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Ohio Tax Talk: Taxpayer Protection Lessons from the Defender Security Decision

On Sept. 29, the Supreme Court of Ohio released its decision in *Defender Security Co. v. McClain*[1] — yet another taxpayer-friendly ruling. This decision provides taxpayers with much-needed guidance on the interpretation of the catch-all provision in Ohio's situsing statute[2] and determination of the location of a customer's benefit when purchasing intangible contract rights. Ohio taxpayers who generate revenue from sales of certain intangible property and services should consider the lessons of *Defender Security*. If appropriate, taxpayers should evaluate whether to file a refund claim with respect to overpaid commercial activity tax, or CAT, liabilities or amend their situsing methodology moving forward. The key takeaways of *Defender Security* can be distilled into the following three lessons:

- There is no look through situsing of certain intangible property receipts.
- Look to the contract to determine the category of receipts.
- Summary documents can become evidence when properly authenticated.

This article will address each of these lessons in order, but first they must be placed in context with some background on the case.

Background

The taxpayer in this case was *Defender Security Company*. *Defender* is an Indianapolis based company that acts as an authorized dealer of *ADT Security Services Inc.* ADT provides home and building security services to customers in Ohio and nationwide.

Pursuant to the master agreement between ADT and *Defender*,

(1) generates leads for new ADT customers through advertising, (2) installs equipment at the Ohio property of new customers, for which

it collects and retains a fee, and (3) at time of installation, signs an alarm-services contract with Ohio customers under which ADT provides security-monitoring services to the Ohio customer.

When Defender collects new alarm service contracts to customers, it transfers them to ADT's dealer support unit in Colorado. ADT accepts most of the alarm service contracts and Defender retains the right to service any of the contracts that ADT does not accept. The transactions at issue in this case were payments made by ADT to Defender under the master agreement as consideration for ADT's purchase of Ohio alarm service contracts from Defender. Defender filed a CAT refund claim on the basis that receipts generated from those Ohio contracts were not taxable in Ohio.

Upon review of this claim, the Ohio tax commissioner, Board of Tax Appeals, and Tenth District Court of Appeals for Franklin County all ruled that the transactions at issue generated taxable gross receipts in the state of Ohio pursuant to the statute referred to as the catch-all provision.[3] It reads as follows:

(l) Gross receipts from the sale of all other services, and all other gross receipts not otherwise situated under this section, shall be situated to this state in the proportion that the purchaser's benefit in this state 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 shall be paramount in determining the proportion of the benefit in this state to the benefit everywhere. If a taxpayer's records do not allow the taxpayer to determine that location, the taxpayer may use an alternative method to situs gross receipts under this division if the alternative method is reasonable, is consistently and uniformly applied, and is supported by the taxpayer's records as the records exist when the service is provided or within a reasonable period of time thereafter.

Based on this statute, the tax commissioner, BTA, and Tenth District all reasoned that the receipts derived from the Ohio contracts were taxable to Ohio because ADT must receive some benefit from those contracts in Ohio. After all, ADT's servicing of the contracts involved property and customers in Ohio.

Defender challenged this reasoning on its appeal to the Ohio Supreme Court.

1. There is no look-through situsing of certain service and intangible property receipts.

On appeal, the Ohio Supreme Court wholly disagreed with the statutory analysis employed by the lower tribunals with respect to the catch-all provision of the statute. Plainly put, the Ohio Supreme Court concluded that:

the tax commissioner, the BTA, and the court of appeals all failed to properly distinguish between the benefit Ohio consumers received from ADT and the benefit ADT received by purchasing consumer contracts from Defender.

In other words, the lower tribunals conflated the benefit received by Defender's customer, ADT, and ADT's customers — retail consumers of services in Ohio.

The Ohio Supreme Court clarified that under the statute, the tax commissioner cannot look through multiple transactions in order to impose tax on transactions further up the chain.

The benefit of Defender's sales of the Ohio contracts to ADT was received at the physical locations where it receives customer payments and performs services for Ohio customers; all of these locations were outside of Ohio.

Thus, Defender's sales of the Ohio contracts were not taxable under the CAT. On the other hand, clearly ADT's sales of those services would be sitused to Ohio because that is where the customers are located and receiving the benefit of ADT's services.

2. Look to the contract to determine the category of receipts.

In its attempt to support his situsing position, the Ohio tax commissioner argued Defender's activities were analogous to services and, therefore, ADT received the benefit of Defender's services in Ohio.

The Ohio Supreme Court put this argument to rest by reviewing the master service agreement between Defender and ADT. In the Ohio Supreme Court's words, the master service clarified that "ADT does not pay Defender for signing up customers; it only pays Defender for those contracts that it purchases from Defender."

While it may seem simple, it is always important to carefully review the contracts involved in a tax dispute or refund claim. These primary source documents can be helpful in clarifying the category of receipt and, thus, which division of the situsing statute applies.

3. Summary documents can become evidence when properly authenticated.

The Defender Security decision also includes a critical discussion of evidence and summary reports. The question of whether evidence is properly authenticated is a common issue in Ohio CAT cases. This case demonstrates that summary reports (not official business records) can be accepted as evidence when they are authenticated at a BTA hearing.

In this case, Defender submitted summary documents in support of its refund claims; it did not submit the original business records underlying those summaries.

The tax commissioner did not raise any issues as to the sufficiency of the evidence at the administrative level before issuing his final determination nor at the BTA level.

Nevertheless, the tax commissioner moved to dismiss Defender's Supreme Court appeal on the basis that "Defender never offered business records to show what it paid on account of its sales of Ohio contracts to ADT."

In response to this assertion, the Ohio Supreme Court essentially said, too little too late.

The tax commissioner had its chance to invalidate these summaries at earlier stages in the litigation but failed to do so.

In fact, the court cited to the record that the summary documents were properly authenticated by testimony of Defender's corporate controller at the BTA hearing.

Taxpayers making refund claims or engaged in a CAT dispute should heed this lesson carefully. It is often difficult to locate original business records.

Plus, summary documents — i.e., excel reports — can be more useful in categorizing and quantifying receipts.

Defender Security provides an example for when such summaries will be accepted by Ohio courts when they are authenticated at a hearing before the BTA and/or otherwise unchallenged by the tax commissioner.

Conclusion

Taxpayers should evaluate the decision in Defender Security if they intend to seek a refund or challenge Ohio's situsing methods for sales of intangible property and contract rights.

For more information, contact any member of Frost Brown Todd's [Tax Practice](#).

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