

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
ADOLPH FALSO AND BARBARA E. FALSO	:	DETERMINATION
	:	DTA NO. 823587
for Redetermination of Deficiencies or for Refund of	:	
New York State Personal Income Tax under Article 22	:	
of the Tax Law for the Years 2006 and 2007.	:	

Petitioners, Adolph Falso and Barbara E. Falso, filed a petition for redetermination of deficiencies or for refund of New York State personal income taxes under Article 22 of the Tax Law for the years 2006 and 2007.

A hearing was held before Donna M. Gardiner, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on June 27, 2011 at 10:30 A.M., with all briefs to be submitted by December 30, 2011, which date began the six-month period for the issuance of this determination. Petitioners appeared by Hiscock & Barclay, LLP (Kevin R. McAuliffe, Esq., and David G. Burch, Jr., Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Christopher O'Brien, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly determined that the payments in lieu of taxes paid by Falso Holding Co., LLC, were not eligible real property taxes pursuant to Tax Law § 15(e).

II. Whether the Division of Taxation properly determined that petitioners were ineligible to claim a qualified empire zone enterprise credit for real property taxes based upon its

determination that Seneca Data Distributors, Inc., did not have a valid business purpose and was formed solely to gain empire zone tax benefits.

FINDINGS OF FACT

1. Seneca Data Distributors, Inc. (Seneca Data) is a New York S corporation, formed on July 10, 2002 with a sole shareholder, Adolph Falso. All income attributes flow through the S corporation to Mr. Falso's personal income tax returns. Seneca Data was certified eligible to receive qualified empire zone enterprise (QEZE) benefits prior to August 1, 2002.

2. Seneca Data is the successor in interest to a predecessor corporation (Predecessor Corporation) that was started in 1979 by two engineers.

3. The Predecessor Corporation's primary focus through the late 1990s was the distribution of computer products manufactured by other companies such as Okidata and Acer America.

4. The management team of the Predecessor Corporation consisted of: Kevin Conley, president; petitioner, Adolph Falso, owner; Jon Verbeck, chief financial officer; Brian Garrett, vice president of sales and marketing, and Doug Phillips, vice president of service. This management team remained in place upon the creation of Seneca Data.

5. Mr. Conley prepared a memorandum dated August 31, 1998 for the management team that identified the operations of the Predecessor Corporation and his concerns with maintaining the operations as they existed. When drafting his memorandum, Mr. Conley had not heard of the Empire Zones program. While Mr. Conley and the rest of the management team discussed the issues and recommendations set forth in the memorandum, no action was taken at that time.

6. Petitioners did not submit any contemporaneous documentation that addressed the reorganization of the corporation into Seneca Data. As set forth in Finding of Fact 5, the memorandum prepared by Mr. Conley was dated almost four years prior to the reorganization.

7. Predecessor Corporation entered into a “Payment in Lieu of Tax Agreement” (PILOT agreement), dated as of September 1, 1999, with the Onondaga County Industrial Development Agency (Round Pond Road PILOT), which agreement governed the payments in lieu of real property taxes that would otherwise have been assessed against the corporation’s real property on Round Pond Road (the Property).

8. Subsequently, on or about October 1, 2002, Predecessor Corporation, Seneca Data and Falso Holding Company, LLC (Falso Holding) entered into a certain agreement titled “Reaffirmation Agreement,” which included, among other things, the transfer of the obligation to pay all real property taxes from Seneca Data to Falso Holding.

9. The Division of Taxation (Division) conducted a desk audit of Seneca Data and an audit of the personal income tax returns of petitioners pursuant to which the Division determined that Seneca Data was not formed for a valid business purpose pursuant to Tax Law § 14(j) and issued notices of deficiency L-033002753 and L-033002752, dated January 14, 2010, to petitioners for the years 2006 and 2007, respectively.

10. The Division’s auditor assigned to this case reviewed Seneca Data’s tax returns for the years 2002 through 2007, as well as the tax return for the tax year ending September 30, 2002, for the Predecessor Corporation. The auditor requested several documents such as internal memoranda, e-mails or written correspondence that could show why the reorganization was undertaken. Although a meeting of the board of directors was held to consider a merger, no meeting minutes were produced. For these reasons, the auditor determined that petitioners failed

to demonstrate a valid business purpose and, as such, issued the notices of deficiency to petitioners reflecting that conclusion. The auditor also concluded that Seneca Data was formed to maximize tax incentives and, as such, was not formed for a valid business purpose.

