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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

R. Gregory Roberts
rroberts@mofo.com

Irwin M. Slomka
islomka@mofo.com

Open Weaver Banks
obanks@mofo.com

Amy F. Nogid
anogid@mofo.com

Michael A. Pearl
mpearl@mofo.com

Richard C. Call
rcall@mofo.com

Ted W. Friedman
tfriedman@mofo.com

Nicole L. Johnson
njohnson@mofo.com

Kara M. Kraman
kkraman@mofo.com

William T. Pardue
wpardue@mofo.com

Rebecca M. Ulich
rulich@mofo.com

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ALJ DISALLOWS COMBINED FILING IN ABSENCE OF SUBSTANTIAL INTERCORPORATE TRANSACTIONS

By Hollis L. Hyans

In *Matter of Knowledge Learning Corporation and Kindercare Learning Centers, Inc.*, DTA Nos. 823962 & 823963 (N.Y.S. Div. of Tax App., June 27, 2013), a New York State Administrative Law Judge held that, because the companies did not establish they had substantial intercorporate transactions, they could not file combined returns, and that an inquiry into distortion that might arise on separate returns was "not the proper analysis" after the statute was amended in 2007. While the conclusion regarding lack of substantial intercorporate transactions was very fact-based, and arose in substantial part from the judge's concern about the absence of documentary evidence to support oral testimony, the second conclusion – that distortion is not the proper analysis – is not supported by the Department's own regulations and pronouncements.

Facts. Knowledge Learning Centers ("KLC") operates children's learning centers and after-school day care programs. In 2005, it acquired Kindercare Learning Center ("Kindercare"), which operated a similar business. Beginning with its tax year ended December 29, 2007 (the "2007 tax year"), KLC filed a New York State combined report including Kindercare, as well as other affiliates. For the years ended December 31, 2005, and December 30, 2006, KLC and Kindercare, both New York taxpayers, had filed separate returns.

On audit, the Department of Taxation and Finance questioned whether the companies met the requirements for filing a combined report. In response to the Department's information request, KLC advised that there were no formal intercompany agreements, and that all employees had been transferred to KLC. It provided a description of intercompany cash transactions, indicating that all cash balances of Kindercare were swept to KLC's account and all payments were made by KLC. KLC also provided voluminous

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accounting spreadsheets, showing more than 1.8 million lines of activity posted to intercompany accounts, including evidence of payments made by KLC on behalf of Kindercare. After review of the records, the Department concluded that KLC was merely paying Kindercare's expenses with Kindercare's own cash, so that substantial intercorporate transactions did not exist.

During the 2007 tax year, KLC recognized a $57.6 million loss, while Kindercare had income of over $109 million. On the combined return, KLC's loss was used to partially offset Kindercare's income.

Evidence presented at the hearing. KLC argued that substantial intercorporate transactions existed. In addition to the accounting spreadsheets, KLC presented testimony of three witnesses, two of whom were from the company's tax department. Each testified that all employees of Kindercare, as well as of other related companies, had been transferred to KLC in 2005. No documents actually effecting or evidencing the transfer were introduced, although KLC presented a memo dated November 14, 2005, with no named addressee, discussing "the growth of KLC and what benefits are expected." There was also testimony that KLC had adopted a common policy manual, code of ethics, employee handbook and employee benefits handbook applicable to all affiliates, and that almost all of the legacy learning centers were converted to the Kindercare brand as a result of a study done in September 2005.

Technical advice issued by the Department shortly after the statute was amended further provided that the Department will "require or permit" combined reporting even where "substantial intercorporate transactions are absent if a combined report is necessary to properly reflect the taxpayer's Article 9-A tax liability. . . ."

Legal Standard. Effective for tax years beginning on or after January 1, 2007, New York's statute on combined reporting was amended to provide that a combined report is required whenever the ownership requirement is met, and there are substantial intercorporate transactions among the related entities. Before the amendment, the presence of substantial intercorporate transactions gave rise to a presumption that separate reporting did not accurately portray the taxpayer's income, but that presumption could be rebutted by a showing that the transactions were conducted on an arm's length basis. The amended statute still provides that, in the absence of substantial intercorporate transactions, a combined report is not required unless otherwise necessary to properly reflect tax liability. Tax Law § 211.4(a)(4). Consistent with the statute, technical advice issued by the Department shortly after the statute was amended further provided that the Department will "require or permit" combined reporting even where "substantial intercorporate transactions are absent if a combined report is necessary to properly reflect the taxpayer's Article 9-A tax liability because of intercompany transactions or some agreement, understanding, arrangement, or transaction." *Combined Reporting for General Business Corporations and Insurance Corporations*, TSB-M-08(2)C (N.Y.S. Dep't of Taxation & Fin., Mar. 3, 2008).

