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# NEW YORK TAX INSIGHTS
Volume 8, Issue 2, February 2017

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## EDITORS

Hollis L. Hyans
hhyans@mofo.com

Irwin M. Slomka
islomka@mofo.com

## NEW YORK STATE + LOCAL TAX GROUP

Craig B. Fields
cfields@mofo.com

Paul H. Frankel
pfrankel@mofo.com

Hollis L. Hyans
hhyans@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

Michael J. Hilkin
mhilkin@mofo.com

Nicole L. Johnson
njohnson@mofo.com

Kara M. Kraman
kkraman@mofo.com

Eva Y. Niedbala
eniedbala@mofo.com

Michael P. Penza
mpenza@mofo.com

Rachel D. Trickett
rtrickett@mofo.com

* Admitted only in Massachusetts

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# Governor Cuomo Releases 2017-18 New York State Executive Budget

By Irwin M. Slomka and Kara M. Kraman

New York State Governor Andrew M. Cuomo released his 2017-2018 Executive Budget, containing an assortment of potentially important tax proposals, including the following:

1. **Extends top personal income tax rates.** Extends the top tax bracket under the personal income tax (the so-called "Millionaires Tax"), which is imposed at a rate of 8.82%, for an additional three years through 2020. The top tax bracket was originally set to expire after 2017. (Part R)

2. **Expands scope of real estate transfer tax.** Significantly broadens the scope of the real estate transfer tax to include as a "conveyance" the transfer of any interest (not only a "controlling interest") in a partnership, limited liability corporation, S corporation, or non-publicly traded C corporation with less than 100 shareholders if the entity in question owns New York real property having a fair market value that equals or exceeds 50% of the value of all of the entity's assets on the date of transfer of an interest in that entity. (Part JJ). The Department of Taxation and Finance would also be given the authority to subject to the "Mansion Tax" – an additional tax on sales of residential real property for consideration of $1 million or more – any conveyance "made pursuant to an agreement, understanding or arrangement that results in avoidance or evasion of the tax." (Part KK)

3. **Conforms New York State S corporation treatment to federal.** Conforms the New York State S corporation treatment to the federal S corporation treatment in all cases. Currently, a federal S corporation has the option of electing to be taxed as a New York State S corporation or instead be taxed as a C corporation under Article 9-A by the unanimous consent of all of its shareholders. This would also result in the nonresident individual shareholders having New York source income from their distributive share of S corporation income even in the absence of an election. The proposal would apply to taxable years beginning after 2017. (Part Y)

4. **Requires marketplace providers to collect sales tax.** Requires a marketplace provider, defined as a person who collects the purchase price and provides the physical or virtual forum where the transaction occurs, to collect sales tax from customers on sales of tangible personal property they facilitate unless they facilitate

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less than $100 million in sales each calendar year. Marketplace sellers who are sales tax vendors would be relieved from the duty to collect sales tax on those sales where the marketplace provider has certified that it is registered to collect the tax and that it will collect the tax. If enacted, the new law would go into effect on September 1, 2017. Currently, marketplace providers are not "persons required to collect tax" under the sales tax law. (Part BB). A similar marketplace provider proposal was included in the 2015-2016 Executive Budget but was not enacted.

5. **Closes sales and use tax "loopholes" for certain related party transactions.** In a scaled-down version of a proposal made (but not enacted) in the 2015-16 Executive Budget, this proposal would amend the definition of "retail sale" to include sales of tangible personal property made to legal entities (such as single member LLCs or partnerships) in situations where the property is resold to related persons or entities. The Governor's Memorandum in Support states that this would close a sales tax "loophole" whereby an entity buys property exempt from sales tax as a purchase for resale, which it then leases to a related entity so that only the lease payments are subject to sales tax. (Part CC)

   Another proposal would eliminate the existing use tax exemption for property or services brought into New York State by a non-resident (other than an individual) unless the non-resident has been doing business outside the State for at least six months prior to the date the property or services are brought into the State. The Memorandum in Support states that this would close a use tax "loophole" whereby a New York State resident avoids use tax by forming an out-of-State entity to purchase property or services outside the State and then bring them into the State tax-free. (Part CC)

6. **Disregarded entity treatment to be followed for tax credit purposes.** A single member LLC disregarded for federal income tax purposes will be disregarded in determining its owner's eligibility for State tax credits. As a result, any tax credit requirements and the tax credit computation are made based on treating the taxpayer and the disregarded entity as a single entity. The Memorandum in Support (and the draft legislation itself) states that the proposal is intended to reverse the effects of a New York State Tax Appeals Tribunal decision holding in favor of the taxpayer that two disregarded SMLLCs owned by an individual should be treated as separate entities in determining entitlement to an Empire Zone tax credit. *Matter of Lisa A. Weber*, DTA No. 825857 (N.Y.S. Tax App. Trib., Aug. 25, 2016). The proposal, if enacted, would apply to all open taxable years. (Part Q)

