

## Ohio Supreme Court Affirms CAT Economic Presence Nexus Standard

### Overview

On November 17, 2016, the Supreme Court of Ohio (the "Court"), in a 5-2 opinion, affirmed decisions of the Ohio Board of Tax Appeals (the "BTA"), consolidated as *Crutchfield Corp. v. Testa*,<sup>1</sup> in which assessments had been issued against an online retailer under the bright-line economic nexus provisions of the state's Commercial Activities Tax ("CAT"). In upholding the BTA decisions, the Court ruled that Ohio's bright-line economic nexus standard is constitutional because: (1) the U.S. Supreme Court holding in *Quill Corp. v. North Dakota*,<sup>2</sup> requiring a physical presence in the taxing jurisdiction in order to impose a sales and use tax obligation, does not extend to a business-privilege tax such as the CAT; and (2) that the \$500,000 taxable gross receipts threshold of the CAT's economic nexus standard complies with the substantial-nexus requirement of the U.S. Supreme Court's ruling in *Complete Auto v. Brady*,<sup>3</sup> is not clearly excessive in relation to Ohio's legitimate interest in imposing the tax, and as a result satisfies the dormant Commerce Clause.<sup>4</sup>

This Tax Alert discusses briefly the background of the subject law and case, summarizes the Ohio Supreme Court's decision, and provides taxpayer considerations.

### The CAT

The state of Ohio levies the CAT on the taxable gross receipts of businesses for the privilege of doing business in the state.<sup>5</sup> In 2005, upon adoption of the CAT, Ohio became the first state to apply a bright-line economic nexus standard. This standard provides that a taxpayer will have a presence in the state sufficient to establish nexus if the taxpayer has during the calendar year: \$50,000 in Ohio property; \$50,000 in Ohio payroll; \$500,000 in taxable gross receipts; or at least 25% of the person's total property, total payroll, or total taxable gross receipts within the state.<sup>6</sup>

### Case Background

During the tax periods extending from 2005 through 2012, Crutchfield was a direct marketer selling products to customers around the country. While Crutchfield was not based in Ohio and had no employees or facilities in Ohio,<sup>7</sup> they did receive gross receipts from sales to Ohio customers. The Ohio Department of Revenue ("DOR") issued assessments against Crutchfield under the CAT's bright-line economic nexus standard for this period, finding that the company's taxable gross receipts exceeded the bright-line nexus standard of \$500,000 in taxable receipts from sales to customers in Ohio.<sup>8</sup>

Crutchfield did not contest the DOR's determination regarding the amounts of estimated CAT, but instead contested the final assessments on both statutory and constitutional grounds asserting its immunity from the tax altogether.<sup>9</sup> On February 26, 2015, in consolidated case Nos. 2012-926, 2012-3068, and 2013-2021, the BTA upheld the assessments, rejecting the statutory challenges and noting that it "lacked jurisdiction to decline to apply statutes on constitutional grounds."<sup>10</sup>

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<sup>1</sup> *Crutchfield Corp. v. Testa*, Slip Opinion No. 2016-Ohio-7760 available [here](#).

<sup>2</sup> 504 U.S. 298 (1992).

<sup>3</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

<sup>4</sup> *Crutchfield* at 3.

<sup>5</sup> Ohio Rev. Code Ann. § 5751.02(A).

<sup>6</sup> Ohio Rev. Code Ann. § 5751.01(H)-(I).

<sup>7</sup> *Crutchfield* at 2.

<sup>8</sup> *Crutchfield* at 5-6.

<sup>9</sup> *Crutchfield* at 6-7. Crutchfield's statutory argument was rejected. *Id.* at 9-10.

<sup>10</sup> *Crutchfield* at 4-6.

### Arguments Before the Ohio Supreme Court

The BTA's holding was subsequently appealed to the Ohio Supreme Court and oral arguments were held on May 3, 2016. Crutchfield renewed its constitutional challenge and asserted that the DOR assessments were unconstitutional, first, because no "substantial nexus" existed between Crutchfield and Ohio as required to impose a taxing obligation on an out-of-state business under the U.S. Supreme Court's holding in *Complete Auto*.<sup>11</sup> Second, that physical presence in the taxing jurisdiction was required to establish substantial nexus under various U.S. Supreme Court decisions regarding gross-receipts type taxes.<sup>12</sup> Therefore, Crutchfield argued, it lacked substantial nexus with Ohio because it did not have a physical presence in the state.<sup>13</sup> Ohio countered with two arguments: (1) Commerce Clause case law does not impose a physical presence requirement to establish substantial nexus and that the \$500,000 taxable receipts measure meets such requirement, and (2) even if a physical presence was required in the case of a business privilege tax, Crutchfield's "computerized connections" (also known as "cookies") with Ohio consumers involved the presence of tangible personal property on computers located in Ohio which constituted a physical presence in the state.<sup>14</sup>