ALJ Decision. The ALJ concluded that combination was not permitted, because KLC had failed to demonstrate the existence of substantial intercorporate transactions. First, the ALJ did not find sufficient evidence that all employees had in fact been transferred to KLC in 2005. Although she noted, in Finding of Fact 26 discussing the testimony of one witness, that the Vice President of Tax and Risk had been transferred to KLC in 2005, she found that the oral testimony of the witnesses was insufficient to establish that all employees were so transferred. The ALJ held that KLC and Kindercare "cannot meet their burden of proof on this issue by relying on the testimony of their witnesses," and that the "lack of documents effecting such transfer…weighed heavily against petitioners…." She also agreed with the Department's argument that the accounting spreadsheets merely showed that KLC was paying Kindercare's expenses using Kindercare's own cash, which had been swept to a KLC concentration account.

The ALJ also noted, citing cases such as *Matter of The Sherwin-Williams Co.*, 12 A.D. 3d 112 (3d Dep't 2004) and *Matter of Talbots, Inc.*, DTA No. 820168 (N.Y.S. Tax App. Trib., Sept. 8, 2008), that valid business purpose and economic substance of transactions are relevant considerations, and that here, the duties, obligations and daily activities of the employees "did not change as a result of their being transferred to KLC."

Finally, the ALJ found that, while KLC and Kindercare had raised an "alternative argument" that combination was necessary to avoid distortion, "distortion is not the proper analysis in light of the 2007 statutory amendment," and she therefore gave no further consideration to the distortion argument.

Additional Insights

This is the first decision issued by the Division of Tax Appeals interpreting the post-2007 combination statute, and it leaves many questions unanswered. The companies appear to have been arguing, in part, that all employees were paid by KLC, while performing services that benefitted not only KLC but

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Kindercare and other affiliates. If so, that would likely explain why KLC has a large loss, and Kindercare – which was not bearing the proper expenses actually incurred on its behalf – had significant income, and certainly seems relevant to the question of whether combined reports should be permitted.

The determination does not reveal what other evidence, if any, was introduced about the expenses of KLC and Kindercare, nor about other areas that are usually significant in combined reporting cases, such as borrowing and any guarantees thereof, common management and direction, economies of scale, centralized management, and a flow of value. Whether or not these facts established substantial intercorporate transactions, they certainly seem relevant to a determination of whether the taxpayers' income is accurately portrayed on separate returns, or whether distortion exists.

Similarly, the determination provides very little description of why the economic substance and business purpose doctrines were referenced. In the cases cited by the ALJ, the Department had argued successfully that affiliates were established without any valid business purpose, and that they had no economic substance, so they could be forcibly combined regardless of the pricing of intercompany transactions. It is not clear how lack of separate business purpose for separate entities, or lack of substance in an entity, supports separate reporting, and the record as recited contains no evidence that the transfer of employees in 2005, assuming it occurred, was done to allow combined reporting rather than for normal business reasons after an acquisition.

The ALJ's conclusion that distortion is not the proper analysis does not appear to be supported by the Department's own TSB-M, which clearly states that combination can be permitted even if substantial intercorporate transactions do not exist. That same standard has been explicitly incorporated in the Department's regulations issued in January 2013, which state that, "[w]here the capital stock requirement is met and substantial intercorporate transactions are absent, a combined report covering corporations engaged in a unitary business may be required or permitted if the Commissioner deems such a report necessary, because of inter-company transactions or some agreement, understanding, arrangement, or transaction, in order to properly reflect the tax liability...." 20 NYCRR § 6-2.1(b). While the regulations are formally effective only for years beginning on or after January 1, 2013, they are interpreting the exact same statute in effect since 2007, and appear entirely consistent with the Department's interpretation of that statute on audit over the past six years.

An extension of time to appeal to the Tax Appeals Tribunal has been granted, so further clarification is likely to be provided by an eventual Tribunal decision.