7. **Closes co-op sale "loophole."** Proposes to close a personal income tax "loophole" whereby the sale by a non-resident individual of shares in a co-op housing corporation generates New York source income subject to personal income tax, but the sale by a non-resident of an ownership interest in an entity whose assets consist solely of co-op stock does not. The current definition of "real property located in this state" would be amended to include an interest in a partnership, LLC, S corporation, or non-publicly traded C corporation with 100 or fewer shareholders that owns New York real property or shares in a co-op where the fair market value of such real property and co-op shares equals or exceeds 50% of the value of all of the entity's assets. (Part Z)

The deadline for enactment of the New York State budget is April 1, 2017.

# ALJ Rejects Department's Use of Market Sourcing Prior to Corporate Reform

By Hollis L. Hyans

A second New York State Administrative Law Judge has rejected the attempt of the Department of Taxation & Finance to source the receipts of a business provided over the Internet to the location of customers, holding that receipts from the provision of electronic bill payment and presentation services should be sourced to where those services were provided, entirely outside New York. *Matter of CheckFree Services Corporation*, DTA Nos. 825971 & 825972 (N.Y.S. Div. of Tax App., Jan. 5, 2017).

*Facts*. CheckFree was based in Norcross, Georgia, and provided, in addition to other services not at issue, electronic bill payment and presentment ("EBPP") services that enabled end-user consumers to receive and pay bills electronically. CheckFree provided its services to, and was paid by, consumer service providers ("CSPs") such as large financial institutions, credit unions, and more than 15,000 community banks, as well as direct billers and health and fitness facilities (the "Service Customers"). CheckFree's services allow consumers – the customers of the CSPs – to log onto CheckFree's website and pay bills electronically to any merchant or vendor in the United States, with funds drawn from the consumers' accounts at the CSPs. For


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some of the larger merchants, consumers are also able to receive and view bills electronically. CheckFree's services allowed its Service Customers to outsource their bill payment and presentment functions, while preserving their own unique brands, since the websites are set up to look like they are the Service Customers' own websites. Service Customers are often unable or unwilling to provide these services themselves, but the services are valuable, since consumers demand the ability to pay bills electronically.

**The ALJ determined that it was "of no moment that the ultimate fulfillment of the desired service is . . . accomplished electronically," and that the computers, servers and other equipment were "simply the tools" used to perform and provide the service.**

CheckFree provided these services using a proprietary transaction processing technology, and assured the transactions would comply with Federal Reserve Automated Clearing House standards for money movement. CheckFree operated primarily on a proprietary "Risk Processing" model, under which it assumed the risk for the consumers' payments once it sent the credit to the merchant, thereby providing a quicker turn-around time to consumers.

CheckFree operated primarily at facilities in Georgia, Ohio, Illinois, and Arizona, and had no employees, assets, or offices involved in generating the EBPP receipts in New York. It had between 3,050 and 4,300 employees during the years in issue, and approximately 70-80% of them performed functions connected with the EBPP business. CheckFree's implementation team manually updated consumer information, while other employees monitored payments that were not processing successfully, and its collections group worked to collect payment when debits were returned for insufficient funds. About 20% of the transactions ended up resulting in paper checks, and those checks were issued from CheckFree's facilities in Ohio and Arizona. CheckFree's activities also included monitoring transactions for potential fraud using a "Fraud Net" System, and it had over 1,000 employees in call centers in several states responding to consumers' calls in the name of the particular CSP and working directing with the consumers to solve problems.

*The Issue:* On its Article 9-A returns for the period July 1, 2004, through December 31, 2009 (the "years in issue"), CheckFree treated its EBPP receipts as arising from a service and, under New York's former apportionment rules, Tax Law former § 210(3)(a)(2)(B), sourced the receipts to where the service was performed, entirely outside New York. On audit, the Department recharacterized the EBPP receipts as "other business receipts" under Tax Law former § 210(3)(a)(2)(D), claiming that there was no "direct human involvement" in the performance of the services, and that the receipts should be sourced to the location of the consumers where, the Department contended, they were "earned." CheckFree objected to the recharacterization but argued that, even if the receipts were "other business receipts," they were earned at the locations where the activities and work were performed. The Department also raised, in its post-hearing brief, an argument that the EBPP receipts were generated by CheckFree allowing access to and use of intangible assets – its website and the EBPP system.

