dated August 28, 2007, to the attention of petitioner's accounting manager informing her of the 2005 amendments to the Empire Zones Program made by chapters 63 and 161 of the Laws of 2005, which, in part, extended, amended and added new provisions relating to the Empire Zones Program Act, including the additional employment test for a business enterprise first certified prior to August 1, 2002.



The August 28, 2007 letter also included a definition of a “valid business purpose” and requested certain documentation from petitioner, which included, among other things: all correspondence between Ward Lumber I, ESDC and NBT Bank in support of the statements in the Schedule G Statement; a copy of the pre-merger plan and all correspondence among Ward Lumber I, ESDC and NBT Bank; documentation from petitioner and NBT Bank respecting an additional \$500,000.00 line of credit extended to petitioner; documentation respecting ESDC’s recommendations in support of the \$500,000.00 line of credit; all documentation dated prior to the merger respecting the decision to reincorporate in Delaware including all board of directors minutes that pertain to the reorganization; and documentation respecting any additional benefits, aside from Empire Zone incentives and benefits, expected to be derived from the merger/reorganization.

By letter dated December 11, 2007, petitioner, through its attorneys, responded to the auditor’s letter, including a number of attachments. The Division responded that although petitioner’s response was “somewhat voluminous,” it was inadequate and did not substantiate the claim that petitioner was formed for a valid business purpose and not solely to gain Empire Zone tax credits. The auditor sent an additional letter dated January 25, 2008 seeking further clarification and documentation from petitioner.

Petitioner, again through its attorneys, responded to the auditor’s second request for information by letter dated February 12, 2008. Petitioner’s second response declined to provide any of the additional documentation that the auditor requested, claiming that the detailed response of December 11, 2007 and the numerous documents provided therein were more than adequate to establish that petitioner was formed for various valid business purposes.

In response, the Division denied petitioner certain Empire Zone tax benefits beginning in 2005 on the basis that petitioner did not have a valid business purpose. Specifically, by letter dated May 8, 2008, the Division disallowed \$61,720.00 in Empire Zone real property tax credits and Empire Zone tax reduction credits claimed by petitioner in 2005 and \$70,040.00 in Empire Zone real property tax credits and Empire Zone tax reduction credits claimed by petitioner in 2006. In addition, by letter dated April 14, 2009, the Division disallowed \$65,819.00 in Empire Zone real property tax credits and Empire Zone tax reduction credits claimed by petitioner in 2007.

***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 petitioner had zero employees in their base period and were established and entitled to receive Empire Zone benefits prior to August 1, 2002 and subject to Tax Law § 14 (b) (1). As such, the Administrative Law Judge held that, in order for petitioner 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 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). 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 rejected petitioner's interpretation of Tax Law § 14 (j) (4) (B). Petitioner 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 affect to all of the words in the statute. In addition, the Administrative Law Judge noted that petitioner's interpretation contradicts statutory maxims by shifting the burden onto the Division.

The Administrative Law Judge determined that petitioner failed to meet its burden of proving the requirements under Tax Law § 14 (j) (4) (B). The Administrative Law Judge found that petitioner was in a dire financial situation in 2001 and needed a forbearance and credit from its bank, NBT, in order to survive. The Administrative Law Judge determined the petitioner reorganized solely for Empire Zone benefits, because such benefits were used to induce NBT to extend additional credit to petitioner. Accordingly, the Administrative Law Judge concluded that petitioner could not be considered a new business because it failed the test under Tax Law § 14 (j) (4) (B), as it did not have a non-tax primary motivation for its reorganization.

#### ***ARGUMENTS ON EXCEPTION***

In its exception, petitioner argues that the determination should be reversed because the Administrative Law Judge misapprehended facts and applied the incorrect legal standard. As a new argument, petitioner argues that we should consider the constitutionality of Tax Law § 14

(b) (1) and Tax Law § 14 (j) (4) (B) as-applied because, petitioner contends that these statutes are being applied retroactively.

