

Minimizing Corporate Taxes: Trends, Challenges, and Solutions



Today's corporations face an economic arena unlike any other. More companies have entered global markets, and the worldwide economy is experiencing a dramatic downturn that creates widespread losses.

At the same time, corporations must contend with constantly changing tax regulations – federal, state, local, and international – with shrinking internal resources and tax departments. The significant impact taxes have on corporate profitability makes attending to certain tax issues an indisputable priority.

Crowe Horwath LLP has identified four critical business tax issues of particular concern now to corporate executives at both private and public companies: income tax accounting, state and local above-the-line taxes, transfer pricing and other international tax issues, and organizational restructuring as it relates to income taxes.¹ There are ways corporations can address each of these issues and minimize their effective corporate tax rates.

Accounting for Income Taxes

Increasing regulation and globalization, as well as the volatile economy, are pushing income tax accounting to the forefront of corporate planning. Compliance with the income tax

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accounting requirements of U.S. generally accepted accounting principles (U.S. GAAP) – newly codified by the Financial Accounting Standards Board (FASB)² – increasingly requires many companies to review their personnel, technology, and processes to ensure the right resources are available to satisfy their financial reporting obligations.

Trends

The past several years have seen a growing number of financial statement restatements as a result of issues related to accounting for income taxes. Prior practices and processes may no longer be adequate as stricter regulation, globalization, and the struggling economy

have focused more granular attention on tax positions, the controls related to those positions, and their reporting in a company's financial statements.

Increasing Regulation

Guidance that was known as FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48),³ took effect for public companies for fiscal years beginning after Dec. 15, 2006, and will apply to most nonpublic companies filing annual financial statements for fiscal years beginning after Dec. 15, 2008. The FASB delayed for two years implementation requirements for nonpublic enterprises, but it appears the deadline will not be extended again. Both public and nonpublic companies now must quantify their income tax exposures under the new recognition and measurement principles of the former FIN 48. Depending on the depth, breadth, and complexity of a company's income tax profile, adopting and maintaining compliance with the former FIN 48 can be time-consuming and complicated. To avoid last-minute surprises and time constraints, financial managers of nonpublic calendar-year enterprises should address the effects of the former FIN 48 on their companies before year end.

A company must also stay up-to-date on the ever-increasing number of developments with other accounting standards, since changes in other areas can have peripheral effects on a company's income tax provision computations. For example, guidance that was known as Statement of Financial Accounting Standards No. 141, "Business Combinations" (effective Jan. 1, 2009, for calendar-year companies), changed, among other things, the

accounting for acquisition transaction costs and the analysis of deferred taxes on goodwill. Multiple changes in the area of financial accounting for fair value and other-than-temporary impairments have the potential to create new differences between book and tax value. The list of such developments grows continually.

Large public companies must also deal with the internal control requirements of the *Sarbanes-Oxley Act* (SOX). A company's failure to accurately document and adequately follow processes and procedures surrounding income tax accounting can lead to the stigma of having to disclose significant deficiencies and even material weaknesses in financial control processes.

Globalization

The increasing need for, and ability of, businesses to expand into other states and countries complicates tax matters even more. When subject to the requirements of multiple tax jurisdictions, companies must understand the relevant local laws, since tax positions in each country and each state must be reviewed and adequately accounted for.

The continuing march away from the use of U.S. GAAP and toward the likely adoption by the United States of International Financial Reporting Standards is another trend to monitor. Changes in accounting standards by both the FASB and the International Accounting Standards Board are intended eventually to lead to the convergence of the two bodies of accounting guidelines. The effort necessary to understand changes in a company's financial accounting,

adopt those changes into income tax accounting models, and also adapt to International Accounting Standard No. 12, "Income Taxes," will certainly require significant advance planning.

Volatile Economy

The economic downturn has forced a growing number of businesses to report financial statement losses and, perhaps for the first time, to be in alternative minimum tax positions and experience carrybacks or carryforwards of tax losses and credits, or to experience significant increases in deferred tax assets owing to the devaluation of assets for financial statement purposes. As a result, companies must scrutinize their ability to realize deferred tax assets without having to establish valuation allowances against them. Corporate tax professionals may find themselves in a position of relearning tax and accounting law that they haven't touched since their school days. Likewise, quarterly economic volatility might for the first time bring into play provisions of the former FASB Interpretation No. 18, "Accounting for Income Taxes in Interim Periods."

