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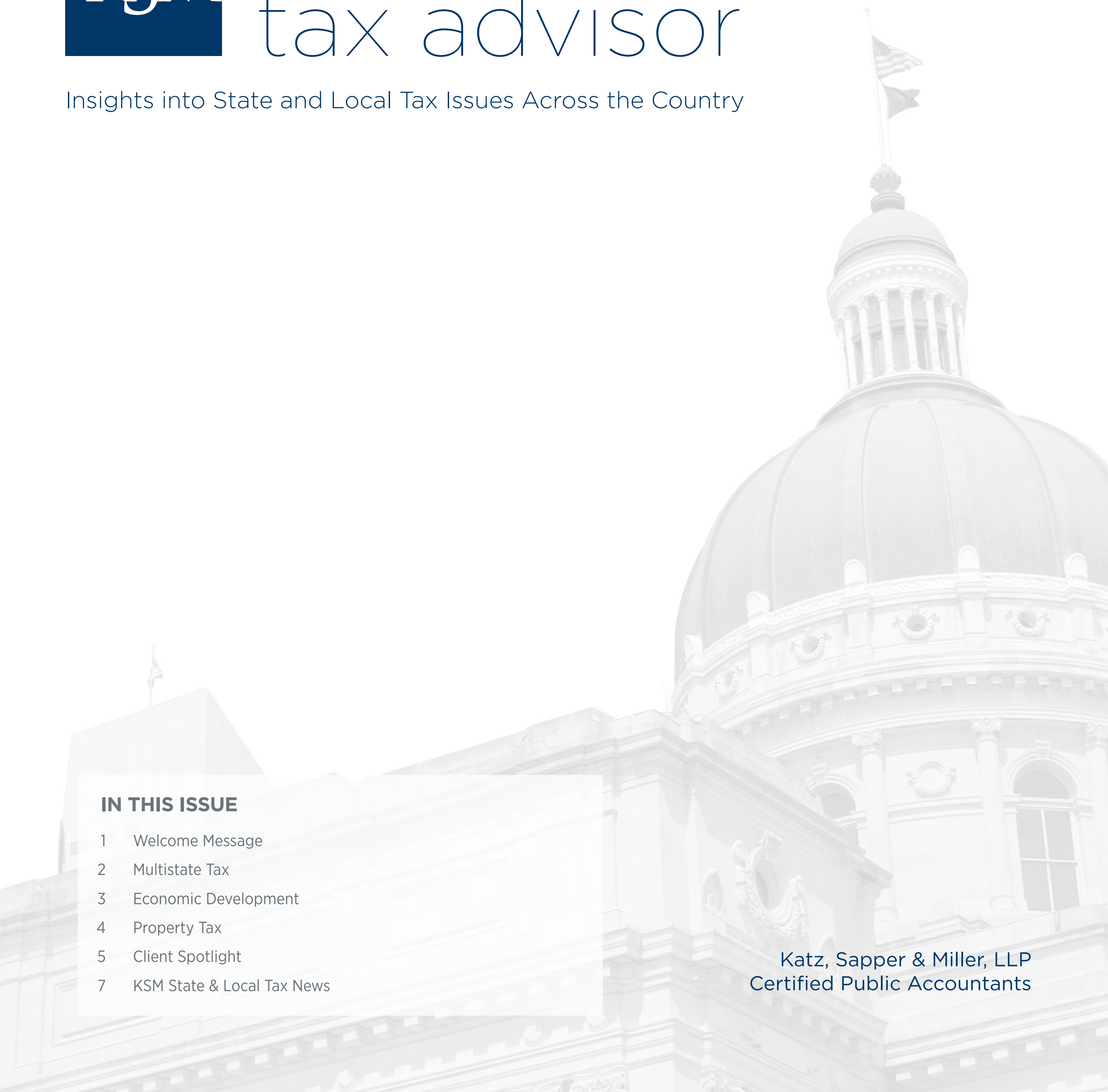
KSM

state & local tax advisor

Insights into State and Local Tax Issues Across the Country



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Welcome Message

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As you read through the articles in this edition of the *State and Local Tax Advisor*, you will see the one thing that all of these articles have in common is that they have nothing common. And that's probably as it should be. The fact is, most state and local taxes have few things in common with one another.

A net income tax is based on the profitability of a business, while a franchise or gross income tax is imposed on a company because it simply exists.