*ALJ Decision.* The ALJ agreed with CheckFree that it was providing services. He found that CheckFree's Service Customers outsourced their EBPP function to third parties such as CheckFree to avoid having to incur the costs for personnel, technological resources, and expertise necessary to create and maintain their own bill-paying websites, and that the Service Customers paid CheckFree for providing this service to their own customers, the consumers. The ALJ determined that it was "of no moment that the ultimate fulfillment of the desired service is . . . accomplished electronically," and that the computers, servers, and other equipment were "simply the tools" used to perform and provide the service.

The Department argued that its regulation, 20 NYCRR § 4-4.3(a), which provided that receipts from services are allocated to New York "whether . . . performed by employees, agents, or subcontractors" required that there had to be "human involvement" at the time the consumers used the website for the receipts to qualify as resulting from services. The ALJ rejected this position as an "impermissible expansion" of Tax Law former § 210(3)(a)(2)(B) and found that the statute by its plain meaning did not require human interaction at the moment of sale. The ALJ also found that the regulation was aimed at the *allocation* of receipts and not the *classification* of receipts, and that the regulation presupposes that the receipts to which it pertains are service receipts. He further found that the "evident aim" of the regulation was to prevent a taxpayer from excluding receipts from being allocated to New York by using agents or subcontractors, and the fact that a corporation may employ technology in performing its



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services does not by itself remove the receipts from being classified as service receipts. In any case, the ALJ agreed with CheckFree that, even if human involvement were required, there was ample evidence of human involvement throughout the process of providing EBPP services, and that the services performed consisted of "much more than a simple, instantaneous, fully automated transaction" occurring solely when customers used their computers, but rather were the provision of efforts that were "highly labor-intensive . . . expensive (requiring a large platform and technology infrastructure), complicated[,] . . . risky . . . and . . . evolving."

**In light of the fact that two ALJs have definitively held that receipts from services, even if ultimately provided electronically, were sourced to where they were performed . . . perhaps the Department will reconsider its "human involvement" approach for the pre-2015 years.**

Finally, the ALJ also rejected the Department's argument that the EBPP receipts were derived from granting licenses allowing access to and use of intangible assets, finding that, when properly viewed in its entirety, CheckFree's business was providing and performing an EBPP service, and any rights granted to access its systems were "only a necessary incident" of providing such service.

After concluding that the receipts arose from the performance of services, the ALJ found that those services all occurred outside New York, citing *Siemens Corp. v. Tax Appeals Tribunal*, 89 N.Y.2d 1020 (1997), in which the Court of Appeals held that, to the extent interest income from loans arose from work performed in New York, such receipts were sourced to New York. Noting that the court in Siemens decided that the interest income was other business receipts under Tax Law former § 210(3)(a)(2)(D) rather than receipts from services, the ALJ found that, under either classification, the receipts were properly allocated outside New York. The ALJ also noted that the New York Legislature amended the Tax Law effective January 1, 2015, to change the sourcing of service receipts from place of performance to the location of customers, which would have been unnecessary if the Department's interpretation of the former statute were correct.

### Additional Insights

The decision in this case is very similar to the one reached in *Matters of Expedia, Inc. and Expedia, Inc. (Delaware Company)*, DTA Nos. 825025 & 825026 (N.Y.S. Div. of Tax App., Feb. 5, 2015). In both cases, the Department was arguing that there was no "human" involvement at the final moment of the provision of services and that such involvement was required under the Department's regulation – an argument now rejected by two different ALJs.

The Department did not file an exception to the *Expedia* ALJ decision, and it is not known yet whether the Department will seek to appeal *CheckFree*. In light of the fact that two ALJs have definitively held that receipts from services, even if ultimately provided electronically, were sourced to where they were performed under the former New York apportionment rules, and in light of the sweeping change in New York law adopting market sourcing after 2015, perhaps the Department will reconsider its "human involvement" approach for the pre-2015 years. If not, and if an appeal is filed in *CheckFree*, there may yet be a precedential decision on this issue from the Tax Appeals Tribunal.

