

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
GRAPHITE METALLIZING HOLDINGS, INC. : DETERMINATION
for Redetermination of a Deficiency or for Refund of : DTA NO. 822416
Corporation Franchise Tax under Article 9-A of the Tax :
Law for the Year 2005. :

Petitioner, Graphite Metallizing Holdings, Inc., filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the year 2005.

A hearing was held before Brian L. Friedman, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on June 17, 2009, at 10:30 A.M., with all briefs to be submitted by November 20, 2009, which date began the six-month period for the issuance of this determination. Petitioner appeared by Stuart S. Stengel, Esq. The Division of Taxation appeared by Daniel Smirlock, Esq. (Clifford M. Peterson, Esq., of counsel).

ISSUE

Whether the Division of Taxation properly denied petitioner's claim for a refund of the qualified empire zone enterprise credit 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

Along with its brief, the Division of Taxation (Division) submitted 40 proposed findings of fact, each of which has been incorporated¹ into the following Findings of Fact except: proposed findings of fact 14 and 38 which are irrelevant; the last five sentences of proposed finding of fact 20 which are excluded since they are based upon a hypothetical example; and the sentence beginning with “The minutes contain no basis” in proposed finding of fact 23 and the second sentence in proposed finding of fact 30 which are conclusory in nature.

1. Petitioner, Graphite Metallizing Holdings, Inc. (GMHI), originally incorporated in the State of Delaware on December 4, 1915 under the name Graphite Metallizing Corporation (GMC 1), became authorized to do business in New York later in the same year. GMC 1 manufactured graphite alloy bushings, brushes, bearings and slip rings which are used as machine components.

2. On June 28, 1988, the real property of GMC 1 was designated into the Yonkers Empire Zone.

3. On May 18, 1995, the City of Yonkers Enterprise Zone certified GMC 1 as an empire zone enterprise under Article 18-b of the General Municipal Law.

4. Dean M. Hottle, a CPA with a masters degree in taxation, joined the accounting and consulting firm BDO Seidman, LLP (BDO Seidman) in June 1997. GMC 1 became a client of BDO Seidman in the fall of 1997.

In December 1997, GMC 1 was looking at a potential acquisition and asked BDO Seidman to comment on the method for making the acquisition. Mr. Hottle researched the issue and

¹ Before being incorporated into the Findings of Fact, some of the proposed findings of fact were summarized.

drafted a memo to GMC 1 advising the company on the various methods (taxable and nontaxable) for acquiring the other company. This memo was sent to GMC 1 by BDO Seidman on February 17, 1998.

GMC 1 makes graphite bearings that are inserted into molten metal parts which Mr. Hottle described as a “dirty, dusty business” with the potential for someone to sustain a significant injury. Accordingly, Mr. Nottle recommended a consolidation to GMC 1 because of the potential for injury and also because of the environmental concerns. The consolidation involved the adoption of a holding company with the operating companies reporting to the holding company. The advantage to the consolidation structure was that multiple companies, each separate from the others, could be acquired under the holding company, and any significant financial problems of one company would not affect the others. On the other hand, with a “vertical structure,” the problems of the parent operating company would affect all of the other companies underneath it.

BDO Seidman also discussed with GMC 1 the option of forming a limited liability corporation, or LLC. On March 2, 1998, BDO Seidman sent a memo to GMC 1 which outlined the advantages and disadvantages of an LLC. Several meetings were held to discuss the different structures; the QEZE program and tax credits resulting therefrom were never discussed at that time. BDO Seidman recommended the holding company structure.

5. The minutes of meetings of the directors of GMC 1 from March 11, 1998 and May 20, 1998 reveal that there were discussions of various aspects pertaining to a proposed acquisition and at the meeting of May 20, 1998, Mr. Eben T. Walker, president of GMC 1, asked for an opinion on setting up a “completely separate entity.” At a stockholders meeting held on May 20, 1998, the minutes contained a President’s Report which stated, in part, as follows:

The coming year will be an even more exciting one with the possibility of tripling our sales volume through the acquisition of a company in a similar business. This acquisition, which is in the due diligence phase, will broaden our product coverage and eventually will increase the stability of our business. In the short term, this acquisition will increase the risk to our shareholders, but we believe that in the long term these risks are worthwhile.

6. At a special stockholders meeting of GMC 1 held on June 16, 1998, a restructuring of GMC 1 was discussed and a resolution was approved authorizing the directors to form subsidiaries, a holding company or a separate company “to best complete any approved acquisition.” The minutes of this meeting contain no mention of QEZE tax credits.

7. The minutes of a meeting of the directors of GMC 1 held on December 14, 1998, under the category “Environmental” contains a table showing progress made in recycling the company’s waste. In addition, under the category “Legal” was a discussion of legal issues arising from GMC 1’s use of the Croton Point Landfill.

8. The minutes from meetings of the directors of GMC 1 held on March 16, 1999, December 15, 1999 and May 23, 2000 contain references to discussions of GMC 1’s potential liability at the Croton Point Landfill and discussions of the direction of GMC 1’s future acquisitions.

