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EDITORS

Hollis L. Hyans
hhyans@mofo.com

Irwin M. Slomka
islomka@mofo.com

STATE + LOCAL TAX GROUP

NEW YORK

Craig B. Fields cfields@mofo.com
Hollis L. Hyans hhyans@mofo.com
Nicole L. Johnson njohnson@mofo.com
Mitchell A. Newmark mnewmark@mofo.com
Irwin M. Slomka islomka@mofo.com
Michael A. Pearl mpearl@mofo.com
Rebecca M. Balinskas rbalinskas@mofo.com
Matthew F. Cammarata mcammarata@mofo.com
Eugene J. Gibilaro egibilaro@mofo.com
Kara M. Kraman kkraman@mofo.com

BOSTON

Craig B. Fields cfields@mofo.com
Philip S. Olsen polsen@mofo.com
Matthew F. Cammarata mcammarata@mofo.com

CALIFORNIA

Bernie J. Pistillo bpistillo@mofo.com
William H. Gorrod wgorrod@mofo.com
Maureen E. Linch mlinch@mofo.com

WASHINGTON, D.C.

Philip M. Tatarowicz ptatarowicz@mofo.com

THIRD DEPARTMENT UPHOLDS DECISION DENYING DEDUCTIBILITY OF PAYMENTS MADE TO CAPTIVE INSURANCE COMPANY

By Hollis L. Hyans

In *Matter of Stewart's Shops Corp.*, No. 525841, 2019 NY Slip Op. 04062, (3d Dep't, May. 23, 2019), the Appellate Division, Third Department, affirmed the decision of the New York State Tax Appeals Tribunal that a corporate taxpayer could not deduct insurance payments made to its wholly owned captive insurance company, because the payments did not qualify as valid insurance premiums under federal income tax law.

Facts. Stewart's Shops Corp. ("Stewart's Shops") owns and operates convenience stores and gas stations in New York and Vermont. After legislation was enacted in 1997 amending the New York Insurance Law to permit the creation of captive insurance companies, Stewart's Shops created a captive insurance company, Black Ridge Insurance Corp. ("BRIC"), to insure some of its self-insured risks. Stewart's Shops met with representative of the Department of Insurance's Captive Insurance Group concerning the new captive insurance program before setting up BRIC and claimed that it had been assured that its premium payments would be deductible for New York State tax purposes under Article 9-A.

On its corporation franchise tax returns for 2006 through 2009, Stewart's Shops deducted the insurance payments. After an audit, the Department of Taxation and Finance disallowed the insurance expense deductions, claiming that because the payments made to BRIC did not qualify as deductible for federal income tax purposes, they were also not deductible for New York purposes. The Department assessed additional tax of nearly $2 million, plus interest and penalties.

The Law. For the tax years at issue, a corporation's entire net income ("ENI") was defined as being "presumably the same as" a corporation's federal taxable income. Tax Law § 208(9). While the statute includes numerous modifications to federal taxable income, none of these were relevant to Stewart's Shops' insurance payments to BRIC.

Decisions Below. An Administrative Law Judge ("ALJ") had concluded that Stewart's Shops' insurance payments to BRIC were not deductible for corporate tax purposes, because they did not constitute insurance payments under

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federal tax law. The ALJ sustained the assessment of additional tax but canceled the penalties, finding that Stewart's Shops had acted reasonably and in good faith. The Tax Appeals Tribunal upheld the ALJ's decision, agreeing that the insurance payments at issue were not deductible for federal income tax purposes, and that federal law controls for purposes of defining ENI unless there is a specific statutory departure, relying heavily on *Matter of Dreyfus Special Income Fund, Inc. v. N.Y.S. Tax Comm'n*, 72 N.Y. 2d 874 (1988).

Although the 1997 legislation did set up competitive premium tax rates for captive insurance companies and established certain assessments to be paid by captives, it did not amend Tax Law § 208(9) to decouple from the applicability of federal law in determining the deductibility of premiums paid to captive insurers.

