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A Critique Of The Nexus Standard For Ohio's New Commercial Activity Tax

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In September 2005, the Ohio Department of Taxation issued an information release describing the nexus standards it will apply to determine whether an entity is subject to Ohio's Commercial Activity Tax ("CAT"). With this announcement, Ohio joins a growing list of states that ignore well-established United States Supreme Court precedent in imposing business privilege taxes on entities that do not have a physical presence within the state.

Physical Presence Test

In order to be subject to a state's sales or use taxes, a business must have a physical presence within the state. The United States Supreme Court reaffirmed this requirement in the much heralded decision of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). This physical presence can be established in a number of ways:

- Owning, leasing, or using any office, plant, warehouse, distribution center, or other place of business in a state;
- Operating a retail store or other selling location in a state;
- Owning, leasing, or using any property in a state;
- Maintaining an inventory, manufacturing products, or storing goods in a state;
- Delivering merchandise to customers in a state in company-owned trucks or vehicles; or
- Maintaining employees in a state.

Throughout its life, the physical presence test has proved a stable guidepost for tax administrators and planners and an important building block of Commerce Clause jurisprudence. More importantly, the test has fostered an environment in which businesses can invest with a level of certainty about the tax consequences of various activities.

The Ohio Department's View Of Nexus

Unfortunately for entities doing business in Ohio, the Department of Taxation has determined that this rule has been too much of a good thing. In an economy increasingly driven by internet and mail-order businesses, the state has been powerless to collect sales and use taxes from entities that lack the traditional brick-and-mortar presence. To capture more of this revenue stream, the Department has now added to the traditional physical presence test a newer "economic presence" test that authorizes the state to assess its CAT against businesses that do not have a constitutional "physical presence" in the state. Under this new policy, mere "economic presence" will be sufficient. Economic presence--or what the Department calls "bright-line presence"--will exist if an entity meets any one of the following criteria:

- Has at any time during the calendar year property in Ohio with an aggregate value of at least $50,000;
- Has during the calendar year payroll in Ohio of at least $50,000;
- Has during the calendar year taxable gross receipts in Ohio of at least $500,000;
- Has at any time during the calendar year within Ohio at least 25% of the entity's total property, total payroll, or total gross receipts; or
- Is domiciled in Ohio as an individual or for corporate, commercial, or other business purposes.

R.C. 5751.01(I).

These rules expand the universe of potential Ohio taxpayers in two key ways. Specifically, a business is subject to the CAT if it earns the required amount of gross receipts in-state ($500,000) or has a sufficient percentage of its gross receipts in-state (25%). This is true even though the business has no employees, no inventory, no warehouses, no stores, and no other property in the state. Thus, the Department ignores the United States Supreme Court's decision in *Quill* and imposes the CAT on entities that do not have a physical presence in Ohio.

What Supports The Ohio Department's New Nexus Test?

Of course, most of the entities affected by this rule do business in many states. On this point, the best that can be said of Ohio's rule is that the Department has arrived late to a bad idea. Before Ohio adopted the policy, at least 16 other states already assessed a business privilege tax against entities without physical presence, either by statute or stated policy. The first was South Carolina, which announced its departure from the *Quill* decision in a South Carolina Supreme Court opinion in 1993. In *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), the court held that the U.S. Supreme Court's "physical presence" requirement as expressed in *Quill* was limited to sales and use taxes and did not apply to the type of tax at issue in that case, an income tax.

The *Geoffrey* court arrived at its innovation by seizing on one sentence in the *Quill* opinion. In *Quill*, the U.S. Supreme Court reaffirmed that the physical presence test, a test first established in 1967, still applied to state sales and use taxes. The *Quill* Court noted that "[a]lthough we have not, in our review of other types of taxes, articulated the same physical-presence requirement . . . established for sales and use taxes, that silence does not imply repudiation of the . . . rule." *Quill* at 314. The *Geoffrey* court essentially stopped reading halfway through the sentence. Noting that the United States Supreme Court had not extended the physical presence test outside the sales and use tax context, the *Geoffrey* court took this as license to declare open season on the Commerce Clause. Of course, a fair reading of *Quill* indicates that the Supreme Court was merely reserving decision on whether the physical presence test applied to other taxes. *See* Mark McGinnis, "Marching to the Beat of the Itinerant Drummer: States Increasingly Refuse to Get Physical before Finding Nexus," 32 Cap. U.L. Rev. 149, 178, Fall 2003.