9. GMC 1 did not make any changes to its corporate structure immediately. In January 1999, GMC 1 purchased a company known as Graphel, which is located in Cincinnati, Ohio.

By a letter to Louis A. Fenderk, Senior Vice President of KeyBank National Association, dated July 17, 2000, Joseph T. Murphy, Vice President and Treasurer of GMC 1, sought a loan for the “buy out of a leading manufacturer of specialty graphite.” Mr. Murphy described the potential acquisition by stating that it would “expand our presence in the graphite industry and help protect our current position with the target [of the acquisition] as a key customer of GMC

[1] and a key vendor for Graphel. Shortly thereafter, the company that GMC 1 was considering acquiring, Poco, was purchased by another company (GMC 1 was outbid by \$2 million). In July 2002, GMC 1 did reorganize, following the consolidation pattern layed out in the BDO Seidman memo of February 17, 1998. By the time of the reorganization, Mr. Hottle was no longer in the employ of BDO Seidman.

10. On July 31, 2002, a subsidiary of GMC 1, known as Graphite Metallizing (New York), Inc., was incorporated in the State of New York. On December 3, 2002, Graphite Metallizing (New York), Inc., was certified under Article 18-b of the General Municipal Law as an empire zone enterprise retroactive to July 31, 2002. After July 31, 2002, GMC 1 began operating as a holding company while Graphite Metallizing (New York), Inc., conducted the manufacturing business. Graphite Metallizing (New York), Inc., continued GMC 1's former business activities using the same assets and location with essentially the same workforce.

10. On December 20, 2002, GMC 1 conveyed its real property to its subsidiary, Graphite Metallizing (New York), Inc.

12. On April 18, 2003, GMC 1 which, as noted in Findings of Fact 1 and 3, was known by the corporate name of Graphite Metallizing Corporation since 1915, changed its name to Graphite Metallizing Holding Corporation and the name of Graphite Metallizing (New York), Inc., was changed to Graphite Metallizing Corporation (GMC 2).

13. On June 1, 2003, Graphite Metallizing Holding Corporation transferred to GMC 2 its cash, accounts receivable, prepaid expenses, inventory, machinery and equipment, investments in securities and other receivables and liabilities in exchange for the stock of GMC 2 pursuant to Internal Revenue Code (IRC) § 351.

14. On June 13, 2003, Graphite Metallizing Holding Corporation changed its name to Graphite Metallizing Holdings, Inc. (GMHI).

15. Beginning with the year 2003, GMHI and GMC 2 reported their tax liability in New York by filing combined returns.

16. For the year 2005, GMHI and GMC 2 filed a form CT-3-A, General Business Corporation Combined Franchise Tax Return.² Along with the CT-3-A, GMHI also filed a form CT-606, Claim for QEZE [Qualified Empire Zone Enterprise] Credit for Real Property Taxes, on which a credit in the amount of \$106,606.00 was claimed.

On line 100a of the form CT-3-A, entitled "Refund of unused tax credits," GMHI claimed a refund of \$140,169.00, which amount included the \$106,606.00 in unused QEZE credit for real property taxes (RPTC). GMHI also claimed an EZ investment tax credit and an EZ wage tax credit, neither of which is at issue in this proceeding.

17. In early 2007, the Division began a review of petitioner's refund claims for the tax credits claimed on the return filed for the 2005 tax year. GMHI (formerly Graphite Metallizing Corporation) became certified in the Yonkers Empire Zone in 1994. Pursuant to Tax Law § 14(e), (d) and (c)(1), respectively, GMHI's test date for QEZE credits is July 1, 2000, its test year is the taxable year ended December 31, 1999, and its base period consists of the calendar years 1994 through 1998.

18. QEZE real property tax credits were allowed to GMHI for the years 2003 and 2004 based upon GMC 2's qualifications. However, changes to the Tax Law effective for years

² GMHI, formerly Graphite Metallizing Corporation, had filed general business corporation franchise tax returns on a separate basis through the 2002 calendar year.

beginning on or after January 1, 2005 required the Division to reexamine GMC 2's qualifications to claim the RPTC for the 2005 tax year.

One of the consequences of the 2005 amendments to the Empire Zones Program made by chapters 63 and 161 of the Laws of 2005 was that a business enterprise that was first certified in an Empire Zone prior to August 1, 2002 and had a base period of zero years or zero employment in the base period was subject to an amended employment test. GMC 2 was certified eligible to receive Empire Zone benefits effective July 31, 2002,³ had zero employees in its base period and its average employment number for its test year (2001) was zero.

In addition, since GMC 2 was making the same products, using the same facilities at the same location under the same management and with the same employees as had GMHI, the Division determined that GMC 2 was substantially similar in operation and ownership to a business entity taxable or previously taxable under Article 9-A of the Tax Law. Accordingly, GMC 2 could not be deemed a new business if it was not formed for a valid business purpose, as defined in Tax Law § 208(9)(o)(1)(D), but solely to gain empire zone benefits.

19. During the audit, the Division determined that during the first half of 2003, GMHI discharged five employees and transferred the balance of its employees to GMC 2.

