Ohio Supreme Court: No physical presence required to impose tax on internet retailers

David M. Kall | Wednesday, November 23, 2016

The Ohio Supreme Court has ruled that no physical presence is required for Ohio to impose its business-privilege tax, the Ohio commercial activity tax, or "CAT," on internet retailers. Writing for the Court's 5-2 majority, Justice William O'Neill held that online retailers Crutchfield Corp., Newegg, Inc., and Mason Companies, Inc. each have "substantial nexus" with Ohio regardless of their physical presence in the State.

Because the retailers exceeded the statutory threshold of $500,000 in sales-receipts in Ohio, the retailers established nexus to impose the CAT. In essence, the Court held that the statutory bright-line presence standard – $500,000 in gross receipts from Ohio sales – is an acceptable measuring stick for the level of economic activity that subjects a business to Ohio taxation.

Background: Ohio tax reform and the Ohio commercial activity tax

Enacted as part of the Ohio General Assembly's 2005 comprehensive tax reform, the Ohio CAT is a tax for the privilege of doing business in the Buckeye State, as measured by a company's gross receipts to Ohio consumers. The State's former business privilege tax, the Ohio corporation franchise tax, was measured by an entity's net income or net worth. Due to several perceived or real "loopholes" with the franchise tax, the General Assembly phased-out the tax beginning in 2005, together with the phase-out of the Ohio personal property tax and the adoption of the CAT.

The CAT already withstood one constitutional challenge in 2009, when retail grocers challenged the tax under the Ohio Constitution as an unlawful excise tax on the sale of food. In *Ohio Grocers Assn. v. Levin*, the Ohio Supreme Court ruled that the CAT passed constitutional muster because it not a tax on consumers for the sale or purchase of food. Rather, the CAT is an excise levied on retail grocers for the privilege of doing business in Ohio.

Constitutional "nexus" issue reaches the Ohio high court

The "substantial nexus" challenge to the CAT arrived at the Ohio Supreme Court in 2015. By Ohio law, all businesses with $500,000 or more annual sales to Ohio consumers are subject to the CAT; the threshold serves as a "bright-line" presence test for nexus to tax.

In three consolidated cases, internet retailers Crutchfield, Newegg, and Mason Companies all challenged the CAT under the dormant Commerce Clause doctrine and Due Process Clause of the U.S. Constitution. In short, they argued that they were not subject to the CAT because they did not have a physical presence in Ohio. Simply exceeding the statutory bright-line sales-receipts threshold to tax, the retailers argued, does not mean that they actually have a sufficient connection with Ohio to tax.

The Ohio Tax Commissioner defended the CAT and the bright-line sales-receipts threshold on the basis that the physical presence standard is inapplicable to a business privilege tax such as the CAT. While the seminal U.S. Supreme Court case *Quill Corp. v. North Dakota* (1992) held that the physical presence standard applies

to determine nexus in the sales and use tax context, most courts agree that its holding does not extend to other types of taxes. Borrowing language from a U.S. Supreme Court case that addressed nexus to impose a business tax, *Tyler Pipe Industries v. Wash. State Dept. of Rev.* (1987), the Tax Commissioner instead urged the Ohio High Court to apply a rule that nexus exists where businesses "establish and maintain a market in the State."

The Tax Commissioner nonetheless argued that, were the physical presence standard in play, the internet retailers satisfied it in any event. The Ohio Board of Tax Appeals (BTA) made few, if any, factual findings, though it collected extensive evidence and expert testimony from the parties as to whether the retailers' activities established a physical presence in Ohio. The Tax Commissioner attempted to show that the retailers were physically present through marketing activities including internet and computerized technology, as well as through third parties acting on their behalf.

