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What the CAT Dragged In: The Tax Outside Ohio's Borders

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Introduction

As most national businesses are already aware (perhaps painfully so), Ohio is phasing out its corporate franchise tax and introducing a commercial activity tax (CAT) on gross receipts from business activities in its place. The CAT is a gross receipts tax — not a sales tax — and therefore must be fairly apportioned to reflect the taxpayer's business activities in the state in order to meet the requirements of the commerce and due process clauses of the U.S. Constitution.

However, the CAT, at least when services are involved, does not fairly apportion receipts based on business activities. Rather, the CAT sourcing rules, promulgated by the Ohio Department of Taxation, source gross receipts from services to the state based on the benefit that the purchaser receives in Ohio. Because the location of the benefit to the purchaser often has no relationship to the location of the business activities that created that benefit, the sourcing rules result in the improper apportionment of income to Ohio. The CAT sourcing rules are distortive at best and entirely unconstitutional at worst. It is only a matter of time before taxpayers begin to take notice and challenge those rules.

The CAT's Sourcing Rules

The CAT is imposed on "each person with taxable gross receipts for the privilege of doing business" in Ohio.[1] The statute sources gross receipts from services to Ohio "in the proportion that the purchaser's benefit in this state with respect to what was purchased bears to the purchaser's benefit everywhere with respect to what was purchased."[2] The statute provides that "the physical location where the purchaser ultimately uses or receives the benefit of what was purchased shall be paramount in determining the proportion of the benefit in this state to the benefit everywhere."[3] Thus, receipts from a service will likely have an Ohio situs if the service is used by the purchaser in Ohio.

The CAT sourcing rules are distortive at best and unconstitutional at worst.

The state tax department has provided specific sourcing rules for 54 different types of services, from accounting to waste management.[4] Many of those sourcing rules plainly apportion an unwarranted amount of income to Ohio. In some factual instances, the rules effectively apportion 100 percent of a business's receipts to Ohio even though there can be little doubt the business has no activities there.

For example, legal services are sitused to Ohio if those services "relate to Ohio . . . regardless of where the services are performed."[5] Thus, "if an attorney drafts a will in Kentucky for a client who resides in Ohio, the gross receipts from this service will be sitused to Ohio since the services relate to an Ohio estate."[6] Similarly, if an attorney prepares a client's case for the Ohio Board of Tax Appeals and

[1]Ohio Rev. Code Ann. section 5751.02.
[2]Ohio Rev. Code Ann. section 5751.033(I); Ohio Dep't Tax, Tax Rule 5703-29-17(A).
[3]Ohio Rev. Code Ann. section 5751.033(I); Ohio Dep't Tax, Tax Rule 5703-29-17(A).
[4]Ohio Dep't Tax, Tax Rule 5703-29-17(C)(1)-(54).
[5]Ohio Dep't Tax, Tax Rule 5703-29-17(C)(32)(a).
[6]*Id.*

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travels to the client's business location in Tennessee, for example, to prepare the case, "the gross receipts received by the attorney for *all services*, including those services related to interviewing the client's employees in Tennessee, are sitused to Ohio."[7] In cases in which the legal matter does not "relate to Ohio," the rules provide for sourcing principles based on the location of the purchaser of the legal services.[8] None of those rules relate to the location in which the legal services are performed, which, of course, would be the most relevant location for the purposes of determining where the activities producing the gross receipts are located.

The rules for other services are no better. For example, the rules for cable and satellite television provide that "gross receipts from cable/satellite services are sitused to Ohio, in general, if the purchaser's (subscriber's) place of primary use is in Ohio, regardless of where the cable and satellite services originate."[9] The rules note that "in general, the purchaser's (subscriber's) billing address will be accepted as the primary use location unless the seller of the service knows the purchaser (subscriber) is using the service in multiple locations."[10] Thus, the department's sourcing rule does not apportion gross receipts for cable and satellite services sold to customers in Ohio on the basis of the service provider's activities in the state, but rather it looks only to the billing address of the customer.