20. Absent its proving that it was formed for a valid business purpose and not solely to gain empire zone benefits, GMC 2, in order to qualify for the real property tax credit for the 2005 tax year, would have had to significantly increase its employment within the Empire Zone. If it had claimed the real property tax credit for the 2005 tax year, GMC 2's average number of

³ GMC was certified in the Yonkers Empire Zone on December 3, 2002, retroactively effective to July 31, 2002.

employees for what would have been its test year, 1999, would have been 56.75 while its average employment number for the 2005 tax year would have been 44.75.

21. As noted in Finding of Fact 18, the Division, having determined that GMC 2 was subject to the amended employment test, examined whether it was formed for a valid business purpose under the Tax Law.

The Division examined the form CT-3-A for the 2005 tax year. Attached to the tax form was a notarized statement from Joseph T. Murphy, Vice President and Treasurer of GMHI. Mr. Murphy stated that GMHI and affiliates entered into a QEZE “for the valid business purpose of achieving cost certainty and facilitating growth in the economic downturn after the September 11, 2001 terrorist attacks.” He further stated that because there was no economic recovery in sight in early 2002, there were two options for the continuance of GMHI’s business in New York: (1) to relocate to Ohio where GMHI’s subsidiary operated in a significantly lower cost jurisdiction; or (2) to restructure the New York operation “to contain costs and assist in the managing, financing and assimilating of new business.” Mr. Murphy indicated that choosing the second option “allowed us to remain in Yonkers and also provided the advantage of utilizing QEZE benefits.”

Mr. Murphy’s statement included no mention of the following reasons for creating a subsidiary: (1) environmental concerns; (2) protection of GMHI from liability issues arising from the Croton Point Landfill; (3) isolation of the Yonkers and Ohio businesses from each other’s debt or financial losses; (4) providing a structure to allow for the divestment of one of the companies; and (5) delineating banking relationships among companies.

22. By letter dated January 22, 2007, the auditor requested certain documentation from GMHI, which included, among other things:

a. Referring to Joseph T. Murphy's notarized statement attached to the form CT-3-A, an explanation as to how the reorganization with a newly formed GMC 2 "served to contain costs and assist in the managing, financing, and assimilating of new business."

b. An explanation as to "what part QEZE benefits [played] in restructuring the New York operation.

c. An explanation as to how GMC 2's stated business purpose has changed the economic position of GMC 2 and GMHI in a meaningful way.

d. A copy of the board of directors minutes that "pertain to setting up GMC [2] as a QEZE" and "copies of the Board of Directors minutes for all meetings pertaining to the operation of GMC[2] as a QEZE enterprise since its inception."

e. Copies of "all internal memos, emails, and other documentation that pertain to the restructuring of the New York operation."

f. Copies of "all correspondence with consultants, representatives or outside third parties who advised [GMHI] about restructuring the New York operation. Include all correspondence that alleges inadequacies of the former business structure which gave rise to the need for a separate legal entity to hold the real property."

g. A copy of the Articles of Incorporation of GMC 2.

23. By a letter dated April 17, 2007, Mr. Murphy responded to the auditor's letter. Along with the letter, Mr. Murphy included a number of attachments. In response to the auditor's request, Mr. Murphy's letter set forth an explanation for the reorganization, which stated, in part, as follows:

In early 2002, there was no normal economic recovery in sight. There seemed to be three obvious options. One would be to consolidate the two locations to reduce direct and indirect costs under existing ownership.

Since Yonkers was not a viable option, Ohio, with more than twice as many employees, would be the natural first choice. The second option was to sell the Yonkers business to a company that could achieve economies of scale to offset the economic downturn, but this again would mean closure of the Yonkers plant and moving out of NYS. The third option would be to make changes in both operations to increase sales and lower costs. In any case, we needed a legal and reporting structure that would allow us to better focus on, evaluate and manage the two locations as independent businesses more effectively. It should also facilitate oversight of future acquisitions and divestitures.

* * *

Furthermore, our outside legal and audit/tax firms advised us that the establishment of a holding company structure would best meet our organizational and reporting needs and allow us to manage current and future separate businesses as a portfolio of investments.

At that time, we were advised that there was also the opportunity to not only achieve the organizational benefits of a holding company structure, but also reduce labor & overhead costs in Yonkers by establishing a QEZE company with related personnel & property tax benefits. Thus the QEZE benefits were a secondary benefit and not the primary reason for the reorganization.

24. In his letter dated April 17, 2007, Mr. Murphy did not identify environmental concerns as a business purpose for the creation of GMC 2. He did not identify the protection of GMHI from liabilities posed by the Croton landfill as a business purpose for the creation of GMC 2. He did not address the need to create GMC 2 to isolate the Yonkers and Ohio companies from each other's debts and financial losses and did not speak to GMHI's concern that without creating a subsidiary, banks could cross collateralize the assets of the Yonkers and Ohio businesses.