In the face of tight liquidity markets, companies are looking for ways to fund domestic operations. U.S. companies with available cash in foreign subsidiaries are considering repatriating that cash or delaying repayment of loans. These types of transactions can have a significant impact on tax filings and provisions. If cash is repatriated, foreign earnings that have historically been considered permanently reinvested may now require the establishment of deferred assets and liabilities on the earnings and related foreign tax pools. U.S. companies

need to plan appropriately during the economic downturn to avoid unexpected tax consequences.

Another issue for many companies in the weakened economy relates to their accounting for share-based payments under what was known as Statement of Financial Accounting Standards No. 123, "Share-Based Payment." A deferred tax asset is created if the amount of financial statement compensation expense associated with a share-based award is expected to result in a tax deduction at a later date. If the tax deduction is ultimately less than the book compensation expense recorded for the award, a so-called tax deficiency occurs that decreases a company's additional paid-in capital (APIC) pool. If the APIC pool is reduced to zero, any tax deficiency must be recorded to income tax expense. As corporate stock prices have fallen and restricted share awards granted in better times are vesting, the likelihood of tax deficiencies is growing. Thus, companies must keep a close eye on their APIC pool computations to determine if deficiency tax expense must be recorded.

With the federal and state governments enacting new laws to increase tax revenue or direct certain spending, a company's tax provisions and related tax positions require regular review and revision to ensure accurate financial reporting and tax filings. As President Obama and Congress look for new ways to create economic growth, more change is likely in the near future.

Challenges

With staffing cutbacks hitting a wide swath of industries, some financial management executives worry that they cannot dedicate the necessary staff resources to their tax accounting and control processes. The company might have a tax director with sufficient expertise but a staff too small or too busy to complete the job on a timely basis. Or the tax department could be fully staffed but lack the necessary technical expertise.

Companies are searching for cost-effective ways to keep their personnel trained in the necessary technical subject matter and to stay abreast of the never-ending changes. Many corporate executives are attempting to automate their processes to achieve efficiency and control with fewer personnel. They might rely on off-the-shelf software to determine their financial statement tax provisions, but the phrase “garbage in, garbage out” often applies to such software. To make the most of this software, a company must have solidly established processes for funneling the necessary data into the software program to obtain accurate results. And, of course, there is no substitute for knowledgeable review and analysis of the reports generated by such software.

Solutions

Financial executives who have suffered through process breakdowns or financial statement restatements need to evaluate the performance of the critical components of their company's accounting for income taxes – personnel, technology, and processes. A breakdown in any one of these areas can lead to

inefficiencies and risk. Companies are looking for opportunities to improve their tax function during a time when their budgets for financial resources are limited. Evaluating these three components can lead to the development of improved processes that enhance efficiency and reliability and, in turn, make better use of personnel.

Even with well-designed processes and state-of-the-art technology, however, a company simply might not possess the resources to finish the job by the deadline. Such a company should consider loan staffing, consulting, or other outsourcing arrangements to augment personnel numbers and expertise. Continuing or increasing the investment in continuing professional education for their tax and financial personnel should not be overlooked.

Each company has unique needs and issues and should consider what areas are generating the greatest risk. The stakes are high. Misrepresentation of taxes on financial statements can lead to expensive and time-consuming restatements. The long reach of SOX, along with continual changes in accounting standards and tax laws, will keep the pressure on.

Managing Above-the-line Taxes

Corporate managers are under growing pressure to reduce operating expenses, and above-the-line taxes represent a prime target, especially for corporations in a loss position. Despite state and local tax authorities' aggressive pursuit of nonincome-tax revenues, some companies can take steps to actually reduce their property and sales tax liabilities.

States are looking for avenues to tax digital goods or Internet commerce, major new revenue sources.

