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NEW YORK TAX INSIGHTS
Volume 10, Issue 11 | November 2019

IN THIS ISSUE

FEDERAL JUDGE DISMISSES NEW YORK STATE LAWSUIT CHALLENGING $10,000 SALT DEDUCTION CAP
Page 1

TAX-EXEMPT PARTNER HELD NOT ENTITLED TO REFUND OF TRANSFER TAX PAID BY TAXABLE PARTNERSHIP
Page 2

ALJ DENIES REFUND TO TAX-EXEMPT RELIGIOUS ORGANIZATION
Page 4

TAX DEPARTMENT REVISES PRIOR NET OPERATING LOSS CONVERSION SUBTRACTION DRAFT REGULATIONS
Page 5

INSIGHTS IN BRIEF
Page 6

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FEDERAL JUDGE DISMISSES NEW YORK STATE LAWSUIT CHALLENGING $10,000 SALT DEDUCTION CAP

By Irwin M. Slomka

A federal district court judge has dismissed a suit brought by New York State (together with Connecticut, New Jersey, and Maryland) that sought to invalidate on constitutional grounds the $10,000 cap on state and local tax ("SALT") deductions enacted as part of the Federal Tax Cuts and Jobs Act of 2017 ("TCJA"). *New York, et al. v. Mnuchin*, No. 18-CV-6427 (JPO) (S.D.N.Y., Sept. 30, 2019). At the time the suit was brought, many felt that the states faced considerable hurdles in pursuing their constitutional challenge. The 37-page decision confirms that those hurdles are indeed considerable.

Background. The federal legislation limited to $10,000 the federal itemized deduction for individuals for the aggregate of state and local property taxes and income and sales taxes ("SALT cap"). In July 2018, New York and the other States (the "Plaintiff States") sued the U.S. Department of Treasury (among others, collectively, the "Government") in federal court, claiming that the SALT cap violates principles of federalism contained in the U.S. Constitution, specifically the 10th Amendment (state sovereign authority), the 16th Amendment (which authorized the federal income tax), and also raised a "coercion" claim rooted in the 10th Amendment, and was therefore invalid. The Government filed a motion to dismiss, and the Plaintiff States filed a cross-motion for summary judgment.

Decision. The court, after first rejecting the Government's claim that the court lacked jurisdiction to hear the case, proceeded to rule in favor of the Government on the merits and dismissed the Plaintiff States' cross-motion for summary judgment.

The decision addressed the Plaintiff States' two principal lines of argument, first, that the U.S. Constitution precludes any congressional attempt to meaningfully limit the SALT deduction and, second, that the purpose and effect of the SALT cap is to "coerce" the allegedly "targeted" states into changing their tax policies in violation of the Constitution.

On the first argument, the court concluded that the SALT cap did not exceed Congress' broad power to tax. While recognizing that the SALT cap is in some

continued on page 2

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ways unprecedented, the court ruled that the fact that Congress has not previously imposed a comparable SALT cap did not mean that Congress is constitutionally prohibited from doing so now ("The States have cited no constitutional principle that would bar Congress from exercising its otherwise plenary power to impose an income tax without a limitless SALT deduction.").

[T]he court ruled that the fact that Congress has not previously imposed a comparable SALT cap did not mean that Congress is constitutionally prohibited from doing so now.

The district court judge found compelling the U.S. Supreme Court decision in *South Carolina v. Baker*, 485 U.S. 505 (1988), where the Court rejected a claim that Congress violated the Constitution when it enacted legislation eliminating a long-standing federal tax exemption for interest on state-issued bonds, even though such interest had been exempt since the enactment of the federal income tax in 1913. The judge found that, while there were several instances of congressional limitations on the SALT deduction historically, interest on state bonds had never been taxed prior to the federal legislation in *Baker*. Therefore, the court in *Mnuchin* concluded that *Baker* presented a stronger case for recognizing a constitutionally rooted limitation than the SALT cap does, and yet the Supreme Court still upheld elimination of the exemption.