25. In response to the auditor's requests set forth in her letter of January 22, 2007, Mr. Murphy provided, amongst other documents, the following:

a. Copies of board of directors' minutes relating to setting up GMC 2 and to the subsequent operation of GMC 2. There were minutes from 20 meetings of the boards of GMHI and GMC 2 from September 18, 2001 until April 24, 2006; and

b. Copies of correspondence from BDO Seidman from July 30, 2002 through June 10, 2003. According to Mr. Murphy's April 17, 2007 letter, the BDO correspondence "supports the premise that our primary emphasis was on developing an organizational structure for the future and a byproduct was the QEZE benefits which allowed us to stay in Yonkers."

Copies of minutes from board of directors and stockholders meetings of GMC 1 were not provided to the auditor; Mr. Walker stated that they were not provided because they were not specifically requested. Minutes of such meetings were, however, introduced into evidence at the hearing held in this matter.

26. By a letter dated July 30, 2002, GMHI⁴ engaged BDO Seidman to provide tax consulting services. A letter confirming such engagement was written on the letterhead of BDO Seidman, was addressed to Mr. Joseph Murphy and was signed by Nicholas A. Nesi, Partner. The copy of the letter presented to the Division during the audit (and which is part of the audit file) is not signed by a representative of GMHI. At the hearing, however, GMHI introduced into evidence a copy of the letter, which was signed by Mr. Murphy on September 20, 2002. This letter stated, in part, as follows:

GMC would like to capitalize on opportunities which exist as a result of the 2000 Empire Zones Program Act, and recent New York State 2002-2003 Budget legislation and which may generate significant state and local tax savings and refunds.

⁴ At the time of this letter, the company was still known as GMC.

* * *

BDO will review GMC business operations and the potential Empire Zone Credits available. Additionally, BDO would assist GMC with the developments and implementation of a restructuring program necessary to take advantage of these potential credits.

27. By a second letter dated July 30, 2002, written by BDO Seidman to Mr. Murphy, BDO Seidman informed GMC 1 that the definition of the term “new business” would be effective August 1, 2002, but would not apply to taxpayers certified as a QEZE under Article 18-B of the General Municipal Law before August 1, 2002 or taxpayers that received a letter of commitment regarding empire zone benefits before that date.

BDO Seidman suggested that the company pursue the following planning and restructuring strategies to maximize the benefits available from the Empire Zone Credits:

- Form new entity(ies) to:
 - hold and manage real estate in the zone; and/or
 - operate segments of the current business in the zone, including receive a transfer of certain existing employees of GMC; and/or
 - make limited strategic *new* employee hires (i.e., not a transfer from the current enterprise or a ‘related person’ pursuant to IRC § 465(b)(3)(C).
- Attempt to obtain QEZE certification or letter of commitment for Empire Zone benefits for the new entity(ies) prior to August 1, 2002 in order to avoid restrictions associated with the definition of a *new business* enacted with the recent budget.

28. On September 11, 2002, a board of directors meeting of GMC 2 was held. Among those attending were Mr. Eben T. Walker (who presided over the meeting) and Mr. Joseph T. Murphy. Mr. Murphy made a presentation to the board concerning the Empire Zone Program. It was identified that “[t]he Empire Zone benefits will encourage GMC to continue our operation

here in Yonkers rather than seeking alternative sites and to locate new activities and employees within the city.”

The directors discussed the pros and cons of taking advantage of the Empire Zone Program. Mr. Murphy indicated that BDO Seidman strongly recommended that GMC take advantage of the program. Mr. Walker investigated the program with other local business people and “confirmed this opportunity.”

29. At the September 11, 2002 board of directors meeting, a resolution was adopted by the board to ratify the following actions that had already been undertaken:

- a. retaining a law firm to form a new corporation to be called Graphite Metallizing (New York), Inc.; and
- b. retaining BDO Seidman to make the application with the City of Yonkers for inclusion in the Empire Zone.

The board also approved, subject to the advice of legal counsel and the final recommendation of management:

- c. the transfer of such real estate assets as required to be included in the Empire Zone to a wholly-owned subsidiary of GMHI; and
- d. retention of BDO Seidman “to complete the review and implementation of the program presented to management on September 5, 2002, a copy of which has been provided to the Board and discussed today.”

30. On December 3, 2002, the subsidiary, Graphite Metallizing (New York), Inc., was certified eligible to receive Empire Zone benefits. The eligibility was made effective retroactive to July 31, 2002.

31. On December 6, 2002, BDO Seidman notified GMHI of its success in having obtained QEZE certification for the wholly-owned subsidiary, Graphite Metallizing (New York), Inc., and described steps to maximize the empire zone benefits.

32. At GMHI's board of directors meeting held on December 10, 2002, Joseph Murphy reported to the board that "Graphite" had received "Empire Zone approval." "Graphite" was to begin filing the required documentation including the approval of the transfer of real estate that had been previously approved.

33. AT GMHI's board of directors meeting held on March 4, 2003, Mr. Murphy advised the board that "[w]ork is proceeding with the State of Delaware to change the company name to Graphite Metallizing Holding, Inc., so that the name 'Graphite Metallizing Corporation' can be used for the QEZE company." Mr. Murphy made a motion to hold a special shareholders meeting on April 10, 2003 to authorize a change of name from Graphite Metallizing Corporation to Graphite Metallizing Holding, Inc.