11. In addition to Empire Zone benefits claimed through Seneca Data, Mr. Falso also claimed Empire Zone benefits, including the real property tax credit, through another certified Empire Zone enterprise, Falso Holding.

12. The amount of the real property tax credit claimed by petitioners on their 2006 and 2007 income tax returns was included as part of the sums sought in the notices of deficiency sent to petitioners for those tax years. The Division concluded that since Falso Holding was not a party to the written agreement with the Onondaga County Industrial Development Agency (IDA), as is required by Tax Law § 15, Falso Holding was not eligible to claim the real property tax credit.

13. Petitioners submitted proposed findings of fact numbered 1 through 33. Such proposed findings of fact have been generally accepted and incorporated herein except for proposed findings of fact 14 through 16 and 26 through 28, which are arguments rather than findings of fact, and proposed findings of fact 17 through 19, which are not supported by the record.

CONCLUSIONS OF LAW

A. In 1986, the Legislature passed the Economic Development Zone Program, established under Article 18-B of the General Municipal Law. This Act sought to improve economic conditions in impoverished areas of New York by stimulating private investment, business development and job creation (*see* General Municipal Law § 956).

Under Article 18-B, certain business taxpayers can be certified as QEZE (*see* General Municipal Law § 958; Tax Law § 14[a]). A taxpayer must meet certain qualifications to be certified as a QEZE, including an employment test (*see* Tax Law § 14[a]). For businesses certified as QEZE prior to April 1, 2005, as here, this test compares the employment number of a qualified business in its base period against its employment number in the years being tested (Tax Law § 14[b][1]). QEZE status provides eligibility for certain tax preferences in the form of credits and exemptions. These benefits include a credit for eligible real property taxes set against personal income tax under Article 22 (Tax Law § 15[a]; 16[a]).

B. Tax Law § 15(e), as first enacted, defined “eligible real property taxes” to mean “taxes imposed on real property which is owned by the taxpayer and located in empire zones with respect to which the taxpayer is certified pursuant to article eighteen-B of the general municipal law for the taxable year” (*see* L 2000, ch 63, effective May 15, 2000 and applicable to taxable years beginning on and after January 1, 2001).

In 2002, Tax Law § 15(e) and its definition of “eligible real property taxes” was amended. Specifically, the term “taxpayer” therein was changed to “QEZE,” a requirement was added that the taxes become a lien on the real property during a taxable year in which the owner of the real property is both certified pursuant to article eighteen-B of the general municipal law and a qualified empire zone enterprise. In addition the definition of the payments that comprised “eligible real property taxes” for purposes of the credit was expanded as follows:

In addition, the term “eligible real property taxes” includes payments in lieu of taxes made by the QEZE to the state, a municipal corporation or a public benefit corporation pursuant to a written agreement entered into between the QEZE and the state, municipal corporation, or public benefit corporation.

By this amendment to Tax Law § 15(e), the Legislature recognized that both PILOT payments and payments of real property taxes made by a certified and qualified QEZE owner of the property constituted “eligible real property taxes” (L 2002, ch 85, effective May 29, 2002 and applicable to taxable years beginning on and after January 1, 2001).

C. In this case, the parties to the original PILOT agreement, dated September 1, 1999, were the IDA and Predecessor Corporation. Subsequently, on or about October 1, 2002, Predecessor Corporation, Seneca Data and Falso Holding entered into the “Reaffirmation Agreement,” which included, among other things, the transfer of the obligation to pay all real property taxes from Seneca Data to Falso Holding.

In reviewing the terms of the PILOT Agreement, executed by the IDA and Predecessor Corporation, it is clear that under its terms only Predecessor Corporation is obligated to make the PILOT payments. Falso Holding’s obligation to make such payments arises solely under the Reaffirmation Agreement among it, Predecessor Corporation and Seneca Data. The fact that the IDA is not a party to the Reaffirmation Agreement precludes petitioner from receiving the credit in issue.

D. The next issue to address is whether the reorganization that created Seneca Data had a valid business purpose within the meaning and intent of Tax Law § 14. After the year 2000, the Legislature identified abuses of the Empire Zones program in a process known as “shirt changing,” whereby an existing business would reorganize into a new entity to qualify for, or enhance, its QEZE benefits. The Legislature held this practice to be inconsistent with the intent of the program (General Municipal Law § 956), and sought to reform the legislation.

Commencing with tax years beginning on or after January 1, 2005, 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.