As for the Plaintiff States' "coercion" claim, the court declined to speculate on Congress' motives for enacting the SALT cap, finding that, even if Congress had intended to encourage the States to lower tax rates, an otherwise valid federal law does not offend the Constitution simply because that law seeks to affect State policies, citing *South Dakota v. Dole*, 483 U.S. 203 (1987) (where the Supreme Court rejected a claim that Congress had exceeded its authority by directing the federal government to withhold federal highway funds from any state that authorized anyone under the age of 21 to consume alcohol). Quoting from *Dole*, the court found that "such a motive [to compel lower state tax rates] poses no constitutional problem as long as the states remain free 'not merely in theory but in fact' to set their own tax policies."

The court also found that the claimed harms resulting from the SALT cap – allegedly that taxpayers in the Plaintiff States will pay "billions of dollars in additional federal income taxes" and that the cap "will decrease[] the value of real estate in the Plaintiff States by billions of dollars" – even if true, did not cause the SALT cap to be unconstitutionally coercive. First, the court found that the Plaintiff States' estimates comparing federal income taxes incurred under the TCJA (with the SALT cap) with what the tax would have been if Congress passed the TCJA without the SALT cap were based on a "flawed assumption" that Congress would ever have enacted the TCJA (and its tax *benefits*) without the counterbalance of the SALT cap. In addition, the court was not persuaded that "the SALT cap puts [the Plaintiff States] to the forced choice of lowering tax rates or facing budgetary catastrophe." Thus, the court rejected the States' alternative claim that the SALT cap is unconstitutionally coercive.

ADDITIONAL INSIGHTS

To many observers, the Plaintiff States' lawsuit was more of a political act than a bona fide constitutional challenge, and the decision dismissing their action is not surprising. As we went to press, neither New York Governor Cuomo nor the governors of the other Plaintiff States have indicated whether they will appeal the decision to the U.S. Court of Appeals. Yet despite the unlikely prospects for reversal, and the undoubtedly substantial costs being incurred to pursue the case, it seems very likely that the States will continue the litigation and file an appeal.

TAX-EXEMPT PARTNER HELD NOT ENTITLED TO REFUND OF TRANSFER TAX PAID BY TAXABLE PARTNERSHIP

By Kara M. Kraman

A New York City Administrative Law Judge rejected a tax-exempt partner's claim that the exemption from New York City real property transfer tax ("RPTT") for transfers of real property to or from a tax-exempt entity should be applied to a sale by a taxable partnership to the extent of the tax-exempt entity's percentage interest in that partnership. *Matter of Jacob & Anita Penzer Foundation, Inc.*, TAT(H) 18-18(RP) (N.Y.C. Tax App. Trib., Admin. Law Judge Div., July 31, 2019, released Oct. 8, 2019).

Facts. The Jacob & Anita Penzer Foundation, Inc. (the "Foundation") is an entity exempt from income tax pursuant to IRC § 501(c)(3). As such, both the Foundation and the Department of Finance agreed that

continued on page 3

it was a tax-exempt organization for RPTT purposes. The Foundation was a 33 1/3% partner in a limited liability partnership (the "Partnership") that owned real property in New York City. The Partnership itself was not a tax-exempt organization for federal or RPTT purposes.

In 2017, the Partnership sold the real property for approximately $83 million and paid RPTT in the amount of $2,182,057 on that sale. The entire amount of RPTT was paid by the Partnership, not the Foundation. The Foundation filed a claim for refund for 1/3 of the RPTT paid by the Partnership ($727,352), claiming that the exemption from RPTT for a tax-exempt entity should also apply to the extent of a tax-exempt entity's ownership interest in a non-exempt seller (here, the Partnership). The Department denied the Foundation's refund claim, and the dispute proceeded to a summary determination action.

The ALJ noted that nothing in the statute suggested that the exemption for tax exempt entities applied to entities which are not themselves tax-exempt but are owned by tax-exempt entities.

