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Ohio: State's Supreme Court holds for taxpayer in CAT sourcing dispute

The Ohio Supreme Court on September 29, 2020, issued a decision in the taxpayer's favor in a case addressing where the benefit of certain purchases were received for purposes of the state's commercial activity tax (CAT).

In doing so, the state Supreme Court overturned decisions from both the Ohio Board of Tax Appeals and a state appellate court.

The case is: *Defender Security Co. v. McClain*, Slip Opinion No. 2020-Ohio-4594 (September 29, 2020). Read the [decision](#) [PDF 156 KB]

Background

The taxpayer—an Indianapolis-based company with four Ohio locations—sold security services contracts to customers in Ohio as an authorized dealer of an out-of-state company (having its principal place of business in Colorado) engaged in providing security monitoring services. The contracts were subsequently resold to the Colorado-based company that then provided monitoring services to the customer.

The Colorado-based company retained the right to reject certain contracts and did not accept all contracts originally sold by the taxpayer.

The taxpayer filed amended returns seeking a refund of CAT paid on receipts from sales of the security monitoring service contracts to the Colorado-based company. In the taxpayer's view, the Colorado-based company (asserted to be its customer in the transaction) received the benefit of the contracts outside Ohio at its principal place of business in Colorado, and therefore the receipts were situated out-of-state.

The Commissioner denied the refund on the basis that the benefit from the sale of the security monitoring contracts was wholly received in Ohio, where the ultimate security monitoring services were provided to protect individuals and property located in Ohio. The matter eventually made its way

to the Board of Tax Appeals and then to the Franklin County appeals court, and the Commissioner prevailed in both instances.

Decision of the Ohio Supreme Court

The state's high court noted that under Ohio law, gross receipts from the sale of services and all other receipts not specifically addressed by statute are situated to Ohio in "the proportion that the purchaser's benefit in Ohio with respect to what was purchased bears to the purchaser's benefit everywhere with respect to what was purchased." The physical location where the purchaser ultimately uses or receives the benefit of what was purchased is paramount in determining the proportion of the benefit in Ohio relative to the benefit everywhere. In the Supreme Court's view, the "paramount" consideration when determining the proportion of the benefit attributed to Ohio is the physical location where the purchaser "ultimately uses or receives the benefit of what was purchased."

The taxpayer argued that the Colorado-based company purchased intangible contract rights and that its physical locations outside Ohio were the places where the Colorado-based company actually used and received the benefit of those contractual rights.

The court agreed, concluding that the Tax Commissioner, the Board of Tax Appeals, and the appellate court all failed to properly distinguish between the benefit Ohio consumers received from the Colorado-based company and the benefit that this company received by purchasing consumer contracts from the taxpayer. The benefit derived from the purchase by the Colorado-based company lay in receiving payments from Ohio customers in consideration for that company providing the contracted-for monitoring services from its locations outside Ohio. Because the Colorado-based company used and received the benefit of the contracts it purchased outside Ohio, the taxpayer's receipts from the sale of those contracts to the Colorado-based company were not situated to Ohio.

The state's high court next addressed certain ancillary issues, including that an administrative rule addressing service receipts was inapplicable because the taxpayer was not providing services for the Colorado-based company when the contracts were sold to it. Rather, the taxpayer was selling intangible assets. The Ohio Supreme Court also rejected the Commissioner's position that the term "benefit" had a special meaning that connoted government services that make business possible and profitable, such as police and fire protection. [The Commissioner appeared to have attempted to argue that this special meaning required the benefit to occur in Ohio where the Colorado-based company benefitted from the presence of police.]

The Commissioner also asserted that the Colorado-based company used or received the intangible contract rights in Ohio to generate income for itself. However, in the Supreme Court's view, that was not the correct analysis under the statute, which focuses on where the company "used or received" the benefit of the contract rights it purchased—not where it used or received the contract rights themselves.

Having decided the issue on statutory grounds, the court determined it was not necessary to reach the taxpayer's constitutional claim that the risk of multiple taxation associated with the Commissioner's interpretation ran afoul of the dormant Commerce Clause.

KPMG observation

This case illustrates that understanding where the benefit is received from the sale of a service or an intangible asset can be a rather nuanced undertaking, particularly when transactions involve more than one potential customer. Tax professionals believe that this decision rightly points out that it was necessary to properly distinguish between the benefit the Ohio customers received from the Colorado-based company and the benefit that this company received by purchasing consumer contracts from

the taxpayer. Taxpayers earning receipts from services or sales of intangible assets need to consider whether they are properly sourcing their receipts based on the court's holding.

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