Trends

Despite declining property values, real estate taxes in many jurisdictions are stable or on the rise. Assessors wanting to protect their tax base are distributing tax notices that use the same values as the prior assessments or reflect an uptick for inflation. Most assessors are unlikely to reduce the values across the board or, in individual cases, in the absence of a taxpayer appeal.

At the same time, many corporations find themselves affected by a fundamental shift in their state tax systems. Some states are moving to replace their income taxes with activity-based taxes to capture at least some revenue from companies that conduct business in the state, even in years the companies fail to generate profits. Such taxes can yield significant revenue at a lower tax rate than income taxes can.

The states of Ohio and Washington, for example, do not impose income tax but instead collect taxes based solely on a corporation's gross receipts – what's called a pure gross-receipts tax. Texas, Kentucky, and Michigan apply modified pure gross-receipts taxes. These changes might dramatically affect taxes for corporations in service and technology industries that typically can avoid sales and use taxes.

States are also looking for avenues to tax digital goods or Internet commerce, major revenue sources not contemplated by tax authorities in the past. The Streamlined Sales Tax Project, a multistate project focused on simplifying the nation's varying sales tax laws, has adopted a standard definition for taxable "digital goods" that ensnares items like videos, ringtones, electronic books, and text messages. Several states, including Indiana and Kentucky, have begun taxing these goods.

Some states are attempting to further expand their traditional sales tax bases by taxing services. States' approaches to these taxes differ. Michigan, for example, enacted legislation broadly defining services subject to sales tax. The laws were quickly repealed, but the effort is unlikely to remain dormant. States such as Ohio are taking a more piecemeal approach, selecting individual discrete services (janitorial, landscaping, parking, and security services, for example) over time to subject to sales tax.

Challenges

Managers interested in reducing their corporations' property taxes must weigh a variety of potentially conflicting challenges. For example, if a company provides a large portion of the tax base

for that jurisdiction, an appeal could also produce negative publicity – if the company prevails, after all, it means less money for local schools.

Depending on the complexity of a property's size, function, and type, the local assessor could find it difficult to accurately determine its fair market value using the usual valuation techniques. The corporation might be forced to appeal the assessment every year because, once a property is overassessed, that assessment will perpetuate and spawn years of overpayments. An inherent issue is whether the reduced taxes will offset the costs of appeal year after year.

If a corporation pays property taxes in multiple jurisdictions, the sheer volume of compliance can be an issue, especially with corporations undergoing budget cuts and layoffs. The corporation must track assessed values, actual tax payments, taxes due, and the reporting of tangible personal property on returns. The corporation could outsource the management of its property taxes, but it must be sure to select the right provider to take full advantage of tax reduction opportunities while outsourcing is undertaken.

Sales taxes present challenges as well. In many ways, compliance comes down to a matter of definition, as states begin taxing activities, digital goods, and services rather than just straight sales. These added tax liabilities can affect a company's pricing strategies. For example, if the company agrees with the tax authority that its service is taxable, it presumably would increase its price. But if its competitors disagree and do not adjust their prices accordingly, the corporation could lose market share. Conversely, if the corporation leaves its

pricing as is, it could face a hefty penalty down the road and has little chance of collecting the taxes from customers after the fact without damaging its customer relations.

Gross-receipts taxes present further challenges to corporate taxpayers. By design, these taxes are broad-based and contain few exemptions and planning opportunities. Many of these taxes are designed to shift the burden of taxation from in-state to out-of-state businesses. These gross-receipts taxes have resulted in a significant increase in the overall tax burden of many businesses that are now subject to taxes in these jurisdictions for the first time.

Solutions

Reviewing a corporation's real estate taxes for possible savings requires performing a market analysis of the subject property, with close attention to the nuances of equity rules for the classification of property. If the corporation's ultimate valuation conflicts significantly with the assessed market value, the corporation can file an appeal. Whether the appeal is heard before the assessor, a board, or a state court, the corporation or a third-party provider will need to compile an array of data to support the valuation.