Petitioner contends that the Administrative Law Judge incorrectly concluded that the Empire Zone benefits served as the primary motivation for the subject business activity. Citing to the record, petitioner contends that both testimony and contemporaneous documentation indicate that its business needed the additional credit and forbearance in order to survive. It contends that the acquisition of credit from NBT served as the primary motivation for the subject business activity. Petitioner contends that under these particular circumstances, we should consider the survival of the business as the primary motivation. Petitioner also raises the benefits of incorporating in Delaware as additional grounds for the reorganization.

Petitioner also contends that the Administrative Law Judge erroneously rejected its interpretation of Tax Law § 14 (j) (4) (B). It does not dispute that there are two parts to the test under this statute. Rather, petitioner condenses the language and argues 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 petitioner's 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. Petitioner argues that the interpretation adopted by the Administrative Law Judge lacks clarity and established a standard that is incongruous with the meaning of the statute.

At oral argument and in its post-oral argument submission, petitioner argues that a different standard of review should apply to this case. Relying primarily on *James Sq. Assoc.*

*LP v Mullen* (91 AD3d 164 [2011]), petitioner makes two contentions. Petitioner contends that the burden of proof should be lowered because Empire Zone benefits resemble contracts, as opposed to typical exemptions from taxation. Additionally, petitioner analogizes the instant facts to *James Sq.*, raising concerns about the retroactivity of Tax Law § 14 (j) (4) (B) that challenge the constitutionality of the statute as-applied to petitioner.

The Division argues that the Administrative Law Judge properly determined that petitioner cannot be considered a new business because it fails the test under Tax Law § 14 (j) (4) (B). In support of its position, the Division cites to the Administrative Law Judge's conclusion that the reorganization itself provided no significant benefits apart from Empire Zone benefits. Citing to the record, the Division argues that the sole purpose of petitioner's reorganization was to acquire the Empire Zone benefits to improve petitioner's financial stability. The Division also argues that petitioner's interpretation was properly rejected because it fails to give effect to the statutory language.

The Division's post-oral argument is that *James Sq.* does not apply because the Court did not alter the burden of proof and because the statutes at issue did not eliminate tax credits for prior years.

### ***OPINION***

The instant matter presents the question of whether petitioner was entitled to the Empire Zone tax credits for the years at issue.

Initially, we note that the legal issues are similar to those raised in *Matter of Dunk & Bright Furniture Co.* (Tax Appeals Tribunal, June 28, 2012). As in that case, the Division denied petitioner's Empire Zone tax credits because it determined that petitioner did not pass the

“new business” test, particularly Tax Law § 14 (j) (4) (B). Along with Tax Law § 14 (b) (1), these amendments were designed to combat “shirt changing,” a practice by which businesses reorganize to create the illusion of jobs and acquire Empire Zone benefits.

We now turn to the instant matter. As amended by the Laws of 2005, Tax Law § 14 (b) (1) provides 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.”

Petitioner was formed on December 14, 2001, and was certified to receive Empire Zone benefits prior to August 1, 2002. Petitioner had zero employees in its base period. Therefore, petitioner can only meet the employment test, thereby retaining its Qualified Empire Zone Enterprise (QEZE) status and Empire Zone tax credits, if it meets the new business test.

The instant controversy centers around the provisions of Tax Law § 14 (j) (4) (B). This portion of the new business test 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.”

On exception, petitioner argues that the statute provides that an entity may not be denied new business status if it meets either the valid business purpose test or was not formed solely to gain Empire Zone benefits. This is the same argument presented by the taxpayers in *Matter of Dunk & Bright Furniture Co.* (Tax Appeals Tribunal, June 28, 2012). As in that case, herein, petitioner failed to establish that the Division’s interpretation was unreasonable or that its interpretation was 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]). Accordingly, we conclude that the Administrative Law Judge properly rejected petitioner's interpretation of Tax Law § 14 (j) (4) (B).