34. BDO Seidman wrote a letter to Joseph Murphy dated April 10, 2003. The letter stated in part as follows:

Graphite Metallizing Corporation ("GMC") is restructuring its real property holdings and business operations for numerous business reasons including: streamline its corporate structure to reduce compliance costs, manage more efficiently and effectively its real property holdings and business operations, and obtain maximum Qualified Empire Zone ("QEZ") tax benefits.

The letter from BDO Seidman noted that GMC 1, on July 31, 2002, formed a 100% wholly-owned subsidiary, Graphite Metallizing (New York), Inc., and upon its formation, issued 100 shares of authorized stock.

In the letter, BDO Seidman never identified environmental concerns or a concern for the protection of GMHI from liabilities arising from the Croton dump as business purposes for the restructuring. Attached to the letter were various documents including a document entitled “QEZE Tax Credit Restructuring Planning Strategy” which is dated “4/10/2003.” In the “Strategy,” BDO Seidman indicated that it would be necessary to “[d]evelop and document business purposes for restructuring.” According to the “Strategy,” the target completion date for the development and documentation of the business purposes for restructuring was “09/05/02,” a date which was approximately six months prior to the date of the “Strategy.”

35. According to the minutes of the May 13, 2003 meeting of its board of directors, GMHI, on April 10, 2003, changed its name from Graphite Metallizing Corporation to Graphite Metallizing Holdings, Inc. Graphite Metallizing (New York), Inc.’s name was changed to Graphite Metallizing Corporation on April 24, 2003.

36. In its minutes of its board of directors meeting held on November 10, 2003, GMC 2 (formerly Graphite Metallizing [New York], Inc.) identified that it was established “to participate as a Qualified Empire Zone Enterprise (QEZE).”

37. According to information attached to its federal form 1120 for the period ended December 31, 2003, GMHI, on June 1, 2003, pursuant to Internal Revenue Code § 351, transferred its cash, accounts receivable, prepaid expenses, inventory, machinery and equipment, investments in securities, other receivables and its liabilities to GMC 2 in exchange for the stock of GMC 2.

38. According to the minutes of a meeting of the board of directors of GMHI held on May 20, 2004, GMC 2 received a positive tax benefit of \$100,000.00 as the result of being a

qualified member of the QEZE. In order to participate in the QEZE exemption, \$50,000.00 to \$70,000.00 was spent.

39. The board of directors of GMC 2, in the minutes of its meeting held on October 25, 2005, noted as follows:

The Qualified Empire Zone Enterprise (QEZE) economic incentives provide a significant reason for Graphite to maintain the company's long term relationship with the City of Yonkers. If the State were to discontinue to [sic] program, management would have to consider relocating with Graphite's sister company in West Chester, Ohio.

40. By a letter to Mr. Murphy dated June 21, 2007, the auditor requested certain additional information including copies of any additional correspondence (including email) which specifically proposed or discussed the following:

a. The **expected** economic benefits, risks and responsibilities flowing to GMC as a result of the reorganization.

b. The means by which the 'restructure of the New York operation' was **expected** to "contain costs and assist in the managing, financing and assimilating of new business.'

41. In response to the auditor's letter of June 21, 2007, Mr. Murphy prepared a letter dated July 13, 2007, which stated, in part, as follows:

As you know, my letter of April 17, 2007 in response to your original request for information of January 22, 2007 included over 150 pages of outside consultant and internal Board of Director documents in support of GMC's [GMC 2's] compliance with the law in effect at the time and right to receive the QEZE benefits that are being withheld. Beyond the previously supplied tax materials, no other written documentation exists regarding our reorganization.

Mr. Murphy then proceeded to summarize how and why GMC 2 was established as a QEZE legal entity. Among the points included in the summary were:

a. A legal and reporting structure was needed that would allow the company to better focus on, evaluate and more effectively manage the two locations (Yonkers and the subsidiary, Graphel, located in Ohio) as independent businesses.

b. A reduction in labor and overhead costs in Yonkers by establishing a QEZE company with related personnel and property tax benefits.

c. The new legal and operational structure would facilitate future acquisitions and divestitures.

d. The action of establishing GMHI as a holding company and the other steps taken in the reorganization were effective and yielded positive results among which were a 50% increase in sales from a low of \$18.6 million in 2002 to over \$28 million in 2006. In addition, new operations were added in Minnesota, Wisconsin and Connecticut.

42. On August 15, 2007, the auditor issued a formal notice to GMHI disallowing its claim for a RPTC in the amount of \$106,606.00. The notice concluded as follows:

We conclude that GMC [GMC 2], operating the same business with the same employees and under the same beneficial ownership as GMHI, does not qualify as a “new business” under Article 1, section 14(j) of the Tax Law because it was not formed for a valid business purpose. Therefore, GMC [GMC 2] does not meet the QEZE employment test for the taxable year ended 12/31/05.

