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Ohio Commercial Activity Tax Passes First Constitutional Hurdle

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The Ohio Commercial Activity Tax ("CAT"), which became effective July 1, 2005, is a broad-based excise tax levied on taxable gross receipts "for the privilege of doing business in Ohio." *See* R.C. 5751.02(A). The CAT was enacted as part of a major overhaul of Ohio's tax structure, replacing the Ohio corporate franchise tax and personal property tax with a single gross receipts tax. This new tax reaches any business that has customers in Ohio in excess of statutory minimums. It will be fully phased-in by 2010.

Although the CAT has been the subject of some criticism -- largely due to the aggressive nexus standards incorporated within the statute and its complicated rules for siting and mandatory group reporting -- there has been little yet in the way of court challenges or judicial guidance. Recently, however, the first court decision involving the new CAT handed a victory to the Ohio Department of Taxation (the "Department"). In *Ohio Grocers Association v. Wilkins*, Case No. 06CVH02-2278 (Franklin Cty. Common Pleas Aug. 24, 2007), Judge Bessey of the Franklin County Court of Common Pleas upheld the tax against constitutional challenges specific to the food industry. In doing so, the court was required to examine the fundamental nature of the tax and explore its underlying tax structure.

Background

The Ohio Constitution prohibits the imposition of excise taxes on the sale or purchase of food at the retail level (Article XII, § 3) and at the wholesale level (Article XII, § 13). Specifically, section 3(C), Article XII of the Ohio Constitution provides in part that "no excise tax shall be levied or collected upon the sale or purchase of food for human consumption off the premises where sold." In addition, Section 13, Article XII of the Ohio Constitution provides that "[n]o sales or other excise taxes shall be levied or

collected . . . upon any wholesale sale or wholesale purchase of food for human consumption, its ingredients, or its packaging. . . .”¹

The Ohio Grocers Association is a non-profit trade association whose membership includes 406 businesses who sell food at retail and twelve businesses engaged in the wholesale distribution of food and grocery products in Ohio. The Grocers Association (along with several named representative plaintiffs²) filed a declaratory judgment action in state court, asserting that the application of the CAT to the retail sellers of food violates the Ohio constitutional prohibition against excise taxes “levied or collected upon” the purchase of food for human consumption. Based on these constitutional prohibitions, the grocers asked the court to declare as a matter of law that the CAT violates the Ohio Constitution when applied to gross receipts derived from the wholesale sale of food and from the retail sale of food for human consumption off the premises where sold.

The Legal Arguments

As a threshold matter, the very nature of the CAT is at issue in this case. Since the Ohio Constitution prohibits only certain taxes – “excise” taxes – in order to prevail, the grocers must first show that the CAT is indeed an excise tax. Secondly, that excise tax must be “levied or collected upon the sale or purchase of” protected food or food-related items.

Excise Tax

The grocers argued that the CAT is clearly an excise tax. In doing so, they relied on a long line of Ohio Supreme Court cases which define excise taxes as a tax “imposed on the performance of an act, the engaging in an occupation, or the enjoyment of a privilege.” Inasmuch as the CAT statutes themselves describe the CAT as a levy “for the privilege of doing business in this state,” it seemed clear that the CAT should be considered an excise tax for purposes of the constitutional analysis.

The Department argued that because the CAT is imposed on the privilege of conducting business in the State of Ohio, it is a “franchise tax” and not an excise tax. What the Department failed to convincingly articulate, however, is why this distinction between franchise taxes and excise taxes was relevant to the constitutional analysis. The Department did not distinguish the body of cases cited by the grocers which expressly held that taxes imposed on the privilege of doing business, including franchise taxes,

¹ Section 13 also contains constitutional prohibitions against taxing items sold to or purchased by a manufacturer, processor, packager, distributor or reseller of food for human consumption, or its ingredients, for use in its trade or business, or taxes in any retail transaction on any packaging that contains food for human consumption.

² The named plaintiffs included CFZ Supermarkets and Reading Food Services (purely retail sellers of food for consumption off-premises), Sanson Company (a company that sells food for human consumption exclusively at wholesale) and Carfagna’s (a company that sells food at both wholesale and retail).

are types of excise taxes. Most authorities in other jurisdictions treat franchise taxes as a form of excise taxes.

“Levied On the Sale or Purchase” of Food

As to the second element, the Department maintained that the tax was not “levied on” the sale of food. Although food sales served as the *measure* of the tax, the Department argued, the tax was not actually *imposed on* the sale of food. The Department reasoned that only “transactional” taxes are prohibited by the Constitution, despite the fact that the word “transaction” appears nowhere in the constitutional language. Relying on expert testimony, the Department then went on to delineate all the differences between sales taxes and gross receipts taxes, concluding that since the CAT is not a traditional sales tax, it is not barred by the Constitution.

The grocers relied instead on the actual operational effect of the CAT. They asserted that the CAT, for all practical and economical purposes, is levied on the sale or purchase of food. Because a state tax statute must be examined by its operation and effect, the plaintiffs argued that the State cannot avoid the constitutional prohibition in this case merely by labeling the tax a privilege tax “measured by” gross receipts. The plaintiffs also supplied expert testimony on this point to show that even though the CAT is ostensibly imposed on the privilege of doing business in the state, it is also *levied on* gross receipts from the sale of food. The grocers point out that for every dollar of food sold in Ohio, a corresponding commercial activity tax is owed. Thus, it operates like a sales tax in practical impact and operation.

Ohio’s Constitution prohibits all excise taxes levied upon the purchase or sale of food – not just “traditional” sales taxes. Therefore, the Department’s attempt to distinguish the CAT from a traditional sales tax, like its franchise tax arguments, is not constitutionally compelling. In practical effect and operation, the CAT is levied “on” the sale of food and thus is inconsistent with the Ohio Constitution.

Court Upholds the Tax

Although the court agreed with the grocers regarding the nature of the CAT, Judge Bessey nevertheless ruled that the CAT did not run afoul of the Ohio Constitution. First, the court held that the CAT is a franchise tax, which is a type of excise tax, imposed on the privilege of doing business in Ohio. However, the court found that even though the CAT is an excise tax, the constitutional prohibitions against excise taxes on food did not apply because the CAT is not “levied or collected upon the sale or purchase of food.” In doing so, the court adopted an unduly constricted reading of the constitutional provisions at issue and overlooked the need to analyze the nature of the tax by virtue of its effect rather than its labels.

In essence, the court adopted the Department’s “transactional” theory in its entirety. The court found that even though the CAT is measured by a taxpayer’s gross receipts, which may include receipts from the sale or purchase of food, it is not a transactional

tax on the purchase or sale of food. Because the court found that the CAT is substantively different from a transactional sales tax, it held that the CAT did not violate the Ohio Constitution.

A Case To Watch

Although “Round One” went to the Department in this matter, the Grocers Association intends to file an appeal to the 10th District Court of Appeals in Franklin County (Columbus). The ultimate resolution of this case will impact not only grocers, but any wholesale or retail seller of food for consumption off-premises, such as restaurants, convenience stores, etc. In addition, the court’s interpretation of the constitutional prohibitions could impact other types of businesses involved in the manufacture or sale of ingredients, packaging or other elements of protected food business activity.

Stay Tuned■

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