By virtue of the facts that Seneca Data was created on July 10, 2002, was certified eligible to receive QEZE benefits thereafter prior to August 1, 2002, and was essentially identical in ownership and had zero employees in its base period, it is a business that will meet the employment test only if it meets the new business “valid business purpose” test, which, as set forth in Tax Law § 14 (former [j][4][B]), 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.

Tax Law § 208(9)(o)(1)(D) defines “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. Therefore, in order to qualify as a new business and consequently establish entitlement to the QEZE benefits of the real property tax credits sought for the years at issue, obtaining QEZE benefits cannot have been the sole purpose for undertaking the reorganization and, also, gaining the benefit of tax avoidance or reduction, either as to taxes in general or in particular as the result of realizing such QEZE tax benefits, cannot have been the primary purpose for the reorganization.

The Tax Appeals Tribunal, in *Matter of Graphite Metallizing Holdings* (Tax Appeals Tribunal, July 7, 2011), stated that:

At issue are QEZE real property tax credits, which are “a particularized species of exemption from taxation” (*Matter of Mallinckrodt*, Tax Appeals Tribunal, November 12, 1992). As it is the party seeking the exemption, petitioner bears the burden of proving clear entitlement to this exemption (*see Matter of Marriott Family Rests. v. Tax Appeals Trib.*, 174AD2d 805 [1991], *lv denied* 78 NY2d 863 [1991])

The inquiry into whether a valid business purpose existed at the time of action “involves a subjective analysis of the taxpayer’s intent” (*Winn-Dixie Stores v. Commissioner*, 113 TC 254, 280 [1999], *affirmed* 254 F3d 1313 [2001], *cert denied* 535 US 986 [2002]; *Gregory v. Helvering*, 293 US 465 [1935]). We note that in cases addressing valid business purpose “the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended” (*Gregory v. Helvering, supra*, at 469; citation omitted).

F. In reviewing the record for evidence that existed at the time of the reorganization, the Division points to exhibit “L,” the initial New York S Corporation Franchise Tax Return (form CT-3-S) filed by Seneca Data. Attached to the return is a statement made under Treas Reg § 1.368-3(a)(1) that describes the purposes of the reorganization as follows:

The purpose of the reorganization were [*sic*] to: (1) reorganize the corporate structure by forming a new corporation governed by New York law, in order to benefit from the flexibility, predictability, and other legal advantages available under New York law; and (2) enable the corporation to maximize economic development incentives and benefits under state law. Both of these reasons are of substantial economic and business value to the corporation and its shareholder.

Other than this statement attached to form CT-3-S, there is no other evidence, contemporaneous to the reorganization, that demonstrates the need for the reorganization. The auditor assigned to this case requested several documents such as internal memoranda, e-mails or written correspondence that could show why the reorganization was undertaken. Although a meeting of the board of directors was held to consider a merger, no meeting minutes were produced. For these reasons, the auditor concluded that petitioners failed to demonstrate a valid

business purpose and, as such, issued the notices of deficiency to petitioners reflecting that conclusion.

At hearing, petitioners offered the testimony of Mr. Kevin Conley to demonstrate a valid business purpose for the reorganization. His testimony addressed the issue regarding changes made to the company in the years following the merger. For instance, Mr. Conley explained that their business model was not sustainable and that certain changes needed to be made. However, his general explanations did not rise to the level of sufficient proof required to find that the reorganization was accomplished for a valid business purpose. There was no explanation as to why a reorganization was required in order to accomplish any of the goals set for the company.

Furthermore, petitioners emphasize that the Predecessor Corporation was mainly a distributor while Seneca Data was more of a manufacturing operation. However, Seneca Data had invested minimally in new manufacturing equipment being placed in service within New York State (Exhibit L). Additionally, the Independent Auditors Reports covering the years 2002 to 2007 prepared by Fust Charles Chambers LLP, describes the corporation's operations as that of a wholesale distributor and service center for computer products. Reports for years 2008 and 2009, which is five years after the reorganization, identified Seneca Data's operations as manufacturer, distributor and value added technology partner. Accordingly, petitioners failed to sustain their burden of proof that the reorganization was accomplished for a valid business purpose and not merely to gain tax incentives.

G. The petition of Adolph and Barbara E. Falso is denied and notices of deficiency L-033002753 and L-033002752 dated January 14, 2010 are sustained.

DATED: Albany, New York
June 21, 2012

/s/ Donna M. Gardiner
ADMINISTRATIVE LAW JUDGE