Sales and use taxes are imposed on the purchase of goods and services, in contrast to most property taxes that are levied on the mere ownership of property.

A number of excise taxes are imposed on a seemingly endless list of activities and property types. Gasoline, kerosene and diesel – and those are just the taxes on fuel. There are also taxes on hotel rentals, wheels, casinos, alcohol, concert tickets ... the list goes on.

Unclaimed property is often lumped into state and local taxes, although it's not a tax but a reporting requirement – one that requires money to be turned over ... like a tax.

Negotiated incentives are that rare exception where a business might actually receive credits, grants, or other incentives from government as opposed to paying the government money.

There is the jargon of state and local taxes, where one comes across terms like nexus, escheatment, obsolescence, throwback and clawbacks. And then there are the peculiarities of state and local taxes that can cause a person to scratch their head, like having to pay a tax for getting married while riding horseback. (Unfortunately, I'm not making this up.)

State and local tax covers a lot of territory. This expanded taxing terrain caused KSM years ago to expand its skill set as a firm. The state and local tax questions that used to fall under a federal tax person's watch during their post busy-season spare time have now evolved into a variety of specialty topics that require their own specialists. Luckily, KSM has specialists in a number of these areas, each on display in the articles they have written for this publication.

The state and local tax questions that used to fall under a federal tax person's jurisdiction during their post busy-season spare time have now evolved into a variety of specialty topics that require their own specialists.

Donna Niesen touches on the myriad of issues emanating from the sale and purchase of digital goods in the world of sales and use taxes. Chad Miller discusses the ways that assessing officials will attempt to determine the market value in use of different types of properties during Indiana's upcoming reassessment season. Lisa Leventhal Weinstein shines a spotlight on the under-advertised value of refundable tax credits. Finally, in our client spotlight, we take a break from taxes and talk with DEFENDER Direct founder Dave Lindsey and discover the secrets behind one of the Midwest's great entrepreneurial success stories, and how Dave is investing the fruits of that success into his philanthropic passions.

In sum, whatever taxing oddity your business may encounter, chances are we've seen it before and can be of help. If you happen to receive a notice about a tax you've never heard of, or if you simply need help with a state and local tax matter in general, please give one of our specialists a call. Or send us an email. There's no tax on sending emails. At least not yet.

Multistate Tax

The Times They Are a-Changin': Sales Tax in a Technologically Advancing World

By Donna L. Niesen, CPA
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Cloud computing. Software as a service. Digital goods. Web-hosted. Web-based. Web-enabled. Licenses. Subscriptions. Nowadays, most companies use a variety of these tools in the everyday operations of their businesses. With such advancements, it has become especially important for businesses to understand the tax ramifications that result from the buying, selling and use of these goods and services.

As the world becomes more connected, technology enables companies to receive a variety of products and services electronically. The laws, rulings and policies of state taxing agencies that govern the taxation of digital goods routinely lag behind the technologies themselves. As a result, states and taxpayers fumble their way through how to deal with these issues, often engaging in the perpetual exercise of trying to fit a square peg into a round hole by applying antiquated laws and policies to emerging technologies. In many instances, officials and divisions within the same state tax agency differ on how subject items should be taxed. Such policy climates force taxpayers to make taxability decisions without decisive guidance to lead the way.

From a sales tax perspective, states attack three major areas of e-commerce: software, digital goods, and the digital equivalent of products formerly sold as tangible personal property.

In the area of software, many states tax canned software regardless of the form or delivery of the product. This precept allows a state to tax both software purchases that are electronically downloaded and software licenses accessed through a hosted server. Variations in other states include software that is received on a disc versus electronically, or software loaded onto a customer server rather than provider-hosted. Because the rules vary from state to state, proper tax treatment requires a separate examination of the rules in each jurisdiction.

Many states have specific sales tax guidance on non-software related digital goods. Items such as downloadable music or videos, e-books, and ringtones are sometimes specifically identified as taxable or non-taxable in a state's statute. This fact is especially true in states that are members of the Streamlined Sales and Use Tax Agreement (SSUTA), a membership of voluntarily participating states that aspire to greater uniformity in the application of sales tax rules. Even within this seemingly huddled cloister of SSUTA states, however, individual jurisdictions still maintain the prerogative to pass or promulgate different laws and regulations than those enunciated under SSUTA. Consequently, a taxpayer is well served to confirm the correct sales tax treatment of digital goods in both SSUTA and non-SSUTA states.