Internet and Web-hosting services and computer programming are also sourced without regard to the location of the business activities that produce the benefit of these services. Instead, "if Internet or web hosting services are performed for a purchaser only located in Ohio, one hundred per cent of the gross receipts are sitused to Ohio regardless of where the web host is located."[11]

Thus, the department's sourcing rules for services taxed by the CAT are affixed to the location of the purchaser of the service, not to the location of the business activities of the taxpayer. If current Supreme Court commerce clause decisions are to be respected, that misattribution results in a tax that is probably unconstitutional on its face, and almost certainly unconstitutional as applied in cases in which the operations of the taxpayer are physically located outside Ohio.

[7]*Id.* (emphasis added).

[8]Ohio Dep't Tax, Tax Rule 5703-29-17(C)(32)(b)-(e).

[9]Ohio Dep't Tax, Tax Rule 5703-29-17(C)(9)(a).

[10]*Id.*

[11]Ohio Dep't Tax, Tax Rule 5703-29-17(C)(30)(a); *see also* Ohio Dep't Tax, Tax Rule 5703-29-17(C)(13)(a) (parallel provision for computer programming).

Constitutional Standards for Apportionment

The U.S. Supreme Court has repeatedly held that under the commerce clause, a state may tax only a fairly apportioned share of the tax base (for example, income or gross receipts) produced by an interstate activity.[12]

As a refinement to that rule, the Court has drawn a clear line between income and gross receipts taxes, which must be apportioned to pass constitutional muster, and sales and use taxes, which need not be apportioned.[13]

Sales and use taxes are not subject to the apportionment requirement because they are generally understood to be a tax on the consumer, as opposed to a tax on the seller, such as a gross receipts tax.[14] Moreover, the Court has found that tradition, custom, and the practical problems of administering the apportionment of a tax imposed on individual transactions justify an exception for sales taxes from the general requirement of apportionment.[15]

In contrast to a sales tax, a tax on gross receipts is "simply a variety of tax on income, which [is] required to be apportioned to reflect the location of the various interstate activities by which it was earned."[16] Thus, "the true distinction between those levies that ought to be apportioned and those that need not be is whether they are designed as taxes on business activity or as taxes on the consumer of goods or services."[17]

The Court has fashioned the so-called external consistency test as one means of ascertaining whether a tax on interstate commerce satisfies this apportionment requirement. That test looks to the "economic justification for the state's claim upon the value taxed, to discover whether [a state's] tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing state."[18] Although that test does not require a strict accounting, "the factor or factors used in the apportionment formula must actually reflect a reasonable

[12]*See, e.g.*, *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) (taxes on interstate commerce must meet a four-part test, including the requirement that the tax be apportioned); *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 31 n.4 (2008); *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

[13]*See Jefferson Lines, Inc.*, 514 U.S. 175; *Cent. Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948) (*Central Greyhound*).

[14]*Jefferson Lines*, 514 U.S. at 178.

[15]*Id.*

[16]*Id.* at 190.

[17]Walter Hellerstein, Michael J. McIntyre, and Richard D. Pomp, "Commerce Clause Restraints on State Taxation After *Jefferson Lines*," 51 *Tax. L. Rev.* 47, 87 (1995).

[18]*Jefferson Lines*, 514 U.S. at 185.

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sense of how income is generated."[19] This scrutiny ensures that a state reaches only "that portion of the revenues from interstate activity which reasonably reflects the in-state component of the activity being taxed."[20]

The language of those opinions also makes clear that a state cannot simply attach the tax to some nominal local activity (for example, the right to do business in the state) as a cover for disguising the actual sweep of the tax. Thus, the Court has stated that labeling a tax "a tax on 'business activity' does not permit us to forgo examination of the actual tax base and apportionment provisions. 'A tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes.'"[21] The Court's rejection of form over substance, of course, is the lynchpin of the Court's modern commerce clause doctrine.[22]

Ohio's CAT Does Not Pass Constitutional Muster

The Ohio Supreme Court has recently dispelled any doubt about the character of the CAT: The CAT is a gross receipts tax, not a sales tax. Therefore, to satisfy the commerce clause, the tax must be apportioned, and the state's failure to adopt a reasonable apportionment formula for services means the CAT is unconstitutional. As such, Ohio's CAT as applied to services is unconstitutional.