Among the reasons for the auditor’s conclusion were the following:

a. No documenting evidence in the board of directors minutes of GMC 2 and GMHI leading up to GMC 2’s incorporation and QEZE certification or in any other correspondence received that illustrates or discusses how the segregation of assets, employees and investments into three separate legal entities, rather than one legal entity,

was expected to achieve cost certainty and facilitate growth, or to contain costs and assist in the managing, financing and assimilating of new business.

b. Not until BDO Seidman's letter dated April 10, 2003, issued eight months after GMC 2's organization and four months after GMC 2's empire zone certification, is there a mention made of "numerous business reasons" for the restructuring. Other than in the opening paragraph, the BDO Seidman document makes no mention of cost containment, management benefit, business assimilation or any other valid business purpose for the formation of GMC 2. It does, however, go on to discuss "exclusively" the steps required to "maximize the QEZE benefits."

43. At the hearing, the auditor stated that she and her supervisors found "the documents that were contemporaneous with the formation of the subsidiary [GMC 2]" to be the most relevant to a determination of whether there was a valid business purpose for the creation of GMC 2. The auditor indicated that these contemporaneous documents were the most relevant "[b]ecause they would indicate to us what was in the mind of the taxpayer at the time." The auditor stated that the contemporaneous documents were the minutes of GMHI's board of directors meeting of September 11, 2002 and the two BDO Seidman letters dated July 30, 2002.

In addition, the auditor found additional support for her conclusion in the minutes of GMC 2's board of directors meeting held on November 10, 2003 where, under the category "Old Business," it stated that the company "was established on July 31, 2002, to participate as a Qualified Empire Zone Enterprise (QEZE)."

Also, in a letter to Joseph Murphy from BDO Seidman on April 10, 2003, other than the mention of reducing compliance costs and managing real property holdings in the opening paragraph, there is no other mention of these two reasons in the rest of the letter, which "is

completely about Empire Zone benefits.” The audit report noted that the BDO Seidman letter was written eight months after GMC 2’s organization and four months after its empire zone certification and was not, therefore, contemporaneous with the formation of GMC 2.

44. In its petition filed with the Division of Tax Appeals, GMHI asserted the following:

Taxpayer has good and sufficient business purpose, other than tax benefits, for its corporate restructuring in 2002.

The period 2000 through 2003 were difficult economic times for most industrial companies. The Board of Directors of Graphite Metallizing Corporation was advised to reorganize their corporate structure for years by outside accounting and legal advisors. A reorganized Graphite would be able to borrow money at the subsidiary level without obligating the parent company. It would be able to buy or sell each company without affecting the other companies. Most important, it could file bankruptcy for one of the companies without filing the other companies.

45. After issue had been joined, the Division requested and received from GMHI’s representative a copy of the BDO Seidman document entitled “Graphite Metallizing Corporation, Empire Zone Program Review,” which was dated September 5, 2002. This report had not previously been provided to the Division during the audit. The report was mentioned in the minutes of GMHI’s board of directors meeting held on September 11, 2002.

The report contains a presentation of anticipated Empire Zone tax credits that GMHI might be able to claim if it created a new subsidiary. In a chart entitled “Overview of Value Creation,” BDO Seidman indicated:

Tax Reduction Credit	\$666,804
Potential Refundable Wage Tax Credit	\$187,500
RPTC Applied Against Tax	\$66,340
RPTC Potential Refundable Tax Credit	\$653,660
Potential Sales & Use Tax Exemption	\$7,620

TOTAL VALUE	\$1,581,924*
Enhanced Investment Tax Credit	To Be Determined

*Total value base on life of credits & incentives available.

In the report, BDO Seidman indicated that it had already applied on behalf of “Graphite” for preliminary certification as a QEZE.

46. Eben T. Walker, president of “Graphite” for over 25 years, stated that the City of Yonkers (where GMC 1 had been located since 1915) was very interested in keeping the company in Yonkers, especially in light of the fact that it knew of the existence of Graphel in Ohio. The city held seminars for a number of the local businesses to discuss the various programs available to these businesses. The Empire Zone credits were one of the programs discussed.

47. Joseph. T. Murphy, Graphite’s vice president, treasurer and chief financial officer, stated that GMC 1’s net income in 2001 was over \$700,000.00. Because of the events of September 11, 2001, GMC 1 lost \$2,300,000.00. The Cincinnati operation, Graphel, went from \$60,000,000.00 in sales in 2000 to \$11,000,000.00 in sales in 2003.

Mr. Murphy indicated that in July 2002, BDO Seidman came to GMC 1 and said that since GMC 1 was going to reorganize anyway, why not do it now to get an opportunity at the empire zone credits. We decided “we are going to do it anyway, why not hit that target date?”

SUMMARY OF THE PARTIES’ POSITIONS

46. Pursuant to the testimony of Joseph T. Murphy, Vice President, Treasurer and Chief Financial Officer of GMHI, and Eben T. Walker, President of GMHI, there were six primary business reasons for the July 31, 2002 reorganization of GMC 1 which were:

- a. The poor economic conditions before and after September 11, 2001;

b. The need to isolate the Yonkers business and the Ohio company from each other's debt, financial losses and environmental issues. In the late 1990s or early 2000s, GMC 1 was notified that there was a potential for millions of dollars of liabilities resulting from the dumping of waste at the Croton landfill during the 1950s and 1960s.

c. A structure to more readily divest one of the companies in line with market conditions should economic conditions worsen;

d. Facilitation of future acquisitions using a holding company structure utilized by most larger corporate groups;

e. A holding company to simplify and clearly delineate banking relationships among companies and to reduce the tendency of banks to attempt to cross collateralize the assets of different operating companies;

f. Cutting costs and managing individual business by having fully independent operating units; and

g. Obtain QEZE tax benefits.