We reiterate that Tax Law § 14 (j) (4) (B) presents a twofold test, which can only be satisfied when an entity establishes 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 test under Tax Law § 14 (j) (4) (B), we now turn to the question of whether petitioner has satisfied both parts of the test. We first address the “valid business purpose” requirement.

Tax Law § 14 (j) (4) (B) requires that an entity establish that it was formed for a valid business purpose. Under the new business test, the definition of a valid business 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, served as the “primary motivation” for the subject business activity; and,

(2) that the subject activity “meaningfully” changed 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 (*Matter of Graphite Metallizing Holdings*, Tax Appeals Tribunal, July 7, 2011).<sup>4</sup> 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], *affd* 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” (*Id.* at 469; *see also In re CM 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.”

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. v US*, 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.

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<sup>4</sup> We note, as did the District Court in *Long Term Capital Holdings v US* (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.



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, the question in this test is:

“[p]utting 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 turn to subject events.

The record establishes that in 2001, the survival of Ward Lumber I was in serious jeopardy. Due to a variety of factors, including outdated facilities and market forces, the company was suffering from severe losses, particularly in its lumber manufacturing division. The losses caused Ward Lumber I to miss the profitability-related covenants in its borrowing agreement with NBT, its primary creditor. Due to the poor performance, the bank’s regulators downgraded Ward Lumber I’s loan rating from an “A” to a “C.” These factors caused concern on the part of NBT, and the bank refused to extend credit to Ward Lumber I without changes to its operations.

Ward Lumber I was facing certain financial doom. Its advisors considered several options, including separating the profitable building materials division from the suffering manufacturing division, and shutting down the lumber mill altogether. The record indicates that Ward Lumber I was, and remains, one of the largest employers in northern New York and that if the mill were to close, more than a hundred jobs would be lost. Several government entities

became involved and formed a task force to try to save Ward Lumber I. These organizations included the ESDC, Essex County IDA, NYSERDA, and the local representatives from the Empire Zones Program. These entities acted in concert in order to provide Ward Lumber I, in part, with the additional credit it needed to survive.

The plan that ultimately saved Ward Lumber I resulted from a public-private partnership. Ward Lumber I underwent significant changes to avoid significant layoffs and continue its operations, including management taking pay cuts, altering work hours, and changing business practices. ESDC provided an immediate grant to the company. NYSERDA provided an Energy “Smart Loan” in the amount of \$350,000.00. Further, the Empire Zones Program provided tax relief in the amount of \$180,000.00 from the period 2002 through 2004. However, the key component to this plan was an additional infusion of credit in the amount of \$500,00.00. NBT was willing to extend this credit, in part based on the stability achieved by the foregoing government programs and operational changes. As a result of this public-private partnership, Ward Lumber I was able to reconfigure through petitioner, and become profitable.

We first consider whether the Administrative Law Judge utilized the proper scope of valid business purpose inquiry. In determining that petitioner failed the “primary motivation” component, the Administrative Law Judge focused exclusively on testimony and the statement attached to petitioner’s 2001 Form 1120-A. This contemporaneous evidence indicates that a purpose of the reorganization was the acquisition of economic incentives, *to wit*, Empire Zone benefits. Viewed in isolation, this evidence may well support the denial of Empire Zone benefits, because the business activity appears to be “shirt changing” (*see e.g. Dunk & Bright Furniture Co.*, Tax Appeals Tribunal, June 28, 2012 [wherein the only contemporaneous

documentation was a similar statement])). However, in the instant matter, petitioner submitted other contemporaneous evidence, including bank and task force documents, which provide a far different picture of the subject reorganization.

We reverse the determination because the Administrative Law Judge erred by viewing the reorganization in isolation as opposed to part of a larger plan.