As a starting point, the CAT does not contain any explicit apportionment mechanism for services. Accordingly, the CAT is facially unconstitutional. Further, under the CAT's situsing rules discussed above, the tax will be imposed on 100 percent of gross receipts in Ohio from many types of services, including, for example, legal services and Internet and Web hosting services, that are not performed in Ohio. Thus, the rules can — and do — severely distort individual taxpayers' tax burdens in Ohio in many cases and lead to instances of unconstitutional application of the CAT.

A. The CAT Is a Gross Receipts Tax and Not a Sales Tax

Under the Supreme Court precedents described above, a gross receipts tax must be apportioned, but a sales tax need not be. Accordingly, the first step in testing the constitutionality of the CAT is to establish that the CAT is a gross receipts tax, as opposed to a sales tax.

> ***To satisfy the commerce clause, the tax must be apportioned, and the state's failure to adopt a reasonable apportionment formula for services means the CAT is unconstitutional.***

The Ohio Supreme Court has recently held just that, concluding explicitly that the CAT is not a sales tax but a gross receipts tax.[23] In *Ohio Grocers*, the grocers association contended that the CAT was a sales tax and challenged its constitutionality under the Ohio Constitution, which prohibits the imposition of taxes on the sale of food.[24]

The court held that the CAT was not an unconstitutional tax on the sale or purchase of food for several reasons. First, the legislature described the CAT as a franchise tax, that is, a tax "for the privilege of doing business in this state."[25] Also, the CAT is imposed on the seller, who is prohibited from adding the tax to the price of the goods sold, in contrast to a sales tax, in which the tax is often added to the sales price.[26] Furthermore, the CAT is imposed on the value of the privilege of doing business in Ohio, as determined using a "broad measure of market access," and is computed based on results over whole business periods (as opposed to a transaction-by-transaction basis).[27] Accordingly, the court concluded that the CAT is a gross receipts tax and not a sales tax.

B. As a Gross Receipts Tax, the CAT Must Be Apportioned

Given that the final arbiter of those matters, the Ohio Supreme Court, has concluded that the CAT is a gross receipts tax and not a sales tax, it must be

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[19] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

[20] *Goldberg v. Sweet*, 488 U.S. 252, 262 (1989); *see also Gen. Motors Corp. v. City & Cnty. of Denver*, 990 P.2d 59, 71 (Colo. 1999). ("In the context of . . . taxes on gross receipts, apportionment must take into account the location where the revenue is generated.")

[21] *See Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 374 (1991) (citing Jenkins, *State Taxation of Interstate Commerce*, 27 Tenn. L. Rev. 239, 242 (1960)); *see also Mead-Westvaco Corp.*, 553 U.S. at 31 n.4 (confirming the need for a connection between the apportionment formula used by the state and the income that the state seeks to tax); *Allied-Signal, Inc. v. Comm'r of Finance*, 588 N.E.2d 731 (N.Y. 1991) (the apportionment system used by the state must be matched to the tax base employed in determining the tax).

[22] *Complete Auto Transit, Inc.*, 430 U.S. 274 (sanctioning direct taxation of interstate commerce so long as the tax meets a four-pronged test intended to ensure that the state does not tax values fairly attributed to other states).

[23] *Ohio Grocers Ass'n v. Levin*, 916 N.E.2d 446 (Ohio 2009).

[24] Ohio Const. Art. XII, section 3(C).

[25] *Ohio Grocers*, 916 N.E.2d at 455 (quoting section 5751.02(A)).

[26] *Id.*

[27] *Id.* at 312.

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fairly apportioned to reflect the business activities generating the receipts in order to comply with the commerce clause. The U.S. Supreme Court has struck down an unapportioned gross receipts tax on strikingly analogous facts. In *Central Greyhound*, the Court examined a gross receipts tax imposed by New York on 100 percent of the receipts from the sale of bus tickets in the state. The question was whether New York could constitutionally impose a tax on all of the bus company's gross receipts from New York ticket sales, even though the transportation services were provided to the ticket holder in multiple states, simply because the ticket was purchased (and therefore the income was realized) within the state.[28] The Court held that because a substantial portion of the activities conducted by the transportation service provider was performed outside the state and those services were clearly associated with gross receipts to be taxed, New York was not permitted to tax 100 percent of the gross receipts derived from the sale of those services.