No physical presence required

The Court's majority dispensed with the notion that physical presence is required in Ohio to impose the CAT. As in *Ohio Grocers*, the Court's decision to uphold the CAT turned upon its nature as business privilege tax. Citing to several state court decisions including the Ohio Supreme Court's own 1996 decision in *Couchot v. State Lottery Comm.*, the Court held that the *Quill* "physical presence" standard is limited to sales and use taxation. Business privilege taxes, whether measured by net income or gross receipts, the Court ruled, are not subject to the physical presence standard.

The Court further rejected the internet retailers' arguments that a physical presence standard is required pursuant to the *Tyler Pipe* case. There, the U.S. Supreme Court upheld a Washington State business tax because the taxpayer actually had a physical presence in Washington due to in-state sales representatives. Rather than establish a physical presence standard, Justice O'Neill wrote, the case merely stands for the proposition that a physical presence is a *sufficient*, but not *necessary*, way to establish substantial nexus. As a result, no physical presence is required in Ohio to impose the CAT.

In the end, the Court held that the $500,000 sales-receipt threshold for imposing the CAT adequately ensures nexus with Ohio. The Court found it unnecessary to address other facts or whether the internet retailers in these cases actually had a physical presence in Ohio. In reaching its conclusion, the Court drew upon a balancing test that is typically applicable only to dormant Commerce Clause issues with state *police power regulations*, not state *tax laws*. Relying upon *Pike v. Bruce Church*, the Court held that the CAT is not a "clearly excessive" burden on interstate commerce in light of legislative efforts to level the playing field among in-state and out-of-state retailers.

Two justices dissent

In dissent, Justice Sharon Kennedy authored an opinion joined by Justice Judith Ann Lanzinger that would have imposed the physical presence standard to establish substantial nexus. The *Quill* decision does not expressly state that the physical presence standard is limited to sales and use taxation and, to Justice Kennedy, there is no "meaningful difference" among the taxes. The dissenting justices would have remanded the case to determine whether the internet retailers were physically present in Ohio.

Seizing on the majority's failure to discuss the facts and circumstances surrounding the internet retailers, Justice Kennedy presented a hypothetical scenario in which a taxpayer meeting the bright-line threshold of $500,000 in Ohio sales-receipts may not have substantial nexus. She noted that just one large sale of equipment could satisfy the $500,000 bright-line sales receipt standard and potentially fall short of creating substantial nexus to tax with Ohio. Absent a strong factual foundation, the Court's majority may have, in essence, invited the internet retailers to petition the U.S. Supreme Court for a writ of certiorari to address the substantial nexus standard in the context of hazy facts.

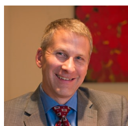
Interestingly enough, the Court's majority ruled that it makes findings of fact in constitutional challenges to tax statutes; as an administrative body, the Ohio BTA below is merely a receptacle for evidence in such cases. While stating this as a rule, the majority failed to make factual findings, other than to find that the internet retailers exceeded $500,000 in Ohio gross receipts, employ no personnel in Ohio, and maintain no Ohio facilities.

By contrast, the dissenting justices, without expressly stating, placed the factfinding function in the BTA's hands, as they would have remanded the case to determine whether the retailers had a physical presence in Ohio. Conceivably, had they reviewed the record to determine the facts and addressed the physical presence question head on, the dissenting justices may have instead concurred with the majority.

Prospects for appeal to the U.S. Supreme Court

Despite the provocative legal issues surrounding the physical presence standard and whether sales activity alone may establish substantial nexus, the U.S. Supreme Court is unlikely to accept the case. The Court has not revisited the physical presence standard since *Quill* was decided in a 1992, when e-commerce was still in its infancy. Rather, the *Quill* decision defers to Congress to decide whether to supersede the physical presence rule, which Congress has declined to do in the intervening years. Without factual findings from the Ohio Supreme Court or the Ohio BTA, moreover, there is little factual foundation for the Court to apply the provocative legal issues.

Crutchfield, Newegg, and Mason Companies have 90 days from the entry of final judgment to petition the U.S. Supreme Court for a writ of certiorari.



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