Ohio Supreme Court Finds *Quill* Does Not Apply to the Commercial Activity Tax

By Michael J. Cataldo

The Ohio Supreme Court has ruled that the Ohio Commercial Activity Tax is a business privilege tax and that the physical presence requirement articulated by the U.S. Supreme Court in Quill *does not limit Ohio's ability to subject out-of-state online sellers to the tax.*

Introduction

The Ohio Commercial Activity Tax (CAT) is imposed on each person with "substantial nexus" with Ohio for the privilege of doing business in the state.[1] A person has "substantial nexus" with Ohio if it has taxable gross receipts of at least $500,000.[2] "Taxable gross receipts" include sales of tangible personal property delivered to customers in Ohio.[3] This nexus standard, often referred to as "factor presence" nexus, is applied whether or not that person has a physical presence in the state.

Ohio was the first state to adopt a "factor-presence" nexus standard, and is the first state to have that standard addressed by its Supreme Court. Several other states have followed Ohio's lead by adopting such a nexus standard for their income taxes or gross receipts taxes,[4] but challenges to other states' "factor-presence" nexus standards have yet to reach any of their state supreme courts.

[1] R.C. 5751.02.

[2] R.C. 5751.01(I)(3).

[3] R.C. 5751.033(E).

[4] E.g., Alabama (Ala. Code section 40-18-31.2); California (Cal. Rev. & Tax Code section 23101(b)); Colorado (Colo. Code Regs. section 39-22-301.1); Connecticut (Conn. Gen. Stat. section 12-216a); Michigan (Mich. Comp. Laws section 206.621(1)); New York (N.Y. Tax Law section 209(1)(b)); Tennessee (Tenn. Code section 67-4-2004(49)(A)); and Washington (Wash. Rev. Code section 82.04.067). While most of these states use a $500,000 receipts threshold as does Ohio, New York uses a $1 million receipts threshold, Michigan a $350,000 receipts threshold, and Washington a $250,000 receipts threshold.

Facts

Crutchfield Corporation had no physical presence in Ohio and made sales of tangible personal property to Ohio residents over the internet exceeding $500,000 during each of the periods at issue.[5] Crutchfield contested the constitutionality of applying "factor-presence" nexus to its business because it had no in-state physical presence.

Ohio Supreme Court Decision

The Ohio Supreme Court ruled in *Crutchfield Corp. v. Testa* that a business with no physical presence in Ohio whose sole connection with the state was selling tangible personal property to Ohio residents over the internet was subject to the CAT because its sales exceeded the $500,000 "factor-presence" nexus threshold.[6] The court held that the physical presence standard set forth in *Quill Corp. v North Dakota*[7] is limited to the obligation to collect use taxes and should not be extended to the CAT, which is a business privilege tax[8] whose imposition must satisfy the "substantial nexus" test set forth by the U.S. Supreme Court in *Complete Auto Transit, Inc. v. Brady*.[9] The court found the CAT's "factor-presence" nexus threshold meets the *Complete Auto* "substantial nexus" requirement even absent any in-state physical presence because it is "imposed with an adequate quantitative standard [i.e., $500,000 in sales] that ensures that the taxpayer's nexus with the state is substantial."[10]

The *Crutchfield* Court stated that the U.S. Supreme Court's decision in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*[11] does not stand for the proposition that an in-state physical presence is required to impose a gross receipts tax, but rather that a physical presence was merely a sufficient basis upon which to impose such a tax.[12]

Dissenting Opinion

Two of the seven Ohio Supreme Court justices disagreed with the majority's holding that the *Quill* physical presence requirement does not apply to privilege taxes, noting that "the last word from the United States Supreme Court [*Quill*] is that a state's ability to tax an out-of-state business depends on a substantial nexus created by a physical presence."[13]

The dissent also did not see a meaningful constitutional distinction between imposing a use tax collection obligation on an out-of-state seller and imposing a gross receipts tax on such a seller, noting the U.S.

[5] The Ohio Tax Commissioner issued Crutchfield assessments covering periods from July 1, 2005, through June 30, 2010.

[6] Slip Opinion No. 2016-Ohio-7760, November 17, 2016 ("Slip Opinion"). *Crutchfield* was consolidated with two other cases challenging the constitutionality of the CAT's "factor-presence nexus" standard. *See Newegg, Inc. v. Testa, Ohio*, No. 2016-Ohio-7762, November 17, 2016, and *Mason Cos., Inc. v. Testa, Ohio*, No. 2016-Ohio-7768, November 17, 2016.

[7] Under *Quill*, an out-of-state vendor must have an in-state physical presence to be required to collect use tax. *Quill Corp. v North Dakota*, 504 U.S. 298 (1992).

[8] Slip Opinion, p. 17.

[9] 430 U.S. 274, 279 (1977).

[10] Slip Opinion, p. 17.

[11] 483 U.S. 232 (1987).

[12] Slip Opinion, p. 21.

[13] Slip Opinion, p. 34.

Supreme Court's reliance on an in-state physical presence to find nexus in *Tyler Pipe*, which involved a gross receipts tax similar to the CAT.[14]

According to the dissent, *Tyler Pipe* supports the taxpayer's position that a physical presence is required to impose a gross receipts tax because the basis for finding nexus in *Tyler Pipe* was the presence of independent contractors in the state, and that "[n]owhere in *Tyler Pipe* did the Supreme Court indicate that anything less than a third-party contractor operating within a taxing state on a taxpayer's behalf would satisfy the substantial-nexus requirement established in [*Complete Auto*]."[15]

Conclusion

Crutchfield is the first state supreme court to address the constitutionality of the "factor-presence" nexus standard, but is not likely to be the last word on the issue. Supreme courts of the other states that have adopted such a standard for income taxes and gross receipts taxes may eventually be asked to address this issue and may very well reach a different result.

It remains to be seen whether the U.S Supreme Court will be interested in reviewing *Crutchfield* to clarify where it stands on *Quill*, or its view on the constitutionality of the "factor-presence" nexus standard. Although Justice Anthony Kennedy indicated, in his now famous concurrence in *Direct Marketing Ass'n v. Brohl*,[16] a desire to have a case before the U.S. Supreme Court to reconsider the *Quill* physical presence standard, *Crutchfield* may not be the right case to do so since the CAT does not involve the obligation to collect use tax. However, if the U.S. Supreme Court were so inclined, it could address whether there is a meaningful constitutional distinction between a use tax and a gross receipts tax for nexus purposes, and in doing so, could possibly revisit *Quill*.

[14] Slip Opinion, p. 28.

[15] Slip Opinion, p. 29.

[16] 135 S.Ct. 1124, 1134, 1135 (2015).

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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