47. GMHI asserts that for several years prior to July 31, 2002, GMC 1 had desired to restructure its operations and, on the advice of its auditors (BDO Seidman) was persuaded to do so. The consolidation blueprint outlined in BDO Seidman's February 17, 1998 memo was identical to the actual reorganization consummated by GMC 1 on July 31, 2002. At all of the meetings held between GMC 1 and BDO Seidman during the years prior to 2002, QEZE tax credits were never discussed as a reason to reorganize.

48. Eben T. Walker, President of GMHI, stated that there would have been a restructuring of the business even if no QEZE credits were available because of the resulting

liability protection from incidents such as the Croton landfill and also for the ability to sell off individual pieces of the business, which is more easily accomplished after the restructuring.

49. The Division asserts the following:

a. To prove entitlement to the QEZE RPTC, GMHI must show that it had a “valid business purpose” as is defined in Tax Law § 208(9)(o)(1)(D) for the creation of GMC 2. GMHI must prove that it had a purpose, other than the avoidance or reduction of taxes, and that the purpose was the principal motivation for the formation of GMC 2;

b. This valid business purpose must also meaningfully change the economic position of GMHI or GMC 2;

c. The contemporaneous documentation to the formation of GMC 2, referred to in its brief as the Formation Documentation, proves that GMHI incorporated GMC 2 solely to gain Empire Zone tax credits. These documents, the Division states, are the minutes of GMHI’s board of directors meeting of September 11, 2002 and the two BDO Seidman letters dated July 30, 2002;

d. By waiting until July 31, 2002 to establish the holding company structure suggested by BDO Seidman in February 1998, GMHI has demonstrated that the Empire Zone benefits were the primary motivation for the incorporation of GMC 2 on that date; and

e. The legitimacy of GMHI’s business reasons is questionable since most of them were offered for the first time after the Division sought further particulars concerning the reasons asserted in Mr. Murphy’s statement attached to GMHI’s form CT-3-A for the 2005 tax year.

CONCLUSIONS OF LAW

A. Tax Law § 14(a) provides that a business enterprise which is certified under Article 18-B of the General Municipal Law and meets the employment test shall be a “qualified empire zone enterprise.”

B There is no dispute that GMC 2 met the above requirements when it claimed the QEZE RPTC for the 2003 and 2004 tax periods. However, commencing with tax years beginning on or after January 1, 2005 (the tax year at issue in this proceeding), chapter 161 of the Laws of 2005 amended Tax Law § 14(b)(1) to provide that:

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.

C. GMC 2 was certified eligible to receive Empire Zone benefits effective July 31, 2002 and had zero employees in its base period. It is indisputable that GMC 2 is a business that is substantially similar in operation to GMC 1 and, as such, is subject to the new business test set forth in Tax Law § 14(j)(4)(B), which provides that a corporation or partnership:

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.

D. Tax Law § 208(9)(o)(1)(D) defines the term “valid business purpose” as follows:

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.

E. In its brief, the Division states that its conclusion that GMHI had no valid business purpose for the incorporation of GMC 2 was primarily based on the minutes of a board of directors meeting of GMC 2 on September 11, 2002 as well as the two letters from BDO Seidman dated July 30, 2002. These documents are referred to in the brief as “the Formation Documents.” The Division contends that these documents “were the most contemporaneous to the date of the creation of GMC [2] and thus indicated what was in GMHI Director’s minds at that time” and that the Formation Documents reveal that “GMHI’s management and its directors were only interested in gaining Empire Zone benefits.”

In examining the record to determine whether there existed a valid business purpose, however, one must look to the entirety of the record. While it is true that the contemporaneous documents to the formation of GMC 2, i.e., the minutes of GMC 2’s board of directors meeting of September 11, 2002 and the two BDO Seidman letters dated July 30, 2002 relate almost entirely to the planning and restructuring strategies to maximize the benefits derived from the Empire Zone credits, it is similarly true that as far back as 1997, GMC 1 retained the services of BDO Seidman to provide advice as to the various options available to best acquire other companies. BDO Seidman’s memos to Joseph Murphy on February 17, 1998 and March 2, 1998 address the various options and set forth recommendations. BDO Seidman recommended the holding company structure.

The minutes of meetings of directors of GMC 1 from March 11, 1998 and May 20, 1998 disclose that there discussions of various aspects of a proposed acquisition and GMC 1's president, Eben T. Walker, asked for an opinion on setting up a completely separate entity. At a stockholders meeting held on May 20, 1998, the minutes contained a President’s Report which

stated that there was a possibility of tripling sales volume through the acquisition of a company in a similar business.

