Ohio: Lawsuit asserts that in-state software nexus standard is unconstitutional

David M. Kall | Thursday, January 11, 2018

The Ohio budget legislation, HB 49, that Gov. John Kasich signed into law last July contained an expanded statutory definition of "substantial nexus," which governs the taxability of sales made by vendors that are located outside of the state. Quoting the legislation at the time, we explained that substantial nexus is presumed to exist when the seller has "gross receipts in excess of $500,000 in the current or preceding calendar year," and the seller does at least one of the following:

- Uses in-state software to sell or lease tangible personal property or services to consumers.
- Provides or enters into an agreement with another to provide a content distribution network in Ohio to facilitate delivery of the retailer's website to consumers.

Commonplace technology such as cookies could potentially qualify as "in-state software" under the new definition.

A content delivery network is a system of distributed servers that delivers websites and other web content to a user based on the geographic location of the user, the origin of the web site or web content, and a server.

The particulars of Ohio's updated definition of "substantial nexus" are set forth in the Ohio Revised Code, and interpreted in the Ohio Department of Taxation's October 2017 update. A remote seller has "in-state software nexus" when it uses in-state software and has more than $500,000 in gross receipts, and is

therefore be subject to the sales tax registration, collection and remittance obligations.

The update illustrates what constitutes in-state software nexus with an example revealing that when a "large out-of-state seller that retails clothing to individual consumers through a website, [and] also provides for the sale of the clothing through a catalog application which is downloaded onto the customer's computer or cell phone… [t]he catalog application is software, as is the html and java script coding used in displaying the seller's website on the customer's computer or cell phone." On the premise that the seller had $2 million of gross receipts in Ohio, the department will presume that the seller has substantial nexus.

The lawsuit

On Dec. 29, 2017, the American Catalog Mailers Association (ACMA), a Washington, D.C. based trade organization representing companies "engaged in and supporting catalog marketing," sued the Ohio Department of Taxation on behalf of "at least one member" subject to the new statute. The suit, filed in Franklin County, seeks a declaration that the newly enacted statute violates federal law by:

1. Exceeding the limitations on state authority to regulate interstate commerce under the dormant Commerce Clause.
2. Discriminating against electronic commerce in contravention of the Federal Internet Tax Freedom Act.
3. Depriving out-of-state Internet vendors of their rights under the Due Process Clause…"

In its complaint, the ACMA points to the Department of Taxation's illustration described above, among other things, to support its allegations that the Department's "theories of in-state software nexus" and other kinds of nexus are unconstitutional.

Citing *Quill Corp. v. North Dakota* that the United States Supreme Court decided in 1992, the plaintiff argues that the precedent renders Ohio's new nexus standard impermissible because *Quill* determined that "sellers who do no more than communicate with customers by mail, wire, or common carrier…lack the necessary substantial nexus with a State for the State to require" out of state sellers to collect and remit sales and use taxes.

The complaint also contends that the Internet Tax Freedom Act (ITFA) "prohibits any state or political division from imposing discriminatory taxes on electronic commerce." The allegations continue that any state tax is therefore impermissible when it obligates a person or entity to collect and pay taxes when a "different person or entity" is not likewise obligated pursuant to transactions involving similar "property, goods, services, or information accomplished through other means than via the Internet."

In a press release announcing its lawsuit, the ACMA declared that the Department of Taxation is committing an "egregious assault on out of state companies seeking to sell to Ohio residents" by "claiming that the mere presence of electrons placed on an Ohio computer pierces the longstanding physical presence test under *Quill* ..." It predicts a number of harms for Ohio's consumers, especially "rural Ohioans, shut-ins and elderly citizens," such as being offered fewer products, and missing out on the benefits of remote shopping available elsewhere in the country.

Nevertheless, the AMCA is optimistic: "We have no doubt the Ohio judiciary, in light of the well-established national precedent created by the highest court in the land, will overturn this illegal new law."

What's next?

As it currently stands, that "well-established national precedent" is somewhat murky when applied to today's sales tools and technology. This is a big reason why there has been so much litigation around it. For example, the Ohio Supreme Court recently addressed another controversial Ohio nexus case,

Crutchfield Corp. v. Testa, which involved Ohio's imposition of the commercial activity tax (CAT) on an out-of-state company. Following an Ohio Supreme Court decision upholding the CAT, the parties settled in April 2017, an outcome that we discussed at the time.

Ultimately, these cases boil down to the taxing authority's application of the law, and the specific facts at issue. The tension between the perceived unfair advantage that out of state internet retailers that are not subject to states' tax laws, and the brick and mortar retailers that feel hamstrung by them, will likely remain until Congress steps in with legislation or the U.S. Supreme Court provides additional guidance.

The business community and many tax practitioners are closely following *South Dakota v. Wayfair,* in which the state of South Dakota has asked the court to review the South Dakota Supreme Court's conclusion that the state lacks authority to impose sales and tax laws on three retailers, Wayfair, Overstock.Com, and Newegg because they lack a physical location there. Originally, the court was scheduled for the Jan. 5, 2018 conference, but that has now been postponed until Jan. 12, 2018.

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Team member bio