COURT REJECTS CONSTITUTIONAL CHALLENGE TO TAX CREDIT DEFERRAL LEGISLATION

By Irwin M. Slomka

In 2010, the New York State Legislature adopted a temporary tax credit deferral in light of the State's budget crisis at the time. Under that legislation, businesses and individuals claiming various business credits (such as the investment tax credit and Brownfields tax credit) were subject to a two year deferral for credits arising in tax years beginning between January 1, 2010 and December 31, 2012, where the total credits for the year exceeded $2 million. The deferred amounts were then phased in over a three year period beginning in 2013. Now, an Albany County Supreme Court judge has upheld that deferral, rejecting a taxpayer's constitutional challenge. *Empire Gen Holdings, Inc., v. State of New York,* 2013 NY Slip Op 23213 (June 25, 2013).

In 2004, Empire Holdings ("Empire") and BASF Corp. entered into a Brownfield Site Cleanup Agreement with New York State, in which Empire agreed to remediate polluted property in the City of Rensselaer in exchange for tax credits. After performing the cleanup and obtaining certification, Empire built an electricity generating plant on the property, placing it in service in September 2010. Under the Brownfields tax credit program, Empire was entitled to an $87 million tax credit for the redevelopment project.

As a result of the tax credit deferral legislation – which became effective in August 2010 – Empire's 2010 tax credit was reduced to $1.6 million, with the balance deferred to future years. Empire brought a declaratory judgment action, challenging the deferral on several constitutional grounds. First, it claimed that the law resulted in an unconstitutional "taking" of a vested property right. However, the judge concluded that Empire had no vested property right in the tax credit, since the credit did not "vest" until the plant was placed in service, which was a month *after* the deferral legislation went into effect. The judge also rejected Empire's claim that the deferral was a Contracts Clause violation, holding that there is no contractual right preventing the deferral of a tax credit. Empire also raised an Equal Protection argument, on the grounds that the deferral applied to the Brownfields credit, but not to the film production credit. This too was rejected by the court, which noted that Brownfields developers and film producers are not similarly-situated groups, and that Empire had failed to show the lack of a rational basis for the distinction.

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Additional Insights

Although not addressed in the judge's decision, the fact that the tax credits were temporarily deferred, rather than completely eliminated, may have had a bearing on the outcome of the case. Interestingly, the judge's decision regarding the taxpayer's Due Process argument suggests that if the property had been placed in service a month earlier – *before* the deferral legislation went into effect – Empire would have had a "vested property right" in the tax credit.

NEW YORK CITY LOSES ANOTHER TRANSFER TAX CASE INVOLVING THE "RECONSTITUTION" OF A HOUSING COOPERATIVE

By Irwin M. Slomka

Undeterred by its recent loss at the Appellate Division on the same issue involving a different taxpayer, the New York City Department of Finance continues to pursue the imposition of real property transfer tax ("RPTT") when a residential housing cooperative terminates its participation in the Mitchell-Lama Housing Program. A New York City Administrative Law Judge has now rejected another attempt by the Department to impose the tax, holding that the dissolution and reconstitution of the cooperative involved neither a conveyance of real property by deed nor a taxable transfer of an economic interest in real property. *Matter of Trump Vill. Section 4, Inc.*, TAT(H) 10-34(RP) (N.Y.C. Tax App. Trib. Admin, Law Judge Div., July 11, 2013).

Background. In the November 2012 issue of *New York Tax Insights*, we reported on a Second Department decision holding that a residential housing cooperative corporation's termination of its participation in the Mitchell-Lama program by "voluntarily dissolving" under the Private Housing Finance Law ("PHFL"), and "reconstituting" itself as a corporation under the Business Corporation Law, did not result in a transfer of real property within the meaning of the RPTT law and was not subject to the tax. *Trump Vill. Section 3, Inc. v. City of New York*, 100 A.D.3d 170 (2d Dep't, 2012).