A final area of increased taxing aggressiveness involves states imposing sales tax on electronically delivered service reports formerly sold in hard copy form. Examples include credit ratings, background checks, and car faxes, all of which have become fodder for sales tax auditors. While the legal authority for a state to impose tax on these items is often untested if not lacking entirely, taxing agencies and their representatives are sometimes inclined to tax these items anyway.

For all of these areas, the smoking gun for whether a transaction is taxed or not can often be found in the terms of the transaction's contract. In some states, these terms may have a significant impact on the taxability. For instance, Kansas has recently published rulings suggesting that hosted software versus a license to use software may have different sales tax consequences. In these instances, the contract terms may contain a provision that is dispositive of how the transaction is taxed. In certain instances, if the contract terms result in an undesirable outcome, the language can be revised to produce a different result, at least prospectively.

One thing is for certain: If taxpayers wish to keep up with the ever-changing tax treatment of technology products, their approach to tracking tax developments will need to evolve with the products themselves.

Economic Development

Refundable Tax Credits = Cash

By Lisa Leventhal Weinstein
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With the continuing emergence of state and local incentives as an increasingly important factor in site selection decisions, businesses have become more sophisticated in their understanding of these programs. As I meet with companies, more and more of them have an understanding of the basic programs available at the state and local level. They have read in the paper about companies receiving a training grant, tax abatement, or some other type of state and local impetus for a project to be located in a specific city, town or state.

These programs can be powerful for emerging companies that have an uncertain tax forecast, especially in the early years of the business.

Interestingly, however, one area where business education has lagged is an understanding of the difference between refundable and non-refundable tax credits. This lack of knowledge continues to cause jurisdictions to lose projects or prospects. It also causes companies to miss out on opportunities for a state or local unit of government to participate in a project that accelerates, facilitates or dictates a site selection decision.

The breakdown in understanding stems from the failure to recognize that not all tax credits are the same. Credits are either refundable or non-refundable. In the everyday vernacular of tax credits, those of the non-refundable variety are the most common. When a credit is non-refundable, the credit can be used only to offset an existing tax liability.

Let's look at two examples.

Example A: If a company has a tax liability of $50,000 and a non-refundable tax credit of $40,000, the tax credit is applied against the tax liability to reduce the $50,000 tax debt to $10,000.

Example B: If this same company had no tax because it operated at a loss in a given tax year and had a $40,000 non-refundable tax credit, that credit would do the company no good in that year because there is no tax liability to apply the credit against.

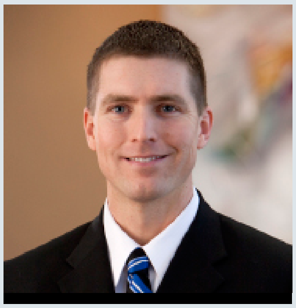
With a refundable tax credit, the company receives the benefit whether it has a tax liability or not. Under Example A, the credit would work the same in reducing the company's debt, reducing the company's tax liability from $50,000 to $10,000. In addition, the $10,000 in unused credit would be converted into $10,000 in cash for the company. Under Example B, while the company has no tax against which to apply the credit, because the credit is refundable the full amount of the credit is paid to the company in the form of a $40,000 refund. In a hybrid of the two examples, let's say that a company has a $50,000 tax liability and a $200,000 refundable tax credit. Here, the $50,000 liability would be offset entirely, and the company would receive a $150,000 refund as a result of the $150,000 of unused credit.

Many states and localities sponsor programs with refundable tax credits, including Indiana. The most common recipients of these programs are projects that result in new job creation. These programs can be powerful for emerging companies that have an uncertain tax forecast, especially in the early years of the business. Likewise for capital-intensive projects involving companies with significant net operating losses – the value of a refundable tax credit even one-tenth the size of a gaudy non-refundable tax credit is infinitely more effective at closing the cost gap for a particular location.

Refundable or non-refundable? That is the question for many companies. Sometimes, the answer can make a world of difference.

Property Tax

Assessing the Best Way to Assess Assessments



By Chad M. Miller
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When speaking with clients about their property taxes, I often find they are frustrated. They feel there is a cloud of mystery surrounding the methodology used by local assessors to determine their proposed assessed value. In states such as Indiana, this should never be the case.