The Department cites one Ohio case for its new rule: *Couchot v. State Lottery Commission*, 659 N.E.2d 1225 (1996). In that case, the taxpayer was a lottery winner who lived out of state but purchased the winning ticket in Ironton, Ohio, and returned to Ohio to claim his prize. In its information release, the Department correctly noted that the Ohio Supreme Court refused to extend the physical presence test to income taxes. However, the court also explained that the taxpayer *did* in fact have a physical presence in the state by virtue of where he purchased and redeemed the ticket. Thus, in this case, the personal income taxpayer was liable for the income tax regardless of whether the court applied the physical presence test. To the best of your author's knowledge, the Department has not identified any Ohio case in which a tax was assessed against an out-of-state entity that did not have any physical presence in the state.

Has The Department Gone Too Far?

Also, even though the Department cites cases in other states as authority for its position, the Department is going far beyond those states in actually applying its CAT to entities without a physical presence in the state. Specifically, while the Department's rule would apply the CAT to entities that only earn gross receipts in Ohio, three of the cited cases involve entities that had intangible property in the taxing states. In *Geoffrey*, *Lanco*, and Indiana's "Letter of Findings," the entities at issue had licensed trademarks to corporations that did business in the state. *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993); *Lanco, Inc. v. Division of Taxation*, 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005); *Letter of Findings No. 02-0310*, Indiana Department of State Revenue, April 1, 2005. Thus, while the taxed entities in those cases did not have employees or offices within the taxing states, they did license trademarks to others whose use of them within those states generated royalty payments for the licensors.

In *Koch Fuels*, the Rhode Island Supreme Court noted that even though the tax was labeled a gross receipts tax, it was "correctly characterized" as a sales or use tax. *Koch Fuels, Inc. v. Clark*, 676 A.2d 330, 333 (R.I. 1996). The court affirmed the holding that the physical presence requirement applies to sales and use taxes and merely concluded that the physical presence requirement was met. In that case, Koch Fuels was a seller and distributor of fuel oil that shipped the oil to Rhode Island via common carrier. The common carrier's cargo contained only Koch oil, Koch maintained continuous contract and control over the carrier, and Koch's sales were consummated only upon delivery in Rhode Island. Thus, *Koch Fuels* does not support the Department's contention that the physical presence requirement does not apply outside the sales and use tax context. Rather, the court in *Koch Fuels* actually applied the physical presence requirement to a sales or use tax and merely found that it was met.

Further, in *General Motors*, the court did refuse to apply the physical presence test to Seattle's business tax. *General Motors Corporation v. City of Seattle*, 107 Wn. App. 42 (Wash. Ct. App. 2001). However, the taxpayers in that case, GM and Chrysler, did more than simply earn gross receipts in the city. The court noted that while GM and Chrysler did not have any offices or employees within the city, they did conduct substantial marketing activities there. The court also noted that as part of its sales strategy, the two companies advertised the warranties that accompanied their cars and employed others to perform repairs on those cars pursuant to the warranties. Also, GM and Chrysler sent representatives to the city to discuss various aspects of the business with dealers in Seattle. Based on the above, the court held that GM and Chrysler did have a substantial nexus with the city. However, because the Ohio rule would impose the CAT based solely on gross receipts, it goes far beyond the facts of this case.

Also, the rule goes beyond the facts of *Steager*, where MBNA America Bank was held liable for a West Virginia corporate income tax. *Steager v. MBNA America Bank, N.A.*, No. 04-AA-157 (W. Va. Circuit Court 2005). In that case, MBNA America extended unsecured credit to West Virginians and received income from the credit cards it issued. Ohio's rule, however, would extend to entities that do not even engage in this level of activity in the state.

Finally, in *Autozone*, the court resolved the case on Due Process grounds without addressing the Commerce Clause issue. *Bridges v. Autozone Properties, Inc.*, No. 2004-C-814 (La. 2005). However, as the U.S. Supreme Court has explained, "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause. *Quill* at 313.

Our Prediction

In conclusion, it is highly likely that the Department's attempted application of the CAT to out-of-state entities with no physical presence in the state will be challenged in the courts. Until the CAT is taken out of the bag, however, entities that merely earn gross receipts in Ohio may be subject to the tax.■

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