### The Ohio Supreme Court decision

On November 17, 2016, the Ohio Supreme Court upheld the BTA decisions against Crutchfield and ruled that (1) a physical presence by the taxpayer in Ohio is not required for imposition of the CAT, and (2) the economic nexus standard imposed by the CAT, specifically the \$500,000 taxable gross receipts threshold complies with the substantial-nexus requirement of the U.S. Supreme Court's dormant Commerce Clause jurisprudence.<sup>15</sup>

Physical presence in Ohio is not required for imposition of the CAT. The Court, in the majority opinion, held that the imposition of the CAT upon Crutchfield was constitutional because the U.S. Supreme Court's holding in *Quill*, requiring a physical presence in the taxing jurisdiction for the imposition of a sales and use tax collection obligation, does not extend to a business-privilege tax such as the CAT, "as long as the privilege tax is imposed with an adequate quantitative standard that ensures that the taxpayer's nexus with the state is substantial."<sup>16</sup> In its discussion of this holding, the Court referenced post-*Quill* cases decided in multiple other states which have "explicitly rejected the extension of the *Quill* physical-presence standard to taxes on, or measured by, income."<sup>17</sup>

\$500,000 taxable gross receipts threshold complies with substantial-nexus requirement. The Court, in the majority opinion, also held that the \$500,000 taxable gross receipts threshold imposed by the CAT was an adequate quantitative standard which complied with the substantial-nexus requirement of the U.S. Supreme Court's holding in *Complete Auto* because it is "not 'clearly excessive' in relation to the legitimate interest of the state ... in imposing the tax evenhandedly on the sales receipts of in-state and out-of-state sellers."<sup>18</sup> Finally, having held the assessments against Crutchfield to be constitutional on the basis that *Quill*'s physical-presence standard is not applicable to the CAT, the Court declined to rule on the DOR's second argument, that Crutchfield's "computerized connections" with Ohio consumers involved the presence of tangible personal property on computers located in Ohio which constituted a physical presence by the business in the state.<sup>19</sup>

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<sup>11</sup> *Crutchfield* at 2 & 12.

<sup>12</sup> *Crutchfield* at 11-15.

<sup>13</sup> *Crutchfield* at 2.

<sup>14</sup> *Id.*

<sup>15</sup> *Crutchfield* at 3.

<sup>16</sup> *Crutchfield* at 17. See also *Nat'l Bellas Hess Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753 (1967). The two-person dissent disagreed with the majority on this point, noting that they saw "no evidence that gross-receipts taxes are meaningfully different from use taxes for substantial-nexus purposes," and thus the physical presence rule established in *Bellas Hess* and *Quill* would continue to be applicable for CAT purposes. *Crutchfield* at 29-30.

<sup>17</sup> *Crutchfield* at 19-20.

<sup>18</sup> *Crutchfield* at 24. Interestingly, the dissent would have found the \$500,000 gross receipts threshold to have been an undue burden on interstate commerce, noting that "it is easy to imagine an Ohio manufacturing business ordering one machine from an out-of-state business, and . . . trigger[ing] a requirement for that business to comply with the CAT." *Crutchfield* at 31-32.

<sup>19</sup> *Crutchfield* at 3.

## Considerations

All businesses (including federally disregarded entities)<sup>20</sup> selling products into the state of Ohio, regardless of their physical presence in that state, should examine their current activities in light of this decision. These businesses may wish to consider how the \$500,000 taxable gross-receipts nexus standard imposed by the CAT would apply to them.

It is not known whether Crutchfield will appeal the decision, and furthermore the U.S. Supreme Court has demonstrated reluctance to grant certiorari to a taxpayer appeal involving economic presence nexus. Although high courts in other states have previously ruled that physical presence is not necessary to impose an entity level net income tax,<sup>21</sup> this decision represents the first time a state's highest court has addressed a so-called "factor-based" economic presence nexus standard.

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<sup>20</sup> Ohio Rev. Code Ann. § 5751.01(A).

<sup>21</sup> See *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); see also *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006).