Simply, the CAT suffers from the same infirmity as the New York tax at issue in *Central Greyhound*. Here, just as in *Central Greyhound*, Ohio imposes a gross receipts tax on 100 percent of the revenue derived from a variety of interstate services purchased within the state, even under circumstances in which the vast majority of the activities (or even all of the activities) conducted by the taxpayers that provide those services were performed outside the state. Just as New York's unapportioned tax was impermissible in *Central Greyhound*, the application of the unapportioned CAT is impermissible here.

Moreover, we believe the two arguably "modern" Supreme Court decisions rejecting challenges to unapportioned gross receipts taxes do not change that conclusion.[29] First, and most importantly, to the extent these cases held that a gross receipts tax need not be apportioned if it is imposed on a "local" subject, they have been effectively overruled by the more recent decision in *Jefferson Lines*, in which the Supreme Court explicitly reaffirmed that gross receipts taxes must be apportioned.[30] Accordingly, after *Jefferson Lines*, "once a levy is properly classified as a gross receipts tax, the arguments in favor of apportionment must be addressed."[31]

Second, those cases are plainly at odds with the Supreme Court's modern view approving the direct taxation of interstate activities so long as the tax is apportioned and abandoning artificial attempts to segregate some local tax event from the interstate business. This view finds support in a number of state court cases striking down unapportioned gross receipts taxes imposed on services by local municipalities following *Jefferson Lines* and *Central Greyhound*. For example, the Pennsylvania Supreme Court has twice invalidated local unapportioned gross receipts taxes, stating that "gross receipts taxes imposed upon receipts from interstate commerce are prohibited unless the tax is apportioned to the taxpayer's activities in the state," and relying heavily on the reasoning and holding in *Jefferson Lines*.[32]

C. The CAT Cannot Be Deemed to Be Apportioned Based on an Imputed Single-Sales-Factor Formula

One might surmise that the CAT's sourcing rules for services could be viewed as providing for apportionment based on a single-sales factor, and that such a single-sales-factor formula is permissible under *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

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[28]*Central Greyhound*, 334 U.S. at 662.

[29]*See Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987); *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560 (1975).

[30]*See* Hellerstein et al., *supra* note 17.

[31]*Id.*

[32]*Phila. Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108, 129 (Pa. 2003); *see also Northwood Const. Co. v. Twp. of Upper Moreland*, 856 A.2d 789 (Pa. 2004). The Arizona, California, and Virginia courts have reached similar conclusions. *See S. Pac. Transp. Co. v. Dep't of Revenue*, 44 P.3d 1006 (Ariz. 2002); *Nw. Energetic Servs. v. Cal. Franchise Tax Bd.*, 159 Cal. App. 4th 841 (2008); *City of Modesto v. Nat'l Med., Inc.*, 128 Cal. App. 4th 518 (2005); *City of Winchester v. Am. Woodmark Corp.*, 471 S.E.2d 495 (Va. 1996).

Two state supreme courts, one in Washington and the other in Delaware, suggest that, at least when the gross receipts tax is imposed on the sale of tangible personal property, the requirement of apportionment may not be as categorical as that imposed on taxes on services. In *Ford Motor Co. v. City of Seattle*, 156 P.3d 185 (Wash. 2007), *cert. denied*, 552 U.S. 1180 (2008), the Washington Supreme Court upheld the city of Seattle's and city of Tacoma's assessments on Ford Motor Co. for business and occupation tax, which is measured by the receipts from wholesaling vehicles in the state. Similarly, in *Ford Motor Co. v. Director of Revenue*, 963 A.2d 115 (Del. 2008), *cert. denied*, 130 S. Ct. 86 (2009), the Delaware Supreme Court upheld the imposition on Ford of wholesalers' gross receipts tax derived from vehicles physically delivered in Delaware. Although conceptually there would appear to be no sound logic for limiting the requirement of apportionment to services only (and therefore the Washington and Delaware cases may simply be wrong in ignoring the *Jefferson Lines* distinction between sales taxes and gross receipts taxes), there is at least a basis for concluding that sales of automobiles by local wholesalers may be treated as a wholly local event for purposes of taxing the receipts from those sales. However, that logic makes no sense in the context of a tax on the value of services performed wholly or partly outside the state. Particularly when electronic services are involved, there may not even be a local activity to be isolated because the sale of the service will often occur in cyberspace and the service will involve simultaneous and necessary actions in a variety of states.