Herein, the record establishes that the reorganization served as a component of a larger plan to save Ward Lumber I. The ESDC grant, the NYSERDA loan, the NBT extension of credit, and the reorganization leading to Empire Zone benefits should be considered together because they served as “components of an overall plan” (*Greene v US*, 13 F3d 577, 583 [1994]). The contemporaneous bank and task force documents unequivocally indicate an overall plan to save the business of Ward Lumber I. We note, that the record shows that the transacting parties each had a stake in saving the business, including avoiding layoffs of over one hundred workers. By submitting this documentation, petitioner met its burden of showing “proof of an agreement or understanding between the transacting parties to bring about the ultimate result” (*Long Term Capital Holdings v US*, 330 F Supp 2d 122, 191 [2004], *affd* 150 Fed Appx 40 [2005]). In the context of the Empire Zones Program and under these particular facts, we conclude that it is appropriate to consider the entire plan for purposes of the valid business purpose test.

We find that petitioner has met its burden of proving that a variety of business purposes motivated the plan, of which the reorganization was a part. The record identifies the primary motivation for the plan as the acquisition of a credit extension from NBT. In particular, the task force minutes and bank documents indicate that Ward Lumber I needed this credit so that it could survive its short term financial difficulties and have an opportunity for longer term success

through upgrading facilities. The NYSERDA loan, the ESDC grant, and the Empire Zone benefits helped induce the credit extension. The record indicates that the operational changes, the capitalization, plus Ward Lumber I becoming a new entity with a new credit history, induced NBT's extension of the \$500,000.00 credit line that petitioner so desperately needed. We find that it is more accurate to view the operational changes, as well as the loan, grant, Empire Zone tax benefits, and the creation of a new entity, as ancillary steps towards saving the business of Ward Lumber I by acquiring the \$500,000.00 credit extension from NBT. Under these particular circumstances, we conclude that the reorganization was a step in a plan that was motivated by various non-tax purposes, as required under the "primary motivation" prong of Tax Law § 208 (9) (o) (1) (D).

We find that petitioner is not the same business that entered into the reorganization. Prior to the plan, Ward Lumber I was facing rapidly declining profits and almost certain insolvency. The plan, which included the reorganization into petitioner, resulted in a new entity for credit ratings, which helped secure a number of financial incentives from various entities including a significant line of credit from NBT. In the long term, the credit provided by the plan permitted significant upgrades to petitioner's facilities, which allowed it to improve efficiency and enter new markets, which resulted in a new, profitable business. We further note that the record indicates that NBT was repaid and that few, if any, jobs were lost as a result of the crisis. We find that petitioner has met its burden of proving that the plan, of which reorganization was a part, meaningfully and materially changed its operations and economic position. Having found that petitioner met both elements of Tax Law § 208 (9) (o) (1) (D), we conclude that petitioner has met its burden of establishing a valid business purpose under Tax Law § 14 (j) (4) (B).

In light of the foregoing discussion, we find that petitioner has proven that Empire Zone benefits were not the sole purpose for its formation. Accordingly, we find that petitioner has met its burdens under Tax Law § 14 (j) (4) (B) and passes the employment test required for the new business designation under Tax Law § 14 (b) (1).

We find the position of the Division and the pursuit of this case by its Audit Department to be inappropriate because the legislative goals of the Empire Zones Program are so clearly met. The purpose of the Empire Zones Program is “to stimulate private investment, private business development and job creation” (General Municipal Law § 956). The record indicates that the Empire Zone benefits served as part of a public-private plan that, in essence brought forth a new private business that saved a significant number of jobs in the northern New York region. However, herein, the Division seeks to deny the Empire Zone benefits by extracting out a single aspect of a plan in isolation and irrespective of the overall plan. In construing the “shirt changing” provisions of Tax Law § 14 (j) (4) (B) against petitioner, the Division seeks a rule that is clearly “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]).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Ward Lumber Co., Inc., is granted;
2. The determination of the Administrative Law Judge is reversed;
3. The petitions of Ward Lumber Co., Inc., are granted; and
4. The Division of Taxation is ordered to retract its letters of denial, dated May 8, 2008,

and April 14, 2009, and the Division of Taxation is further ordered to grant the credits at issue to petitioner.

DATED: Albany, New York  
July 10, 2012

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

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