The current case involved a different Trump Village cooperative ("Trump Village 4"), but substantially similar facts. Unlike the earlier Appellate Division case, where the taxpayer bypassed the City Tribunal and brought a summary judgment action in the New York courts, this case was heard before an ALJ. Briefly, Trump Village 4 is a residential housing cooperative complex located in Brooklyn, New York. Formed in 1961 as a Mitchell-Lama cooperative under the PHFL, it received City property tax benefits and low-cost financing. Under that program, tenant-shareholders who moved out could only sell their shares back to the cooperative at fixed (and usually below-market) prices. The shareholders of Trump Village 4 decided to withdraw from the Mitchell-Lama program. This plan was carried out through a plan of voluntary dissolution and reconstitution in 2007, under which the corporation's certificate of incorporation was amended to, among other things, remove all references to the PHFL. Trump Village 4 retained the same federal employer identification number that it had before reconstituting. No new deed of the real property was ever made or recorded.

In 2010, the Department assessed $12 million in tax, penalty and interest against Trump Village 4, asserting that the dissolution and reconstitution amounted to a conveyance of real property. The Department estimated the taxable consideration at $313 million, based on the sales prices of the co-op apartments after the reconstitution. At the administrative hearings, both sides introduced evidence and expert testimony on valuation of the alleged consideration.

As it did in the earlier case, the Department claimed that the dissolution and reconstitution resulted in the formation of a new corporation, and thus the amended certificate of incorporation was in effect a "deed" subject to RPTT. However, in this case, the Department raised a new issue, possibly after losing at the Appellate Division in *Trump Vill. Section 3*. It claimed that even if there was no taxable "deed," the transaction should be deemed a taxable transfer of an "economic interest" in real property. Moreover, even though the tenant-shareholders remained the same before and after the transaction, the Department argued that the transaction did not qualify as an exempt "mere change in form," because the stock ownership changed significantly, resulting in a change in "beneficial ownership."

ALJ determination. The ALJ ruled in favor of the taxpayer on both issues. The ALJ held that the Appellate Division decision in *Trump Vill. Section 3* not only precluded a finding that there was a transfer of real property by deed, but that its rationale also compelled a conclusion that there was no transfer of an economic interest in real property. Since the same legal entity existed, with the same shareholders, both before and after the reconstitution, there was no transfer of an economic interest.

The ALJ also found that even if there *was* a transfer of an economic interest, the transfer would qualify for exemption as a "mere change in form," since there was no change in beneficial ownership in the cooperative corporation, despite the increased value of the stock after the reconstitution. The ALJ saw no reason to apply a decision under the Martin Act, in which the Court of Appeals held that the dissolution-reconstitution of a Mitchell-Lama cooperative involved the "offering or sale" of securities. *East Midtown Housing Co., Inc. v. Cuomo*, 20 N.Y.3d 161 (2012). According to the ALJ, the purpose of the Martin Act, to protect the public from fraud, is inapplicable to the RPTT.

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The ALJ held that the Appellate Division decision in *Trump Vill. Sec. 3* not only precluded a finding that there was a transfer of real property by deed, but that its rationale also compelled a conclusion that there was no transfer of an economic interest in real property.

Additional Insights

Like the earlier Appellate Division decision in *Trump Village Section 3* (which we understand the Department is seeking leave to appeal), this decision correctly concludes that the mere act of amending a certificate of incorporation for the same legal entity is not a "transfer" or "conveyance" of real property. This decision goes further, however, because it addresses the Department's alternative argument that an economic interest in real property was transferred, although it does not identify precisely what the claimed "economic interest" was. The Department's position in this case — that there was a change in beneficial ownership because of the increased value of the owners' shares after leaving the Mitchell-Lama program — would be a significant departure from its prior interpretations of the "mere change in form" exemption, and was also rightly rejected.

It is anticipated that the Department will pursue its position by appealing to the City Tribunal.

INSIGHTS IN BRIEF

Department Issues Tax Bulletin on Bulk Sales Procedures

The Department of Taxation and Finance has issued a Tax Bulletin setting out the special procedures to be followed when a bulk sale transaction takes place in order to protect the purchaser from liability for the seller's unpaid sales or use taxes. *Tax Bulletin ST-70*, "Bulk Sales," TB-ST-70 (N.Y.S. Dep't of Taxation & Fin., June 24, 2013). Among the helpful subjects covered are examples of bulk sale transactions, the prescribed forms that should be used by the purchaser, and a discussion of the seller's obligations in the case of a bulk sale.