Appellate Division Decision. The Third Department agreed with the Tribunal that federal law governed and that Stewart's Shops was not entitled to the deductions. The statute, Tax Law § 208(9), explicitly provides that ENI is "presumably" the same as federal taxable income, and the court found that federal law controls, since the statute specifically incorporated federal law for the purpose of determining ENI. As the Court of Appeals held in *Dreyfus Special Income Fund*, the word "presumably" does not provide the Department with the ability to depart from reliance on federal taxable income, but merely means that federal taxable income governs in the absence of a specific state adjustment. Stewart's Shops did not dispute that its insurance payments to BRIC did not constitute insurance premiums for federal income tax purposes.

The court rejected Stewart's Shops' argument that, while there is no explicit deduction allowed for captive insurance premiums, the deduction should be inferred from the creation of captive insurance companies in 1997, because, Stewart's Shops claimed, the legislature "expressly intended to establish a favorable tax regime" for such companies. The court found that it was Stewart's Shops' burden to establish its entitlement to a tax deduction, and that Stewart's Shops failed to meet that burden. Although the 1997 legislation did set up competitive premium tax rates for captive insurance companies and established certain assessments to be paid by captives, it did not amend Tax Law § 208(9) to decouple from the applicability of federal law in determining the deductibility of premiums paid to captive insurers. The court held that Stewart's Shops' "conclusory assertion" that the "tax deductibility of premiums was a critical part" of the new insurance legislation was unsupported by any clear provision in the 1997 statute, and that the Legislature is presumed to be aware that federal law governed for tax purposes, but did not make any statutory amendment governing deductibility.

The court also found no support in the record for Stewart's Shops' allegation that it had been provided with an "affirmative representation" by the Insurance Department that its payments to BRIC would be tax deductible, noting that the head of the Captive Insurance Group testified that he did not recall making any representations regarding tax deductibility, and Stewart's Shops never sought an informal or advisory opinion from the Insurance Department prior to creating BRIC.

Because the court found no ambiguity regarding the applicability of federal law, it concluded that it did not need to consider whether the 1997 Insurance Law and Tax Law § 208(9) must be read together, or whether subsequent amendments in 2009 and 2014 provide evidence of the Legislature's intent, since those amendments did not modify the computation of ENI or otherwise permit deductions to a captive insurer.

ADDITIONAL INSIGHTS

The determination that the statute's definition requiring ENI to "presumably" be the same as federal taxable income has been part of the tax law for generations, and at least since the Court of Appeals decision in *Dreyfus Special Income Fund* more than 30 years ago it has been found to bar variation from federal taxable income in the absence of specific New York statutory modifications. It has been employed both to protect taxpayers from adjustments sought to be imposed by the Department – as in *Dreyfus Special Income Fund*, where the court invalidated a regulation under which the Department purported to deny regulated investment companies a deduction for dividends paid to shareholders – and, as in *Stewart's Shops*, to deny taxpayers deductions that are not permitted under federal law.

Captive insurance companies have become a common corporate insurance vehicle. If certain requirements are met, deductions for payments paid to captive insurers are recognized for federal purposes, and under the *Stewart's Shops* decision, these deductions should also be

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respected for New York State purposes for years governed by pre-2015 law. The court explicitly noted that Stewart's Shops could have structured its arrangement with BRIC to achieve the risk shifting and risk distribution that are required under federal law to constitute bona fide insurance by, for example, having BRIC insure affiliated companies or reinsuring risk with a third-party insurer.

Under current New York State and City law, effective for years beginning on or after January 1, 2015, a taxpayer is required by statute to include a captive insurance company in its combined reports where less than 50% of the captive insurance company's premiums are from arrangements that constitute valid insurance for federal purposes. Tax Law §§ 2, 1500(a) and 1500-b(a). N.Y.C. Admin. Code § 11-651.

APPELLATE COURT UPHOLDS NARROW INTERPRETATION OF NYC REIT TRANSFER TAX PROVISION

By Irwin M. Slomka

The Appellate Division has confirmed a decision of the New York City Tax Appeals Tribunal upholding the Tribunal's narrow interpretation of a provision in the New York City real property transfer tax ("RPTT") law that affords preferential tax treatment to qualifying transfers to newly formed real estate investment trusts ("REITs"). *VCP One Park REIT LLC. v. N.Y.C. Tax Appeals Trib.*, No. 9102, 2019 NY Slip Op 03149 (1st Dep't, Apr. 25, 2019). At issue was the proper application of the longstanding test that must be satisfied in order for a transaction to qualify as a REIT transfer.