## ALJ Rules That City Utility Tax Does Not Apply to Charges Related to Long-Distance Telephone and Internet Access Services

By Michael J. Hilkin

A New York City Administrative Law Judge held that an assortment of charges related to long-distance telephone services were not subject to the New York City utility tax ("Utility Tax") because they were for exempt transactions "originating or consummated outside the territorial limits" of New York City. Further, the ALJ held that New York City was barred by the Internet Tax Freedom Act ("ITFA") from imposing the Utility Tax upon "local DSL fee[s] for Internet access." *Matter of U.S. Sprint Communications Company, LP*, TAT(H)14-12(UT) *et al.* (N.Y.C. Tax App. Trib., Admin. Law Judge Div., Dec. 29, 2016).

*Facts*. U.S. Sprint Communications Company, LP ("Sprint") provided local and long-distance telephone service in New York City. Sprint's local telephone service involved telephone calls both initiated from and received within the City, while long-distance telephone service involved calls that either were initiated from the City and received outside the City or initiated outside the City and received within the City.



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Sprint owned no local telephone equipment but instead paid access charges to use the facilities of a local exchange carrier ("LEC") to bring long-distance calls the "last mile" between the customer's location and Sprint's "point of presence," meaning Sprint's long-distance switch. Such access charges were based on a schedule set by the Federal Communications Commission. Some of the access charges were based on usage and others were a fixed monthly fee per line.

Sprint charged its long-distance customers a "per-minute" rate for long-distance calls, accompanied by a series of other charges ("Charges at Issue") that the ALJ placed into five categories: (1) the recoupment of taxes and fees attributed to long-distance telephone calls; (2) access charges paid to LECs based on usage; (3) access charges paid to LECs on a fixed, per-customer basis; (4) charges for additional services, including voicemail, access to toll-free telephone numbers, call routing, three-way calling, call waiting, and caller ID; and (5) charges for the sale and installation of telephone equipment at the customer's premises. Separately, Sprint provided some of its customers with digital subscriber line ("DSL") Internet access, and such customers were charged for the lines that provided that access.

*Tax Law.* New York City imposes the Utility Tax under the authority of New York State's General City Law ("GCL") § 20-b, which enables cities to impose a utility tax on certain utility services, including telecommunication services. However, GCL § 20-b prohibits cities from imposing a utility tax on "*any transaction* originating or consummated outside the territorial limits of any such city, notwithstanding that some act be necessarily performed with respect to such transaction within such limits." (Emphasis added.) Therefore, the Utility Tax may not be assessed on a long-distance telephone call even if some part of the call occurs within the City.

*The Decision.* The ALJ concluded that GCL § 20-b prohibited most of the Charges at Issue from being subject to the Utility Tax. The ALJ first examined the language of GCL § 20-b to determine its scope and concluded that "once a long-distance transaction is identified, all of the revenue associated with it is exempted" by GCL § 20-b, so the all charges "related" to a long-distance telephone call, including "cost-recovery charges," are not subject to tax.

Next, the ALJ examined all of the Charges at Issue to determine whether they relate to long-distance telephone calls. With respect to charges for the recoupment of taxes and fees attributed to long-distance telephone calls, the ALJ concluded that all of the taxes recouped by such charges were imposed on Sprint solely because it provided long-distance telephone services and thus were not subject to the Utility Tax. Similarly, the access charges paid to LECs based on usage and on a fixed, per-customer basis were associated solely with long-distance telephone calls and therefore not subject to Utility Tax. The ALJ gave special attention to the fixed access charges, which the City claimed "relate to a purely local transaction between Sprint and the LEC" – i.e., the "last mile" access. While the ALJ agreed that the charges related to local transactions "so far as the cost is concerned," he concluded that such charges are paid exclusively "in order to provide long-distance telephone service," and the language of GCL § 20-b states that the exemption applies "notwithstanding that some act be necessarily performed with respect to such transaction within such limits."

**The ALJ . . . concluded that "once a long-distance transaction is identified, all of the revenue associated with it is exempted" by GCL § 20-b . . .**

With respect to the charges for additional services, including access to toll-free telephone numbers, call routing, three-way calling, call waiting, caller ID, and voicemail, the ALJ found that, except for charges for voicemail and the sale and installation of telephone equipment, the charges were not subject to tax because they "correspond to Sprint's long-distance telephone service, and . . . were billed only to long-distance customers who received the service." However, the ALJ determined that Sprint did not demonstrate that charges related to voicemail service were exempt because "[v]oicemail can exist apart from a long-distance call." The ALJ also rejected Sprint's claim that charges for the sale and installation of telephone equipment at the customer's premises were not subject to the Utility Tax because the plain language of the statute specifically includes "equipment and services provided therewith." Admin. Code § 11-1101(9).