Law. Administrative Code § 11-2108(a) provides that a refund claim "may be made by the grantor, the grantee or other person who has actually paid the tax." The RPTT law exempts from tax "any deed, instrument, or transaction conveying or transferring real property or an economic interest therein by or to" a tax-exempt organization. Admin. Code § 11-2106(b)(2). The RPTT law also provides an exemption from RPTT for any deed, instrument, or transaction conveying real property or an economic interest therein that "effects a mere change of identity or form of ownership or organization to the extent the beneficial ownership of such real property or economic interest therein remains the same." *Id.* at (b)(8).

ALJ Determination. The ALJ first determined that the Foundation did not have standing to assert a claim for refund because it did not pay the tax, and therefore held that the Petition must be dismissed. Despite finding that the Foundation did not have standing, the ALJ proceeded to address the Foundation's tax exemption claim. In doing so, the ALJ applied the well-settled principle that tax exemption provisions are to be construed in favor of the taxing authority.

The parties had agreed that if the *Foundation* had conveyed the real property, the sale would have been exempt from RPTT. However, the ALJ concluded that the exemption did not extend to the conveyance of the real property in this case because the *Partnership* conveyed the property, and the Partnership was not a tax-exempt entity. The ALJ noted that nothing in the statute suggested that the exemption for tax-exempt entities applied to entities which are not themselves tax-exempt but are owned by tax-exempt entities.

The ALJ also rejected the Foundation's claim that it was appropriate to rely by analogy on the exemption for transactions that "effect[] a mere change of identity or form of ownership." The "mere change in form" exemption applies to conveyances of real property "to the extent" the beneficial ownership of the real property conveyed remains the same. The ALJ concluded that, unlike the language of the "mere change in form" exemption, the tax-exempt entity exemption clearly requires that the grantor or grantee be a tax-exempt entity, which the Partnership was not.

ADDITIONAL INSIGHTS

While the ALJ held that the transfer by the Partnership was subject to RPTT under the plain language of the statute, it is possible that the desired result would have been reached had the transaction been structured differently. For example, if each of the partners in the Partnership had sold their interests in the Partnership to the grantee instead of the Partnership selling the real property to the grantee, perhaps the result would have been different. Under the aggregation rules in 19 RCNY 23-02, transfers of an economic interest in entities that own real property made within three years of each other are aggregated in determining whether a taxable transfer of a controlling interest has occurred. While the three transfers would be aggregated, nonetheless, the Foundation's transfer of its 1/3 interest in the Partnership would have likely qualified for the exemption under Administrative Code § 11-2106(b)(2).

continued on page 4

ALJ DENIES REFUND TO TAX-EXEMPT RELIGIOUS ORGANIZATION

By Hollis L. Hyans

Finding that a tax-exempt religious organization failed to meet the requirements of the statute providing for exemptions from the motor fuel tax for exempt organizations, a New York State Administrative Law Judge has upheld the Department of Taxation and Finance's denial of a refund. *Matter of Watchtower Bible and Tract Society of New York, Inc.*, DTA Nos. 827916 & 828547 (N.Y.S. Div. of Tax App., Sept. 26, 2019).

Facts. Petitioner Watchtower Bible and Tract Society of New York, Inc. ("Watchtower") is a New York not-for-profit corporation exempt from sales and use taxes under Tax Law § 1116(a)(4). Its purposes are religious and charitable, and it supports the activities of Jehovah's Witnesses by, among other activities, printing and distributing religious material, supporting religious education, and building and owning facilities where religious activities are performed.

Construction of Watchtower's world headquarters in Warwick, New York, began in 2013 and concluded in 2017. The construction site presented unique challenges, since it was small but occupied by many workers and pieces of equipment working under a tight deadline. At the site, approximately 108 pieces of equipment owned by Watchtower were fueled with diesel motor fuel, which was transfered first into fuel tanks, primarily a 4,500 gallon tank carried on a fuel truck. For most of the project, Watchtower dispensed the diesel from its fuel tanks into a smaller 600 gallon tank that could easily navigate the construction site and was used to deliver fuel to the various pieces of equipment on site. Each tank was equipped with a diesel nozzle that was capable of fueling the equipment used by Watchtower. Although the nozzles were too large to fuel most on-road vehicles such as passenger cars and trucks, they could be used to fuel buses and tractor trailers. Watchtower did not permit any of the fuel to be used for on-road vehicles, and implemented policies and security procedures—such as securing all tanks and nozzles with keys kept in a secure location, limiting access to the keys, and hiring security guards—to prevent the fuel tanks from being used to fuel anything other than its off-road construction vehicles.