Guidance Issued for Businesses that Contract with New York State

A new Tax Bulletin issued by the Department of Taxation and Finance explains the general rules for the required certification of contractors (including their affiliates and subcontractors) that contract with New York State. *Tax Bulletin*, "Certification Requirements for Businesses that Contract with New York State," Sales and Use Tax, TB-ST-118 (N.Y.S. Dep't of Taxation & Fin., June 12, 2013). Tax Law § 5-a requires businesses that are awarded State contracts in certain instances to certify that they are registered to collect State and local sales tax on sales to in-State locations. That certification must be made using Form ST-220-TD (filed with the Department) and Form ST-220-CA (filed with the procuring agency).

Implementation Announced of Tax-Free Initiative: START-UP NY

Legislation enacted earlier this year provided for a new initiative offering tax abatements to new businesses in areas designed as "NYS Innovation Hot Spots," and agreement on implementing legislation has now been announced. Benefits are available to companies that either start a new business, relocate to New York from outside the State, or expand their existing businesses as long as they can demonstrate they are actually creating new jobs and not merely moving existing jobs. Businesses will need to align with an academic institution, and participating companies will not pay business/corporate taxes, sales taxes or property taxes for 10 years, while their employees will pay no income taxes for five years and reduced taxes for a second five years. Press Release, Andrew M. Cuomo, *Governor Cuomo and Legislative Leaders Announce Agreement on Start-Up NY Legislation That Will Implement Tax-Free NY Initiative* (June 19, 2013).

Appeals Court Upholds MTA Payroll Tax as Constitutional

The Appellate Division has now reversed last year's decision by a trial court, and found that the Metropolitan Commuter Transportation Mobility Tax Law, commonly known as the MTA Payroll Tax, was properly enacted and therefore constitutional. *Mangano v. Silver, et al.,* 2013 NY Slip Op. 04783 (2d Dep't, June 26, 2013) The Appellate Division rejected the argument that the statute, which imposes a payroll tax on employers and self-employed individuals to raise funds for the improvement of commuter transportation in the New York City area, had been invalidly enacted without a "home rule" message. Such a message is not required when a special law serves a "substantial state concern," and the appeals court found that improvement of commuter mass transit in the New York City area has already been held to be "a matter of public interest, affecting not only the people of that city, but of the whole state," *Matter of McAneny v. Board of Estimate & Apportionment of City of N.Y.*, 232 N.Y. 377, 393 (1922), so that no home rule message was required.

Sprint Nextel False Claims Act Case Survives Motion to Dismiss

On July 1, 2013, the State's Supreme Court, the trial court, rejected Sprint Nextel's motion to dismiss in its entirety the State's first whistleblower action filed under the 2010 version of New York's False Claims Act ("FCA"). Fin. Law §§ 189-194. The complaint charged that Sprint Nextel did not collect and remit the proper amount of sales tax on its wireless calling plans, that Sprint improperly excluded a portion of the

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revenue from monthly calling plans from the base on which tax was charged by allocating the monthly service fees between taxable and nontaxable components in an arbitrary manner, and that Sprint Nextel owed over $100 million in additional tax. Sprint Nextel had moved to dismiss all of the causes of action, arguing that its method of assessing tax by unbundling the monthly charge to exclude the amount attributable to nontaxable interstate telecommunications was supported by the plain language of the sales tax provisions, Tax Law § 1105(b), and by the federal Mobile Telecommunications Sourcing Act ("MTSA"). It also argued that applying the FCA to statements made before the effective date of the legislation extending the FCA to tax claims violated the *Ex Post Facto* Clause of the U.S. Constitution.

The trial court refused to dismiss the action in full. It noted, first, that for purposes of a motion to dismiss, the court is required to accept all facts alleged in the complaint as true, and to afford the plaintiff – in this case, the Attorney General suing in the name of the people of the State of New York – the "benefit of every favorable inference." Under this standard, the court evaluated all of the facts alleged in the complaint and held that, if eventually found to be true, they could establish a violation of the FCA. The court also found that the civil penalties imposed under the FCA were not "*sufficiently* punitive in nature and effect" to give rise to the protection of the *Ex Post Facto* Clause.

The court dismissed the conspiracy claim raised in the complaint, since the court readily found that Sprint Nextel could not conspire with its own subsidiaries, and also held that claims under the Tax Law and the Executive Law were time-barred to the extent they applied to periods prior to March 31, 2008.

Sprint Nextel has filed an appeal of the decision with the Appellate Division.

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ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
AE Outfitters Retail v. Indiana
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
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