Law. The RPTT law provides beneficial tax treatment for qualifying "REIT transfers" in two ways: first, by imposing the New York City transfer tax at only 50% of the applicable rate (1.3125% rather than 2.625%); and second, by measuring the taxable consideration based on the "estimated market value" shown in the most recent real property tax assessment notice for the property issued by the Department of Finance for the property, rather than based on the actual consideration. Admin. Code § 11-2102.(e)(1), (3). In order to qualify as a REIT transfer, the statute provides what is known as the "40% Test." To satisfy that test, the "value of the ownership interests in the REIT . . . received by the grantor as consideration" must be equal to at least 40% of the "value of the equity interest" in the realty or economic interest conveyed by the grantor. Admin. Code §11-2102(e)(2)(C). At issue was whether, in applying the 40% Test, Administrative Code § 11-2102(e)(3) must also be applied. That section provides that "for purposes of determining the consideration for a [qualifying REIT] transfer . . . *the value of the real property or interest therein shall be equal to the estimated market value* as determined by" the Department of Finance on the most recent assessment notice for real property tax purposes (Emphasis added). It is common knowledge that the annual estimated market value on the Department's property tax assessment notices is usually lower than the fair market value of the property.

Facts. On March 1, 2011, the grantor (One Park Avenue Mezz Partners LLC) transferred its 100% economic interest in real property located at One Park Avenue in Manhattan, which it owned through a tiered ownership structure, to two newly formed REITs. The grantor received consideration (cash and ownership interests in the REITs) of approximately $5.6 million, $3.375 million of which represented the ownership interests. At the time of the transfer, the real property was encumbered by a $375 million mortgage.

An RPTT Return was filed reporting the transaction as a qualifying REIT transfer, with the transfer tax computed at the reduced tax rate and using a $240 million estimated market value from the Department's most recent notice of real property assessment as the taxable consideration. Transfer tax of approximately $3 million was paid by the grantees.

Following an audit, the Department concluded that the 40% Test was not satisfied, because the value of the REIT interests received by the grantor ($3.375 million) was only 39.13% of the total consideration of $5.6 million plus the $3 million transfer tax paid by the grantees, and therefore the transaction did not qualify as a REIT transfer. The Department assessed additional transfer tax of $10.8 million, plus interest. This litigation followed.

ALJ determination. In 2017, an Administrative Law Judge held that the transaction qualified as a REIT transfer, and was therefore taxable at the reduced tax rate and using the lower estimated market value as the consideration. The ALJ rejected the Department's various arguments, including the claims that the use of the estimated market value did not apply to transfers of economic interests and that the 40% Test is meaningless where, as here, the $375 million mortgage is greater than the estimated

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market value, resulting in a negative equity. The ALJ concluded that therefore, by definition, the grantor's interest was at least 40% of the equity, satisfying the 40% Test, and noting: "It is beyond the authority of this Tribunal to re-write the statute or substitute a different test."

Unless the decision is reversed by the Court of Appeals, or remedial legislation is enacted, some REITs may now be subject to significant (and unexpected) transfer tax exposure.

Tribunal decision. In 2018, the City Tribunal reversed, upholding the Department's assessment, with some minor modifications, after concluding that the 40% Test was not met. The basis for the Tribunal's conclusion (which did not appear to be what the Department had argued) was that the provision for use of estimated market value (Admin. Code § 11-2102(e)(3)) is superseded by the general definition of "consideration" contained in Administrative Code § 11-2101(9). According to the Tribunal, had the Legislature intended for the consideration to be equal to the Department's estimated market value for the property, it would have expressly provided as such, as it did for other provisions in the RPTT law. Thus, the Tribunal held that using the actual consideration for the transfer meant that the $3.375 million valuation of the grantor's interests in the grantee REITs was less than 40% of the actual consideration of $11.7 million (a different amount than the Department used), and thus the transfer did not qualify as a REIT transfer.

Appellate Division decision. The First Department, in a terse decision, has now confirmed the City Tribunal decision, concluding that the grantor failed to show that the Tribunal erred in its application of the 40% Test and in calculating the consideration subject to the higher tax rate.