The Law and the Dispute. Article 13-A of the Tax Law imposes tax on petroleum products sold or used in the State, which is passed through to the purchaser by the seller as part of the selling price. Tax Law § 301-b(h) provides an exemption for non-highway diesel motor fuel, known as "dyed diesel," sold to nonprofit organizations, if the fuel is delivered to the premises of the exempt organization, used exclusively for exempt activities, and consumed other than on State highways. The statute also explicitly provides that the exemption does not apply "to a sale of non-highway diesel motor fuel which involves a delivery at a filling station or into a repository which is equipped with a hose or other apparatus by which such non-highway . . . fuel can be dispensed into the fuel tank of a motor vehicle." While all other requirements of the statute were met, the disputed issue was whether Watchtower's acceptance of the dyed diesel into fuel trucks and tanks equipped with nozzles disqualified it from receiving the exemption.

The ALJ held that the statute does not "look to whether the exempt organization permits dyed diesel to be dispensed into motor vehicles but whether the repository . . . *can* fuel a motor vehicle."

The Determination. The ALJ denied the refund. He rejected the argument made by Watchtower that the statute should be interpreted to allow the exemption because the dyed diesel was not permitted to be dispensed into vehicles other than construction vehicles, and had not been actually used for other purposes, finding that tax exemptions are to be strictly and narrowly construed, with a presumption against the taxpayer and in favor of the taxing authority. The ALJ held that the statute does not "look to whether the exempt organization permits dyed diesel to be dispensed into motor vehicles but whether the repository . . . *can* fuel a motor vehicle." (Emphasis added.)

Watchtower had argued that the strict interpretation made the exemption impossible because there are no fuel nozzles in existence capable of filling exempt road building machinery but not ordinary motor vehicles, so there was no way for Watchtower to comply with the statutory requirement. However, the ALJ found that Watchtower could have qualified for the exemption if, instead of accepting delivery into intermediary repositories and then fueling its equipment, it had directed its supplier to directly fuel the construction vehicles.

continued on page 5

ADDITIONAL INSIGHTS

It is a familiar principle that tax exemptions are strictly and narrowly construed, so any party seeking an expansive definition of an exemption will have an uphill battle. Some taxpayers have argued that an exemption should not be interpreted so narrowly that the intended purpose is thwarted, but that argument does not seem to have been raised here, and the determination does not discuss any legislative history, or delve into the reasons why the exemption was crafted with the specific language governing the nature of the equipment rather than the actual use made of the product. It is always important to closely examine the exact requirements of an exemption statute in structuring a transaction in which a party hopes to take advantage of any tax exemption.

TAX DEPARTMENT REVISES PRIOR NET OPERATING LOSS CONVERSION SUBTRACTION DRAFT REGULATIONS

By Irwin M. Slomka

The New York State Department of Taxation and Finance has recently revised its draft Article 9-A regulations relating to the Prior Net Operating Loss Conversion ("PNOLC") subtraction. *Computation of the Prior Net Operating Loss Conversion (PNOLC) Subtraction* (N.Y.S. Dep't of Taxation & Fin., released Oct. 2, 2019). Among the revisions are important new provisions on the impact of changes or corrections to the PNOLC subtraction pool calculation in tax years prior to 2015.