Finally, the ALJ agreed with Sprint that its DSL Internet access charges were exempt from the Utility Tax under the ITFA. The ALJ reasoned that the ITFA specifically imposed a moratorium on "taxes on Internet access" imposed and actually enforced subsequent to September 30, 1998, and the New York City Department of Finance specifically released guidance both in 1999 and 2007 stating that it was the Department's policy "not to treat Internet access service as [taxable] telecommunications services for Utility Tax purposes."


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### Additional Insights

While this case involves a tax that applies to a relatively narrow industry, and the case is still subject to appeal to the New York City Tax Appeals Tribunal, it may serve as a general reminder to taxpayers that the City and State departments of taxation often interpret very narrowly the categories of transactions that are not subject to tax. Taxpayers should closely scrutinize any audit assessment for adjustments imposing tax on transactions that were treated as exempt and consider whether the reversal may not be supported by the tax law.

# INSIGHTS IN BRIEF

### Tribunal Reverses Summary Determination Because NYS Department Did Not Show There Were No Material Issues of Fact in Dispute

Reversing an Administrative Law Judge decision that granted summary determination in favor of the Department, the New York State Tax Appeals Tribunal held the Department failed to make a prima facie case showing that certain charges by the Buffalo Sewer Authority were not real property taxes eligible for the Qualified Empire Zone Enterprise credit under Tax Law § 15(e). *Matter of William J. Jones, et al.*, DTA No. 826618, et al. (N.Y.S. Tax App. Trib., Dec. 20, 2016). Since the nature of the charges in question was a material issue of fact, the Department's failure to introduce evidence regarding the nature of those charges – it was relying on Court of Appeals' precedent regarding the charges that significantly predated the tax year in issue – the Tribunal held that the Department was not entitled to summary determination and remanded the case back to the ALJ.

### NYS Tribunal Holds That Department Not Entitled to Dismiss Untimely Petition Due to Questions About Taxpayer's "Last Known Address"

The New York State Tax Appeals Tribunal reversed an Administrative Law Judge determination that held that an individual failed to timely file a Petition from a Conciliation Order. *Matter of Leandro Campos-Liz*, DTA No. 826984 (N.Y.S. Tax App. Trib., Jan. 12, 2017). The taxpayer, who was seeking a New York earned income credit, admitted that he did not file his Petition within the 90 days allowed by law and did not dispute that the Conciliation Order was mailed to his last known address. However, the Tribunal held that the Department did not meet its burden of showing that the taxpayer's Florida mailing address used in the Order – which was based on statements the taxpayer made at the conciliation conference – was clearly his last known address, particularly in light of other evidence that he used a Bronx, New York, address, both prior to and subsequent to the conciliation conference. The Tribunal withdrew the notice of intent to dismiss and remanded the case to the ALJ for further proceedings as to the timeliness of the Petition and, if appropriate, for a decision on the merits.

### After Remand, NYS Tribunal Affirms That SUNY Professor's Distribution from a Rollover IRA Does Not Qualify for State Pension Exclusion

After remanding the case to an Administrative Law Judge for a more complete analysis of how the rollover of an otherwise qualifying SUNY pension by a retired SUNY professor into an IRA changed the nature of the pension, the New York State Tax Appeals Tribunal has affirmed the ALJ's determination that a distribution from the IRA did not qualify for the 100% exclusion from the personal income tax for pensions paid to State employees. *Matter of Peter and Marguerite Kane*, DTA No. 824767 (N.Y.S. Tax App. Trib., Dec. 21, 2016). The Tribunal concluded that an employer-sponsored retirement plan is fundamentally different from an IRA, justifying different tax treatment, despite the fact that the IRA was funded with a rollover from a pension that would have qualified as generating tax-free income if it had not been rolled over. The Tribunal relied on what it found to be significant differences in the IRA from the original pension, including the sole control over the IRA by the employee, funding of the IRA by the employee rather than by the State employer, and the ability of the employee to make further deposits into the IRA.

### Tribunal Affirms Decision Attributing Flow-Through Income to Subchapter S Corporation Shareholder

The New York State Tax Appeals Tribunal has held that the Department properly attributed additional flow-through income from a Subchapter S corporation to a shareholder. *Matter of Patricia Devesta-Owrutzky*, DTA No. 826371 (N.Y.S. Tax App. Trib., Dec. 29, 2016). The additional income arose from a sales tax audit of the S corporation, which found substantial amounts of unreported sales and increased the income of the corporation. The Tribunal held that results of sales tax audits may properly be the basis of determinations of additional income tax owned by the business owner, and that the petitioner had failed to introduce any evidence disproving her ownership percentage in the business or to otherwise overcome the presumption of correctness afforded to the Department's determination.



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