Under current law in Indiana, the assessor's directive is to assess a value that represents the property's approximate "market value in use." Market value in use means the value of the property as it is currently being used. While some assessors incorrectly attempt to value a property based upon its highest and best use, Indiana requires assessed values to be based on market value in use.

While some assessors incorrectly attempt to value a property based upon its highest and best use, Indiana requires assessed values to be based on market value in use.

While applying this principle correctly is critical for all types of property, it becomes especially important when dealing with so-called "special use properties." A golf course, for example, is considered a special use property. In the past couple of years, Indiana has begun to require assessors to use what is known as the income approach to valuation to determine the market value in use for golf courses. Under an income approach to valuation, the objective is to arrive at the present value of the property by taking into account the net operating income for the property in conjunction with its useful life. Based upon the specialized nature and use of golf courses, the income approach has been deemed the best method of determining an appropriate assessed value. In order to arrive at this value, a golf course will submit its income and expenses to the local assessor for the calculation. As it pertains to golf courses, Indiana recently released what is known as the cap rate that must be applied to the net operating income of a golf course. A cap rate percentage is usually a reflection of the amount of risk that is involved in an investment. By applying a variable cap rate that changes from year to year, an assessor is able to ensure that an accurate value is assigned to the property based on the income and value of the property for the year in question.

Agricultural property is another example where market value in use ensures a more appropriate assessed value. Imagine a piece of vacant land is located at the corner of a new interchange. If this property sat vacant, it would be assessed on a per acre market basis. Because of its location, the market for this property could be quite high, and thus the per-acre value would reflect the market value in the area. If this vacant land were farmed, however, the use of the property would be considered agricultural. The vacant lot would then be assessed based upon the agricultural per acre base rate. Currently, for the March 1, 2011, assessment date payable in 2012, the base rate for agricultural property is $1,500 per acre. Since $1,500 per acre would be much less than the market value of the land, the property tax benefit of the landowner utilizing the land for agricultural use would be significant.

These are just two of many examples of how market value in use differs from highest and best use, and how this difference can significantly reduce a property owner's real estate taxes. As clients become more educated about these and other rules surrounding property taxes, the cloud of mystery surrounding how properties are assessed begins to lift, and strategies that might reduce a property owner's tax burden can be more clearly considered.

Client Spotlight

Dave Lindsey of DEFENDER Direct

It's an urban legend that some of the most successful businesses started in someone's basement. But in the case of DEFENDER Direct and founder Dave Lindsey, it's true. Well, almost. "It was actually a spare bedroom," Dave says with a chuckle.

Dave and his wife Jessica founded DEFENDER Direct out of their Indianapolis duplex in 1998 after moving back to Indiana, both leaving behind successful corporate careers in Virginia. "We wanted to start our own business. Jessica was working in banking sales, which allowed me some freedom to focus on the business. We literally started with about $20,000, which we got from selling our Ford Explorer."

While today DEFENDER Direct is the nation's top dealer of ADT home security systems, Dave is the first to admit the company started from humble beginnings. "The original idea started from the fact that I used to work for a lock manufacturer. There are a lot of silly stories about me trying to help friends and family by taking the locks off their doors, then not being able to put the locks back together. It occurred to me if someone wanted a lock, they might want an alarm system. I got ADT to take a chance with us. In the first month we did eight sales, the next month we did 15 sales, then 35, then 150, and it just went up from there. Today we are doing 15,000 installations each month."

While the company's success is clearly evident today, there have been obstacles to overcome along the way, such as no-call list laws, which are kryptonite for a business that had been totally reliant on outbound telemarketing. Dave points to the company's triumph over that challenge as one of DEFENDER's proudest moments. "We're always looking for ways to turn a problem into an opportunity. With the no-call list, Marcia Barnes, who is now our CEO, was our director of marketing at the time. She went to Direct Marketing 101 classes, joined the Direct Marketers Association, and read at least 50 books on direct marketing the year after the no-call list rules came out. She put our business and our people on her back." By converting the business model from outbound calls to inbound sales generated from direct mail, the company took off. "When the business became in-bound, we were able to just sell on the phone. We didn't need to set an appointment, we would just do it all on the phone."

Don't base your decision on the highest paying job; base it on who will grow your skills the most. You're going to be working a long time, get the skills.