Background. NOL carryovers generated in tax years beginning prior to 2015 – when New York corporate tax reform went into effect – cannot be carried forward after 2014. Instead, those unabsorbed NOLs must first be converted into a "PNOLC subtraction pool," which requires making certain calculations in the corporate taxpayer's last tax year beginning in 2014 (the "base year"). Those calculations include multiplying the corporation's unabsorbed NOLs eligible for carryover on the last day of the base year by its business allocation percentage ("BAP") in that base year. The resulting PNOLC subtraction pool amount is then available for carryover, claimed 1/10 per year following the base year, with any unused amount eligible for carryover for up to 20 years until fully utilized. Alternatively, at the taxpayer's election, up to 1/2 of the subtraction pool can be deducted in each of the taxpayer's first two tax years beginning after 2014.

Perhaps the most controversial aspect of the draft PNOLC regulations released by the Tax Department in 2017 was the creation of a three-year limitation period from when the PNOLC subtraction is first claimed by the taxpayer for adjustments to the taxpayer's unabsorbed net operating loss ("UNOL"). The draft regulations specifically provided that any federal changes finalized after that period, whether they increased or reduced net income, would not be considered. The draft regulations also provided that no changes to the taxpayer's BAP (or changes in the base year tax rate) could be made, either by the taxpayer or by the Tax Department, after the expiration of three-year statute of limitations for the base year.

The revised draft PNOLC regulations retain [the Department's] approach of limiting subsquent changes to the PNOLC subtraction pool amount.

At the time, some felt that the draft regulations should allow adjustments to the pool amount in any year that the taxpayer claimed a PNOLC subtraction, regardless of limitation period, which would have been consistent with the rules regarding assessments and refunds arising from NOL carryforwards, for both federal and New York State tax purposes. However, because of the unique nature of the PNOLC subtraction, and the desire for finality and certainty regarding the PNOLC subtraction, many (including the Tax Department) felt that the Department's approach was both reasonable and legally permissible.

Revised Draft Regulations. The revised draft PNOLC regulations retain this approach of limiting subsequent changes to the PNOLC subtraction pool amount, and contain a new section entitled "Subsequent changes" (draft § 3-9.12) to provide further clarity. Specifically, the draft regulations now provide that, in the case of errors made in the calculation or application of the PNOLC subtraction in a year for which the three-year statute of limitations for assessment has expired:

- Where there are changes to the taxpayer's base year BAP (or base year tax rate), any federal changes that are finalized after the limitations period for the year has expired are not considered in computing the PNOLC subtraction pool amount.

continued on page 6

- Where there was an error in the calculation of the PNOLC subtraction pool or the application of the PNOLC subtraction in a year for which the statute of limitations has expired, both the taxpayer and the Tax Department will be bound by the position taken by the taxpayer on the Article 9-A return filed for that year. For example, a taxpayer on its 2014 base year return reported a BAP of 15%, but in its 2015 return computed its PNOLC subtraction using a base year BAP of 100%. The Department does not discover the error until it audits the taxpayer's 2016 return in 2019, after the statute of limitations for 2014 and 2015 have expired. In those circumstances, the taxpayer is bound by the 15% BAP it reported for 2014, which results in a lower PNOLC subtraction pool available for carryforward.

- The PNOLC subtraction carryforward can be corrected, however, for any years for which the statute of limitations is still open, and for future years.

- In the first year for which the correction may be made – that is, where the limitations period is still open – the corrected PNOLC subtraction pool is reduced by the subtraction that was used erroneously in a tax year for which the statute of limitations has expired.

These new provisions are consistent with the Department's approach to limit changes to the PNOLC subtraction pool in tax years subsequent to the base year in order to provide finality and certainty regarding the PNOLC subtraction. The Department is seeking comments by January 2, 2020. The Department has not yet indicated when it will begin the formal promulgation process for this or any of its draft regulations under corporate tax reform, all of which still remain on its website in draft form.