ADDITIONAL INSIGHTS

The Appellate Division summary decision does not explain how it reached its conclusion, and anyone wanting to fully understand the issues will benefit from reading the City Tribunal's decision along with the ALJ's determination. The decision certainly will not encourage the formation of REITs in New York City, the principal purpose for the enactment of the REIT transfer provision. The decision fails to explain why the use of estimated market value under § 11-2102(e)(3) should not apply to the 40% Test set out in §11-2102(e)(2)(C), which measures the value of the ownership interests in the REIT against the "value of the equity interest" in the realty or economic interest conveyed. Many REIT transfers in New York City employed the same methodology that the City Tribunal and the Appellate Division have now invalidated. The Department did not acknowledge that the taxpayers' reporting position in this case had been routinely accepted by the Department for many years. Unless the decision is reversed by the Court of Appeals, or remedial legislation is enacted, some REITs may now be subject to significant (and unexpected) transfer tax exposure.

NEW YORK STATE ALJ HOLDS THAT DOCK RENTAL FEES ARE SUBJECT TO SALES TAX

By Kara M. Kraman

A New York State ALJ held that a yacht club's charges for dock rentals to its members were taxable "dues" paid to a social or athletic club for sales tax purposes, and not nontaxable charges for the leasing or rental of real property. *Matter of Genesee Yacht Club, Inc.*, DTA No. 827668 (N.Y.S. Div. of Tax App., May 2, 2019).

Facts. Genesee Yacht Club, Inc. ("Genesee") is a not-for-profit social and athletic club that owns waterfront property on the Genesee River. Genesee charges its members annual fees and makes its clubhouse facilities available to all members. In addition, Genesee owns and maintains docks that may be leased by its members. The docks, and the piers to which they are attached, are located entirely within Genesee's property and are permanent structures, constructed from wood and steel, and immovably attached to pilings driven into the ground. Genesee's charges to its members for renting a dock are separate from and in addition to annual membership dues, and the annual dues do not entitle a member to use Genesee's docks. Genesee collected and remitted sales tax on its membership dues, but did not charge sales tax on the dock rental fees.

The Department had audited Genesee for sales tax periods from 2008 through 2011 and determined that Genesee should have collected sales tax on the dock rental fees it charged to its members. However, the Department declined to assess sales tax for the audit period because

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of Genesee's reliance on a Monroe County Supreme Court judge's unpublished decision in *Rochester Yacht Club v. Department of Taxation & Finance* (Sup. Ct. Monroe Cnty, Sept. 4, 1985). In that case, the judge held that a yacht club located less than a mile away from Genesee on the same river did *not* have to collect sales tax on charges for rental of its docks and moorings because the charges were nontaxable charges for the lease of real property. Like Genesee, Rochester Yacht Club's docks and piers were solely within its property, were permanent structures constructed of wood and steel, and were immovably attached to pilings driven into the ground. Nevertheless, and notwithstanding the decision in *Rochester Yacht Club*, the Department instructed Genesee that going forward it was required to collect and remit sales tax on the charges to members for dock rentals. Genesee remitted sales tax for the next sales tax period and then requested a refund.

Law. Sales tax is imposed on "dues" paid to any social or athletic club. Tax Law § 1105(f)(2). Dues are defined as "[a]ny dues or membership fee including any assessment, irrespective of the purpose for which made, and any charges for social or sports privileges or facilities." Tax Law §1101(d)(6). The regulations set forth examples of charges that are considered taxable dues. One of those examples reads as follows:

> A club organized and operated for the promotion of yachting, and other aquatic sports, which is a social and athletic club, owns and maintains docking and mooring facilities for the use of its members. The club makes a charge to each member using its facilities. The amount of the charge depends upon the size of the member's boat and the location of the docking and mooring facilities used. The charges made by the club for these facilities constitute taxable dues or membership fees.

20 NYCRR 527.11(b)(2)(i)(c), ex. 6.

ALJ Determination. The ALJ held that the definition of "dues" was very broad, and that dock fees, regardless of whether they are charges for leasing or renting real property, fell within the definition of "dues" under the Tax Law and were therefore taxable. The ALJ also found that the docking fees "squarely fall" within the example given in the regulation. In support of his conclusion, the ALJ cited to *Matter of Youngstown Yacht Club, Inc.*, DTA No. 813503 (N.Y.S. Tax App. Trib., Dec. 11, 1997), in which the Tax Appeals Tribunal held that charges to members for a mooring, *i.e.*, a weight or anchor sunk at a designated area in the water and attached by a chain to a mooring ball, were "dues" subject to sales tax. The ALJ did not address the fact that movable moorings are unlike permanent docks, which are affixed to real property.