Outsourcing personal property tax management can help a corporation maintain compliance and avoid penalties as well as track values so that the accrual process is more streamlined for financial reporting purposes. Unlike real estate taxes, personal property taxes are generally self-reported, although in some cases the assessor computes the market value. Otherwise, a corporation reports its personal property taxes using

depreciation multipliers developed by the state. Typical steps to identifying amended return opportunities include:

- Examining the underlying data relied on in the return, including the calculations;
- Ensuring that the return claims all of the eligible pollution control equipment, which may be completely exempt;
- Questioning certain types of assets based on their age and verifying that the assets are still on hand;
- Checking the state laws regarding the taxability of software; and
- Applying accelerated depreciation for computers, where allowed.

Note that corporations must file amended returns before the statutory deadline.

As with an appeal of a real estate assessment, an amended return requires the corporation to compile data in support of the value.

Corporations also must research on a regular basis the taxability of their goods and services. Often a corporation with solid grounds for interpreting a tax statute as inapplicable to it can avoid penalties and negotiate prospective taxation if the interpretation fails. If a company that has been selling so-called digital goods is audited, for example, it might be able to persuade the authority to dismiss its assessment of back taxes and require the collection of only the applicable taxes going forward. Corporations also can request rulings from tax authorities on the taxability of goods or services when it is unclear.

Transfer Pricing and Related International Tax Issues

Multinational corporations (MNCs) have long sought to minimize their effective global tax rates by shifting income through transfer pricing policies. As a result, jurisdictions around the world are developing more stringent laws, regulations, guidelines, and statutes for transfer pricing. As multinationals extend their operations into the global economy, they must demonstrate that their transfer pricing policies can withstand scrutiny by tax authorities.

Tax authorities worldwide are targeting any size company that has intercompany transactions of tangible or intangible property, services, or financing.

Trends

Many countries have developed, or are developing, tighter transfer pricing regulations to ensure that the losses of MNCs can be attributed to legitimate business reasons rather than improper transfer pricing policies. The Organisation for Economic Co-operation and Development members and many other countries are reviewing and revising transfer pricing regulation and enforcement standards. The United States, China, and Russia are among the countries that have recently adopted new regulatory standards. As a result of such changes, a transfer pricing policy that was acceptable in the past might now be prohibited. Alternatively, previously prohibited policies might be allowed today and could give rise to a tax planning opportunity.

Further, many countries require taxpayers to disclose on their tax returns whether

they have intercompany transactions between related parties. Canada, for example, requires taxpayers to disclose the transfer pricing methodology used to determine whether intercompany transactions qualify as satisfying the “arm’s-length standard.”⁴ In addition, some countries require the disclosure of whether contemporaneous transfer pricing documentation has been completed at the time the annual tax return is filed.

With the downturn of the global economy, MNCs with intercompany transactions – transfers of tangible

or intangible property, services, or financing – must demonstrate to U.S. and foreign tax authorities that their losses are not due to faulty or improper transfer pricing policies. In most countries, doing so requires MNCs to conduct a transfer pricing study to establish that their intercompany transactions were conducted pursuant to the arm’s-length standard. Annual preparation of contemporaneous transfer pricing documentation is required to demonstrate to tax authorities that taxable income has not been skewed by a faulty transfer pricing policy on the part of the MNC.

Transfer pricing studies are increasingly common because more MNCs are reporting losses, and losses often are a red flag for tax authorities. Large MNCs are not the only ones at risk – tax authorities worldwide are targeting any

size company that has intercompany transactions of tangible or intangible property, services, or financing. For example, the U.S. Internal Revenue Service provides all of its auditors with a checklist that calls for the examination of contemporaneous transfer pricing documentation for every MNC. In addition, Canada requires Tax Form T106, “Information Return of Non-Arm’s Length Transactions with Non-Residents,” to be filed and sent to a specialty unit of the Canada Revenue Agency for review and examination.

Challenges

MNCs must understand and implement new global transfer pricing regulations as they become effective. Multinationals that are suffering losses must be especially vigilant about complying with local countries’ transfer pricing laws, guidelines, regulations, and country-specific statutes. MNCs are required to make “reasonable efforts” in demonstrating that they are meeting the arm’s-length standard. Reasonable efforts can be met only by completing contemporaneous transfer pricing documentation at the time the MNC’s tax return is filed.