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Not so. First, *Moorman* does not alter the requirement that a gross receipts tax on an interstate service be apportioned to fairly reflect the activities within the taxing state, nor does it hold that single-sales-factor apportionment is permissible in every instance. *Moorman* involved an Iowa income tax that was imposed on a taxpayer's net income apportioned by applying a single-sales-factor formula. The Supreme Court upheld the tax because there was no evidence that the single-sales-factor formula did not fairly reflect the taxpayer's activities in the state in that case. Thus, the taxpayer failed to show that "Iowa in fact taxed profits not attributable to activities within the State during" the applicable period.[33] Nevertheless, the Court noted that in other cases, it has found that "the application of a single-factor formula to a particular taxpayer violated due process" and the commerce clause.[34]

Ohio's CAT involves a gross receipts tax, which is unlike the net income tax at issue in *Moorman*. In contrast to net income — which, one may rationally speculate, may have arisen entirely in the taxing state — gross receipts are closely linked to costs and are necessarily closely linked to the location of the taxpayer's business activities. Thus, even if the CAT's sourcing rules are viewed as a single-sales-factor apportionment formula, the application of that formula to many taxpayers that provide interstate services will clearly tax receipts far in excess of those earned from activities in Ohio. That is precisely the evidence the Court indicated was lacking in Moorman's unsuccessful constitutional challenge.

In this case, by taxing 100 percent of a taxpayer's gross receipts in Ohio — whether those receipts are from legal services, Internet hosting, or the provision of cable television — without providing any apportionment mechanism at all, Ohio's CAT clearly "reaches beyond" the portion of value created by the service that is fairly attributable to the taxpayer's economic activity in Ohio.

Conclusion

In sum, the CAT is a gross receipts tax that must be apportioned to comply with the requirements of the U.S. Constitution. Because the CAT contains no apportionment mechanism whatsoever, it is facially unconstitutional. Moreover, the CAT's sourcing rules for many types of services impose the tax based on the location of the purchaser and not, as is constitutionally required, on the location of the business activities that generate the receipts. Thus, for many taxpayers, the application of the CAT's sourcing rules will be severely distortive.

> ***Because the CAT contains no apportionment mechanism, it is facially unconstitutional.***

Ohio can presumably head off a broad challenge to the CAT by adopting legislation apportioning the tax base by a formula that is meaningfully related to the location of the business activities that produce the receipts being taxed. In the interim, the tax department should work with individual taxpayers or industries to employ specifically tailored solutions to eliminate distortion.[35] ✰

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[33]*Moorman*, 437 U.S. at 272.

[34]*Id.* at 274. Also, it cannot be that the Court's careful distinction between sales taxes, which need not be apportioned, and gross receipts taxes, which must be, can be circumvented simply by adopting a single-sales-factor apportionment formula. Such a formula would, in every case, produce the same tax base as the unapportioned gross receipts tax. Surely the Court did not intend that result when in *Jefferson Lines* it reaffirmed that gross receipts taxes must be fairly apportioned.

[35]Our observations regarding the CAT are now equally applicable to Washington's business and occupation tax on services. Effective June 1, 2010, apparently bowing to pressure from in-state businesses, the state abandoned its prior system, which looked to the location of costs, in favor of an Ohio-like system of looking solely to the location of the benefit of the services. Second Engrossed Substitute Senate Bill 6143, L. 2010, Chapter 23 section 105; Wash. Admin. Code 458-20-19402.

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