The ALJ also rejected Genesee's argument that the *Rochester Yacht Club* decision – which the Department did not appeal – collaterally estopped the Department from relitigating the same issue in Genesee's case. The ALJ found that while Genesee met its burden in showing identity of the issues was the same, he concluded that the doctrine cannot be invoked against a governmental agency to preclude it from enforcing its laws, except in rare circumstances not present in this case, and further noted that collateral estoppel does not apply in tax cases unless "unusual circumstances support a finding of manifest injustice." (Citation omitted.) He also found that requiring Genesee to collect sales tax on its dock rental fees, but not requiring Rochester Yacht Club to collect sales tax on its dock rental fees, did not affect a manifest injustice.

[T]he docks at issue were clearly permanent and immovable structures affixed to real property owned by Genesee, and charges for their use were arguably charges for the rental or lease of real property, which is not subject to sales tax . . . .

ADDITIONAL INSIGHTS

Charges by a club to its members for docking facilities are clearly subject to sales tax under the regulation. However, it is possible that the example in the regulation itself is invalid to the extent it imposes sales tax on the rental of real property. While Genesee did not appear to challenge the validity of the regulation, the docks at issue were clearly permanent and immovable structures affixed to real property owned by Genesee, and charges for their use were arguably charges for the rental or lease of real property, which is not subject to sales tax, rather than dues. Moreover, finding that the regulation impermissibly subjects rentals of real property to sales tax is not precluded by the Tribunal's decision in *Matter of Youngstown Yacht Club*, which was relied upon by both the ALJ and the Department. That case involved charges for non-permanent moorings that were installed and uninstalled annually and were not located on the yacht club's property, and thus may not have involved the rental of real property at all.

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INSIGHTS IN BRIEF

APPELLATE COURT UPHOLDS DENIAL OF INDIVIDUAL'S CLAIMED BUSINESS LOSSES

The Appellate Division has upheld the New York State Tax Department's disallowance of an individual's losses from her photography business that she claimed on her New York State Personal Income Tax Returns. *Mayo v. Div. of Tax Appeals, Tax Appeals Trib.*, No. 525172, 2019 NY Slip Op. 03705 (3d Dep't, May 9, 2019). The taxpayer claimed that she was deprived of her due process rights because the Department had issued tax bills based on the disallowance of her losses before it had conducted an audit or given her an opportunity to respond to requests for documentation. The Third Department held that the Tax Law gives the Department the discretion to determine the most suitable standards and procedures for examining a tax return, and there was no showing of any impropriety by the Department in the method chosen. The court also noted that despite having engaged in conciliation proceedings and a hearing before the Division of Tax Appeals, the taxpayer never documented the claimed business losses.

TRIBUNAL AGAIN UPHOLDS RETROACTIVE APPLICATION OF QEZE STATUTORY CHANGE

The New York State Tax Appeals Tribunal has affirmed the decision of an ALJ disallowing qualified empire zone enterprise ("QEZE") credits for the 2009 tax year, finding that the decertification of the petitioners' businesses by the Department of Economic Development in June 2009 based upon a statutory change could be applied retroactively to the entire 2009 year. *Matter of Carl Montante, Sr. & Carol Montante, et al.*, DTA Nos. 827235-827239 (N.Y.S. Tax App. Trib., May 2, 2019). While agreeing with the petitioners that application of a statutory change in June 2009 back to the beginning of 2009 is indeed retroactive, as it had also found in similar cases, the Tribunal determined that the short period of retroactivity from June to January 2009 did not violate the Due Process Clause. Even though the Tribunal agreed that the retroactive amendment lacked a valid public purpose, it concluded, just as it had last year in *Matter of Clayton H. Hale, Jr. & Patricia H. Hale, et al.*, DTA No. 827149 et al. (N.Y.S. Tax App. Trib., June 14, 2018), that "the extremely short period of retroactivity outweighs the lack of a public purpose."

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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)

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