MNCs must therefore understand and implement new global transfer pricing regulations as they become effective as well as comply with the various transfer pricing laws in the jurisdictions in which they operate. Multinationals should develop transfer pricing policies that both comply and fit within the framework of the organization.

To develop an effective transfer pricing policy, a corporation must determine definitively which of its entities bears particular risks, functions, and asset utilization. Implementation of global transfer pricing regulations is often complicated by an inconsistent understanding within the MNC of which related parties are responsible for which business operations as well as which bear particular risks, functions, and asset use. Personnel in different parts of the corporation might respond differently to consultants and advisers about such critical issues.

Solutions

All multinationals are required to create and maintain transfer pricing studies and a transfer pricing policy. If a transfer pricing study does not support arm’s-length pricing, the MNC will likely need to change its approach to transfer pricing. Generally, two types of approaches are used. Transaction-based approaches, such as the comparable uncontrolled price (CUP) methodology and the comparable uncontrolled transaction (CUT) methodology, compare the prices of related party transactions to the prices of unrelated party transactions (transactions with third parties or unrelated parties) and also look at contractual comparability. On the other hand, a profits-based approach, such as the comparable profits method or the transactional net margin method, focuses on comparing the profits that result from related and unrelated party transactions. Since most tax authorities prefer transaction-based approaches, a transfer pricing policy that employs the CUP or CUT method is likely to have greater credibility in the eyes of many tax authorities.

Rather than simply conducting transfer pricing studies only when required by tax authorities, MNCs should take a proactive approach to their transfer pricing policies – an approach that might also result in tax minimization or planning opportunities. Corporations may identify tax minimization strategies that can be legitimately achieved through transfer pricing policies, including strategies that involve absorption of net operating losses, excess foreign tax credits, points for passage of title to minimize taxation, and rationalizing which related parties bear risks and functions and employ assets.

An MNC could, for instance, shift the development, financing, and licensing of second-generation intangible property to countries with a more favorable tax rate on royalty income. It could also consolidate or shift risks and functions to jurisdictions with lower tax rates when business purposes exist. Yet another planning alternative is entering into an advanced pricing agreement with one or several tax jurisdictions. Contractually binding both parties to certain transfer pricing policies in this way provides the MNC with assurance that the tax authority is unlikely to challenge it in the future on transfer pricing issues or tax planning structures that have been set in place.

Organizational Restructuring for Income Tax Purposes

Often a corporation is assembled without taking into account the income tax consequences of the structure. In other cases, a corporate structure that was once tax-efficient has become tax-inefficient as a result of operational changes or changes in the tax laws. Businesses should evaluate the tax-efficiency of their structure to see if reorganization could result in state, federal, or international tax savings.

Trends

For years, corporations have relied on strategies that use intangible property holding companies, financing subsidiaries, and similar tools to control their tax costs. A corporation, for example, might transfer the legal rights in a valuable brand name to a separate legal entity located in a tax-friendly jurisdiction. That entity would charge the group's operating entities a royalty to use the brand, in turn allowing those entities to claim a deduction in their home states, while the royalty income went untaxed by the tax-friendly jurisdiction. States have responded to such traditional planning techniques by either expressly disallowing deductions for royalty fees or requiring corporations to use combined reporting, with all the entities reporting as a single corporation.

Many states also are replacing income taxes with alternative activity-based tax systems that are based on gross receipts. Some corporations incur significant tax increases in these states, while others see significant reductions. Ultimately,

though, the burden and imposition of taxes are shifting. States are intent on designing tax systems that make it easier to tax out-of-state corporations to build revenue without hurting in-state companies.

A corporation must determine whether the desired tax benefit from restructuring is sustainable for the long term.

In certain circumstances, simple corporate reorganizations can reduce obligations for state income or sales taxes. Consider a group of corporations based in a separate filing state. If one member of that group generates \$10 million in income and another entity in the group loses \$10 million, the first corporation must pay its income tax without the benefit of the second corporation's offsetting loss. But if the entities merged, the corporations would have no taxable income in the separate filing state.