At a special stockholders meeting of GMC on June 16, 1998, a restructuring of GMC 1 was discussed and a resolution was approved which authorized the directors to form subsidiaries, a holding company or a separate company to best complete any acquisitions.

Minutes from GMC 1's directors meetings on December 14, 1998, March 16, 1999, December 15, 1999 and May 23, 2000 discuss the direction of GMC 1's future acquisitions and, in addition, the company's potential liability from its use of the Croton Point Landfill.

None of these documents from 1998, 1999 or 2000, when the various restructuring options were first considered and discussed and the stockholders approved the formation of a holding company or other separate entity, contain any mention of empire zone credits. While it is true that no corporate restructuring took place for four years, or until 2002, it is clear that there existed a valid business purpose for the corporate restructuring.

GMC 1 wanted to expand its business by acquiring other companies while, at the same time, minimizing its exposure to the potential liabilities resulting from its disposal of waste at the Croton Point Landfill. Additionally, it wanted to ensure that the debts, financial losses and environmental liabilities of one of the companies were isolated from the other companies. These business purposes were paramount before the issue of empire zone credits was considered by GMC 1. Mr. Murphy's letter of July 17, 2000, seeking a loan from KeyBank to acquire a leading manufacturer of specialty graphite, described the potential acquisition by stating that it would expand the company's presence in the graphite industry and help protect the company's current position.

F. As provided in Tax Law § 14(b)(1), for a corporation such as GMC 2, which was first certified prior to August 1, 2002, the employment test will be met only if it qualifies as a new business under Tax Law § 14(j)(4)(B), which provides that the corporation will not be deemed a new business if it was not formed for a valid business purpose and was formed *solely* to gain Empire Zone benefits.

The definition of “valid business purpose” set forth in Tax Law § 208(9)(o)(1)(D) defines the term as one or more business purposes, which alone or in combination constitute the primary motivation for the business activity or transaction which activity or transaction changes, in a meaningful way (apart from tax effects) the economic position of the taxpayer. In its reply brief, citing GMHI’s tax returns for the years 1999 through 2007, GMHI asserts that its sales, which declined each year from 2000 through 2003, increased each year from 2003 through 2007 and that its net income, which showed a loss in 2002 turned a nearly steady profit thereafter (net income was slightly over \$2 million in 2007). Clearly, the economic position of Graphite changed in a very meaningful way after restructuring.

G. The Division contends that GMC 2 cannot be deemed a new business under Tax Law § 14(j)(4)(B) because it “was formed solely to gain empire zone benefits.” In support of its position it cites to the Formation Documentation, i.e., the minutes of GMHI’s board of directors meeting of September 11, 2002 and the two BDO Seidman letters dated July 30, 2002, which the Division contends reveal that GMHI’s management and its directors were only interested in gaining Empire Zone benefits.

As previously noted, while these documents do pertain solely to the Empire Zone benefits and the steps necessary to obtain such benefits, it seems quite clear that since GMC 1 was going

to restructure anyway, it was to its advantage, thanks to the Empire Zone credits, to effectuate the restructuring on or before July 31, 2002.

A memo to Joseph Murphy of GMC 1 from BDO Seidman dated July 30, 2002, advised GMC 1 that effective August 1, 2002, the employment test would be met only if the enterprise qualifies as a new business. However, this definition does not apply to taxpayers certified as a QEZE before August 1, 2002. BDO Seidman recommended that GMC 1 follow planning and restructuring strategies to maximize the benefits available from the Empire Zone Credits. As part of such planning and restructuring strategies, BDO Seidman advised that GMC 1:

Attempt to obtain QEZE certification or letter of commitment for Empire Zone benefits for the new entity(ies) prior to August 1, 2002 in order to avoid restrictions associated with the definition of a *new business* enacted with the recent budget.

While it can reasonably be argued that at the exact time of the restructuring, i.e., the creation of Graphite Metallizing (New York), Inc. (later Graphite Metallizing Corporation [GMC 2]), the primary motivation was to gain Empire Zone benefits, it was not the *sole* motivation. The timing of the restructuring clearly reflected the company's desire to avoid having to meet the restrictive definition of a new business as set forth in amendments to Tax Law § 14(j). However, while there may have been other underlying reasons for the restructuring which created a holding company (GMHI) to manage the assets and liabilities of the operational companies (GMC 2 and Graphel), petitioner has satisfied its burden of proof by providing considerable evidence (documentary evidence and testimony) to show that GMC 2 was formed for the following valid business purposes (in addition to obtaining QEZE tax credits): to facilitate the acquisition of other companies, to increase sales volume and market share in the graphite industry, and to isolate potential liability arising out of the use of the Croton Point Landfill. Accordingly, it must

be found that the Division improperly denied petitioner's claim for a refund of the qualified empire zone enterprise credit for real property taxes for the year 2005.

H. The petition of Graphite Metallizing Holdings Inc. is granted, and the Division of Taxation is hereby directed to issue a refund to petitioner of a Qualified Empire Zone Enterprise real property tax credit in the amount of \$106,606.00, plus applicable interest.

DATED: Troy, New York
April 29, 2010

/s/ Brian L. Friedman
ADMINISTRATIVE LAW JUDGE