But Dave calls DEFENDER's employees the company's "secret sauce." Spending any amount of time around the DEFENDER campus on the north side of Indianapolis, or talking with its executive team, one regularly encounters the company's core operating principle, "Businesses don't grow, people do." Where some companies focus on technical abilities, or the "maverick superstar" as Dave calls them, DEFENDER targets high-character applicants with a desire to grow. "For us, the right people have three qualities: competence, character and humility. My dad gave me great advice when I first started in the workforce. He said, 'Don't base your decision on the highest paying job; base it on who will grow your skills the most. You're going to be working a long time, get the skills.' At DEFENDER, we're looking for ordinary people who can do extraordinary things."

Another core philosophy at DEFENDER is its commitment to help the community at large. From the start of the business, DEFENDER has contributed 10 percent of each quarter's profits to charitable causes. Dave credits his wife Jessica for insisting on that philosophy from the beginning.

Continued on page 6.

Client Spotlight

(continued from page 5)

"I really believe in those early days with Jessica demanding that we give back 10 percent, it was in our DNA to be givers. I get way too much credit for DEFENDER's success. We did it together."

While DEFENDER continues to grow its business by expanding its satellite TV services and venturing into the HVAC market, Dave has expanded the company's community reach. Through Dave's leadership, DEFENDER has broadened its charitable initiatives to include building homes for the poor in Mexico and the Dominican Republic.

DEFENDER has paid to send more than 3,000 employees and their families to build 150 homes over the last five years. For Dave, involvement in such initiatives is a core component of DEFENDER's corporate philosophy. "I think businesses have to be about more than a profit motive. The young people today will demand that. This idea about businesses existing just to serve the financial desires of the shareholders is not how the founders of capitalism imagined it. It is a component, but businesses can be much more than that. Customers and employees are going to demand that."

By populating DEFENDER with a strong executive team, Dave has been able to decrease his involvement in the day-to-day running of the company and focus his efforts on his philanthropic passions, including his new non-profit project, Companies With A Mission (CWAM). While a separate organization from DEFENDER, CWAM is an extension of DEFENDER's home-building efforts in other countries. "We have taken almost 100 business leaders, their spouses and their families, on trips to Mexico and the Dominican Republic to build houses for the poor. I talk to so many business leaders who say, 'That is so cool that you do these mission trips. I've always wanted to take my family on a mission trip.' If I've heard it once, I've heard it a million times."

Another civic invention of Dave's is the Central Indiana Service Challenge, targeted to co-employees forming small groups within their companies to support the charity of their choice. Employees volunteer their time to a not-for-profit and make a video or PowerPoint telling the story of their day. A committee of local business leaders awards $100,000 in prize money to the winning entrants, which is ultimately given to the charity they served. As Dave points out, DEFENDER started a program along these lines and the results exceeded his expectations. "At DEFENDER it has been amazing to watch the teams. Instead of talking about how their computer screen is blurry or how their chair doesn't fit, the conversation is, 'Did you see the pictures from what so-and-so did last week?' We've seen the business metrics increase within our own company. We attribute that to the increased teamwork and camaraderie that is coming out of these charitable services."

Dave is so pleased with the results in Central Indiana that he looks to take this program on the road. Next year's destination: New Orleans, which just happens to be host to Super Bowl XLVII. "There is nothing formal at this point, but we're chatting with the New Orleans Super Bowl Host Committee. It's a city with a great amount of need."

For more of our discussion with Dave Lindsey, click on the following links:

Dave Lindsey on building relationships with business partners

Dave Lindsey on the key to building a new business from the ground up

Dave Lindsey on the importance of giving back to the community

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KSM State & Local Tax News

The members of **KSM's State & Local Tax Practice** are dedicated to reducing your tax burden. Our commitment to this is evidenced by our leadership and active involvement in a number of industry and professional associations.

Tim Conrad spoke at the Indianapolis Bar Association's Continuing Legal Education event, "'Green' Federal & State Tax Incentives," an educational event covering both federal and state tax incentives for renewable efficiency.

Chad Miller and **Heather Judy** attended the Indiana County Assessors Association's 2012 Summer Conference.

Donna Niesen attended the North Americas meeting for Nexia International, a leading worldwide network of independent accounting and consulting firms.

For more information about Katz, Sapper & Miller, please visit ksmcpa.com.

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