INSIGHTS IN BRIEF

TAX DEPARTMENT ISSUES GUIDANCE ON NEW ADJUSTED BASIS DEFINITION FOR QUALIFIED NEW YORK MANUFACTURERS

The New York State Department of Taxation & Finance has issued guidance on the effect of recent legislation that, for tax years beginning on or after January 1, 2018, changed the definition of a "qualified New York manufacturer" that is entitled to, among other things, a 0% tax rate on business income and real property tax credits. *Technical Memorandum*, "New York State Adjusted Basis Adjusted Basis for Qualified Manufacturers," TSB-M-19(5)C, (6)I (N.Y.S. Dep't of Taxation & Fin., Oct. 18, 2019). Under that legislation, for purposes of meeting the $1 million (or $100 million) property threshold for qualification, the "New York State adjusted basis" for the property is now used rather than the former "federal adjusted basis" measurement. This change was enacted into law because of concern that under the federal Tax Cuts and Jobs Act, taxpayers electing to treat certain expenditures as expenses, potentially reducing the federal adjusted basis of the property, might jeopardize their qualification as qualified New York manufacturers. The memorandum explains how the "New York State adjusted basis" is computed. It also advises taxpayers that have already filed their 2018 New York State returns and did not qualify because they did not meet the "federal adjusted basis" threshold, but that now meet the "New York adjusted basis" threshold, to file amended returns to claim the benefits for 2018.

ALJ DENIES REFUND OF SALES TAX

An ALJ has denied the claim by a purchaser of a residential swimming pool for refund of sales tax paid on the purchase of materials used in the construction and installation of the pool, finding that the transaction did not qualify for the exemption for capital improvements. *Matter of William E. Carl*, DTA No. 828109 (N.Y.S. Div. of Tax App., Oct. 17, 2019). The ALJ rejected the purchaser's argument that the contract he signed with Islander Pools and Spas, Inc. ("Islander") called for Islander both to purchase the necessary pool component parts and materials, and install the pool — a capital improvement — through its subcontractor. The ALJ instead determined that the contract provided that the installation was not included in the pool price and that the purchaser separately purchased and paid for the installation services from a third party, which had merely been recommended by Islander. Therefore, no exemption was available under the statute, which does not provide an exemption from sales tax on the purchase of materials even if they are used in the construction of a capital improvement.

continued on page 7

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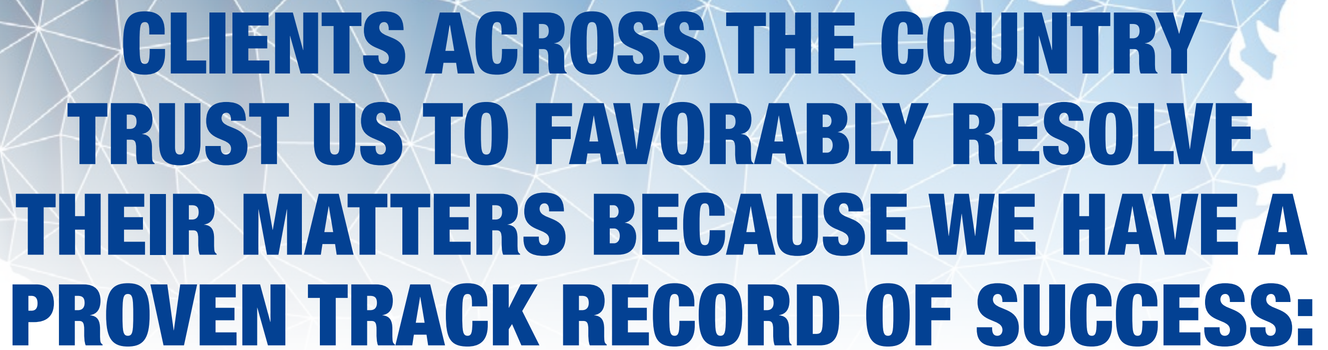

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MeadWestvaco Corp. v. Illinois (U.S. 2008)
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Wendy's International, Inc. v. Illinois (IL App. Ct. 2013)
Wendy's International, Inc. v. Virginia (VA Cir. Ct. 2012)
Whirlpool Properties, Inc. v. New Jersey (NJ Sup. Ct. 2011)
W.R. Grace & Co.-Conn. v. Massachusetts (MA App. Tax Bd. 2009)

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