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## FIRST NEXUS CHALLENGE TO OHIO'S COMMERCIAL ACTIVITY TAX--OVERSTOCK.COM, INC.

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Overstock.com recently filed the first nexus challenge to the Ohio commercial activity tax ("CAT"). In its complaint, Overstock.com alleges that the CAT violates the Commerce Clause of the United States Constitution and the Due Process Clauses of the United States and Ohio Constitutions because the CAT requires companies with *no* physical presence in Ohio to register for and pay the CAT.<sup>1</sup> Overstock.com asks the court to declare the CAT unconstitutional and enjoin the Ohio Department of Taxation ("Department") from enforcing the CAT.

### Factual Background of the Complaint

Overstock.com's principal place of business is in Utah. It has no offices, employees, representatives or agents in Ohio. Overstock.com sells its merchandise almost exclusively via the Internet. It ships all goods to customers via common carriers.

The Department has demanded not only that Overstock.com register for the CAT but that it allow the Department to audit Overstock.com's books and records. Further, if Overstock.com refuses to do so, the Department stated that it will assess CAT based on the information in the Department's possession.

### Overstock.com's Constitutional Claims

Overstock.com asserts that although the CAT purports to be imposed on the privilege of doing business in Ohio, it is in application a sales tax. Thus, Overstock.com claims that the CAT violates the Commerce Clause because it imposes sales tax obligations on an out-of-state retailer without the required physical presence with Ohio.

Overstock.com also attacks the CAT's siting provisions on due process grounds alleging that the CAT is unfair because it attempts to tax gross receipts based on the relationship between Ohio and the person who receives the property rather than the relationship between Ohio and the person who receives the gross receipts.

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<sup>1</sup> *Overstock.com, Inc. v. Levin*, Franklin County Common Pleas Court No. 08CVH-11-16412.

Overstock.com further alleges that the CAT is impermissibly vague and overbroad because the:

- CAT situs gross receipts to Ohio even if the seller has no physical presence in Ohio.
- Siting provision conflicts with requirement that the CAT's imposition must be consistent with the United States Constitution.
- CAT unfairly burdens the out-of-state retailer with determining whether the property will be located or used in Ohio.

### **The Ohio Tax Commissioner and Ohio Attorney General Have Raised Jurisdictional Challenges To The Complaint**

Both the Ohio Tax Commissioner and Ohio Attorney General ("OAG") filed motions asking the court to dismiss Overstock.com's complaint. The OAG's main objection is that Overstock.com included the OAG as a defendant. The OAG claims that while it must be sent a copy of the complaint, it is not a party because it has no direct involvement with the assessment, collection or enforcement of the CAT.

The Tax Commissioner's motion raises more critical objections to the complaint. In essence, the Tax Commissioner asks the court to find that Overstock.com must wait until it receives a CAT assessment before it can object to the CAT. In support of this request, the Tax Commissioner's claims that:

- There is no actual controversy between the parties;
- Overstock.com can't attack the constitutionality of the CAT because of its denial of substantial nexus with Ohio; and
- The issues raised by Overstock.com could be adequately addressed in the statutory administrative review process by the Tax Commissioner and the Board of Tax Appeals.

It's no surprise that the Tax Commissioner has asked the court to dismiss the complaint. The Tax Commissioner would prefer that the constitutionality of the CAT nexus provisions be addressed in the administrative review process which would allow a direct appeal to the Supreme Court of Ohio.<sup>2</sup>

### **The Controversial Nexus Standard Under The CAT**

The CAT has been in effect since July 1, 2005. The CAT is a broad-based, low rate tax (.26% when fully phased in) imposed on gross receipts for the privilege of doing

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<sup>2</sup> R.C. 5751.31 permits a direct appeal from the Tax Commissioner's final determination to the Supreme Court of Ohio if the primary issue is the constitutionality of the CAT nexus provisions in R.C. 5751.01(H)(3).

business in Ohio. It replaces Ohio's tangible personal property tax and corporate franchise tax for most businesses, and will be fully-phased in by 2010. The CAT's "bright-line" nexus standard conflicts with *Quill's*<sup>3</sup> physical presence test and significantly expands the number of out-of-state companies subject to tax in Ohio.

R.C. 5751.01(H) sets forth the legal standard used by the Department to determine whether a person is subject to the CAT. Under the statute, a person has "substantial nexus" for CAT purposes if it:

- Owns or uses part or all of its capital in Ohio;
- Holds a certificate of authority authorizing it to do business in Ohio;
- Has "bright-line" presence in the state; or
- Otherwise has nexus under the United States Constitution.

***Economic Nexus: "Bright-Line" Presence***

The "bright-line" presence test provides the real teeth of the nexus standard. It is a quantitative measure defined in R.C. 5751.01(I) to reach any out-of-state company that has significant sales or customers in Ohio. It is important to note that the Department has expressly noted that it will not enforce the CAT against companies that fall below the quantitative thresholds specified in the statute, even if the company otherwise has constitutional nexus.

Specifically, a person has "bright-line" presence in Ohio – and thus is subject to the CAT – if any of the following applies:

- It has property or payroll in Ohio of at least \$50,000;
- It has gross receipts of at least \$500,000 from Ohio sources;
- At least 25% of its total property, payroll or gross receipts are in Ohio; or
- It is domiciled in Ohio.<sup>4</sup>

Under these standards, sales to customers in Ohio in excess of \$500,000<sup>5</sup> will create CAT filing obligations, even if the company has no property, employees, solicitors or other physical presence whatsoever in the state, and even if the company would

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<sup>3</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)("substantial nexus" under the Commerce Clause requires physical presence).

<sup>4</sup> R.C. 5751.01(I).

<sup>5</sup> Companies that have less than \$500,000 in annual sales to Ohio residents may also be subject to tax, if the Ohio sales amount to more than 25% of the company's total sales.

otherwise be insulated from state income tax obligations by P.L. 86-272 or from state sales/use tax obligations by *Quill's* physical presence standard.

### **Is the CAT Imposed For the Privilege of Doing Business or Is It a Transactional Tax?**

The CAT's economic nexus standard's survival may hinge on the answer to this question. If the CAT is a transactional tax (like a sales tax), then *Quill's* physical presence standard will control. The statute that imposes the CAT, R.C. 5751.02(A), expressly states that the CAT is a tax imposed "for the privilege of doing business in [Ohio]."

Despite this specific language by the Ohio General Assembly, the Tenth District Court of Appeals recently held in the *Ohio Grocers Association* case that the CAT is, in operation, a transactional tax, at least as it applies to gross receipts from food sales.<sup>6</sup> In that case, the Court found it necessary to look beyond the statutory language to the actual operation of the tax. Given the importance of the revenue generated by the CAT to Ohio, it's no surprise that the Supreme Court of Ohio has agreed to review the *Ohio Grocers Association* decision.

Stay tuned to the State Tax Return for further developments on the CAT.



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<sup>6</sup> *Ohio Grocers Association v. Wilkins*, No. 07AP-813 (Sept. 2, 2008), appeal accepted by Ohio Supreme Court, 2008-Ohio-4420 (February 4, 2009).