A corporation also might restructure or reorganize to manage sales tax exposures in other states. Other planning techniques might utilize sales companies or procurement companies to lower the overall tax burden on a business.

Globalization can play a role, too, with corporations expanding internationally or adding international layers through acquisition. To minimize their effective worldwide tax rate, such corporations must consider the interplay between domestic and foreign tax laws as well as various resulting complexities – including, but not limited to, the management of foreign tax credits, transfer pricing rules

and regulations, planning related to intangible property ownership, and the tax implications of potential financing arrangements. Structuring to maximize planning opportunities, or minimize exposure, requires knowledge and experience with not only the applicable domestic and foreign rules and regulations but also the vast income tax treaty network.

Challenges

It is one thing for a corporation to recognize that reorganization might save state or international taxes. The hard part lies in balancing the theoretical approach to saving taxes with day-to-day business issues related to implementation. An ostensibly brilliant tax solution can create an operational issue that makes it ultimately unfeasible. Will reorganizing produce additional administrative costs that outweigh the tax savings? Could reorganization require the renegotiation of a favorable contract? Do legal or regulatory hurdles lurk just beyond the horizon?

Some corporations interested in reorganizing also must realize that they operate in a constantly evolving legislative environment. The risk exists that the desired tax benefit could eventually be eliminated by the relevant states. The benefits of intangible property holding companies, for example, are no longer available in many states. Essentially, a corporation must determine whether the desired tax benefit is sustainable for the long term.

From an international perspective, a corporation must evaluate each jurisdiction for the potential effects and implications relative to its tax-saving goals. Without expertise in the various

jurisdictions, a corporation could avert tax issues in one jurisdiction at the expense of creating issues in another.

Solutions

Unfortunately, no single strategy applies for corporate reorganizations from a state and international tax perspective. Every corporation's situation is unique, with different internal and external drivers, and requires a strategy that:

- Reduces the corporation's total tax liability;
- Provides a structure that works within the corporation's overall business operations; and
- Does not impose an undue administrative burden on the corporation.

Developing such a strategy requires an iterative process that works from a broad outline of where the corporation is headed to identify possible solutions and the associated tax-related pros and cons for each possible solution. An effective process will involve an interdisciplinary team, with representatives from the legal, financial, accounting, tax, and operations areas.

Conclusion

In a world with heightened scrutiny of financial and tax reporting, coping with the tax issues detailed in this paper can be challenging and time-consuming, especially for corporations forced to tighten their belts. But corporations cannot afford to take unnecessary risks – they must stay on top of the evolving tax regulations and competing corporate interests to minimize their effective tax rates. It is essential that corporations find

a way to support their tax departments, even in the face of dwindling resources.

¹ The identification of these issues, a result of Crowe's experience with clients, is also informed by a survey Crowe conducted in August 2008. The responding tax executives identified these four business tax issues as the most critical their organizations would face in the coming 12 months.

² On July 1, 2009, the *FASB Accounting Standards Codification*[™] (ASC) became the single official source of authoritative, nongovernmental U.S. GAAP, superseding all existing literature from the FASB, the American Institute of Certified Public Accountants, and the Emerging Issues Task Force. FAS 109, its newer companion, FIN 48, and other income-tax-based guidance were reorganized into FASB ASC 740, "Income Taxes."

³ References in this paper to any former FIN or FAS are to guidance that has been reorganized into the ASC.

⁴ According to UTransferPricing.com, the arm's-length principle of transfer pricing "states that the amount charged by one related party to another for a given product must be the same as if the parties were not related. An arm's-length price for a transaction is therefore what the price of that transaction would be on the open market. For commodities, determining the arm's-length price can sometimes be as simple a matter as looking up comparable pricing from non-related party transactions, but when dealing with proprietary goods and services or intangibles, arriving at an arm's-length price can be a much more complicated matter."

Under U.S. Treasury rules issued in 2005, we must inform you that any advice in this communication to you was not intended or written to be used, and cannot be used, to avoid any government penalties that may be imposed on a taxpayer.

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