DON'T BE SURPRISED BY WHAT THE CAT DRAGS IN: OHIO COMMERCIAL ACTIVITY TAX UPDATE

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A. Background

The CAT is a broad-base, low rate tax imposed on the privilege of doing business in Ohio governed by Chapter 5751 of the Ohio Revised Code. It replaced the franchise and personal property taxes and represents a shift to market-based tax policy. The CAT is generally imposed at each level of the supply chain.

The CAT is not a transactional tax and may not be invoiced / billed directly to customers.

B. Bright-Line Nexus – R.C. 5751.01 (H) & (I).

All for-profit enterprises with substantial nexus with Ohio are subject to the CAT. A company has substantial nexus with Ohio if it has a bright-line presence, which is defined as:

- $50,000 of property or payroll in Ohio;
- ***$500,000 in taxable (Ohio) gross receipts***;
- 25% of total property, payroll, or sales in Ohio; or
- Commercially domiciles in Ohio.

Previous lead case, *L.L. Bean, Inc. v. Testa*, S.Ct. Case No. 2014-0456, has been settled. Now, three cases are pending before the Ohio Supreme Court with oral arguments completed on May 3, 2016. *Crutchfield Corp. v. Testa*, S. Ct. Case No. 2015-0386; *Newegg, Inc. v. Testa*, S.Ct. Case No. 2015-0483; and *Mason Companies, Inc. v. Testa*, S.Ct. Case No. 2015-0794. Other states have affirmed non-sales/use tax nexus upon companies lacking a physical presence in cases where taxpayer received royalties from intangible assets used in the state and other businesses with "significant economic presence". *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C., 1993), *cert. denied*, 510 U.S. 992 (1993). *Tax Comm'r v. MBNA America Bank, N.A.*, 220 W.VA. 163, 640 S.E.2d 226 (2006) *cert. denied, FIA Card Services, N.A. v. Tax Comm'r of W.Va.*, 551 U.S. 1141 (2007). *Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d 176 (N.J. 2006) *cert. denied* 551 U.S. 1131 (N.J. 2007). *KFC Corp. v. Iowa Dept. of Rev.*, 792 N.W.2d 307 (Ia. 2010) *cert. denied* 132 S.Ct. 97 (2011).

C. Group Reporting

1. Consolidated Election – R.C. 5751.011.

   Taxpayers with common ownership of ***at least*** 50% or 80% may elect to file as a group. The election is binding for eight quarters. The primary benefit from a consolidated election is the exclusion of intercompany receipts.

2. Combined Groups – R.C. 5751.012.

   If a consolidated election is not made, combined reporting is required for taxpayers with ***more than*** 50% common ownership. Entities without nexus with Ohio, however, are not included in combined group. Intercompany receipts between members of the combined group are not excluded.

3. Common Ownership – Ohio Admin. Code 5703-29-02.

   Common ownership is determined based upon a vertical control test. Control of majority voting rights in the lower-tier entity will result in common ownership. The IRS family attribution rules do not apply. There is no need for the businesses to form a unitary or functionally integrated business. Accordingly, private equity / venture capital firms often create significant group reporting concerns.

4. Members of a combined or consolidated taxpayer are treated as a single taxpayer and are jointly and severally liability for tax, interest and penalties of the group. R.C. 5751.014. The Tax Commissioner has provided for a procedure for requesting to file separately under Ohio Admin. Code 5703-29-08, however, separate taxpayers are not entitled to multiple $1 million exclusions and all members of would-be combined group remain jointly and severally liable for tax liability.

D. Taxable Gross Receipts – R.C. 5751.01(F)

"'[G]ross receipts' means the total amount realized by a person without deduction for the cost of goods sold or other expenses incurred, that contributes to the production of gross income of the person, including the fair market of any property and any services received, and any debt transferred or forgiven as consideration." The following are excluded from a taxpayer's "gross receipts":

- Interest (except on a credit sale).
- Dividends and distributions from corporations and pass-through entities.
- Receipts from the sale, exchange or disposition of 1221 or 1231 assets.
- Principal amount of a loan.
- Compensation received by an employee.
- Capital contributions and proceeds from the corporation's issuance of stock.
- Insurance proceeds (unless received from the loss of business).

- Sales / use taxes collected by a vendor.
- Returns and allowances.
- Bad debts.
- Cash discounts based upon timely payment or volume.
    - Ex: "X per cent, y-day" – 2-10, net 30, or coupons / rebates for volume purchases (coupons reimbursed by manufacturer do not qualify).
- Amounts received by real estate brokers, except the commission being retained by the broker (not paid to another real estate salesperson or broker).
- Amounts received by a professional employer organizations (PEOs), except the administrative fee charged to the client employer.
- Amounts "received or acquired by an agent on behalf of another in excess of the agent's commission, fee, or other remuneration."
    - An agent is a person authorized by another to act on its behalf to undertake a transaction for the other. Agency relationship is determined by common-law test, not contractual designation. Ohio Admin. Code 5703-29-13.
    - Examples include: insurance brokers; consignment shops; lottery sales agents; restaurants (i.e., exclude gratuities); and general contractors (if required to act in property owner's best interest and acting as a conduit for payments to subcontractors).
    - *Moorehead Communications, Inc. v. Testa* (BTA Case No. 2015-195). Taxpayer is a large authorized dealer for Verizon Wireless that excluded commissions paid to sub-agents (premium partners) based upon the agent exclusion. Taxpayer asserted such commissions should be excluded from the tax base because it received them as Verizon's agent and passed-through to the sub-agents – *i.e.,* acting as a conduit. The Tax Commissioner denied the exclusion because the contracts between taxpayer and premium partners explicitly disclaimed an agency relationship. But the Tax Commissioner focused on the incorrect relationship, as taxpayer claimed exclusion based upon agency relationship with Verizon, and failed to look beyond contractual language.
- Qualified Distribution Center receipts, which requires the distribution center to obtain certificate from Department of Taxation (QDC Holders available at: http://www.tax.ohio.gov/commercial_activities/qualified_distribution_centers.aspx).
- Qualifying integrated supply chain receipts (enacted per H.B. 64).
    - Defined as receipts of a qualified integrated supply chain vendor from the sale of qualified property to another qualified integrated supply chain vendor. A qualified integrated supply chain vendor means a person, other than a retailer, that is a member of an integrated supply chain and that provides integrated supply chain services within a qualified integrated supply chain district to another qualified integrated supply chain vendor

located within the same district but does not share a common owner with that person. Qualified property means parts used to hold, contain, package, or dispense a personal care, health, or beauty product or aromatic product including candles, or work-in-progress inventory that will become such a product capable of being sold at retail. A qualified supply chain district means contiguous parcels of land of between 400 and 700 acres owned by a single person on July 1, 2015, and located in a county with a population greater than 165,000 but less than 170,000 and in a municipal corporation with a population greater than 7,500 but less than 8,000. H.B. 64 specified that this exclusion is intended to clarify existing law and applies retroactively to tax periods beginning on or after July 1, 2011.

- Due to restricted definition, applies to a single location in the Columbus region - The New Albany International Beauty Campus operated by Bocchi Laboratories.

E. Sourcing Gross Receipts from TPP Sales

Gross receipts from the sale of tangible personal property are sitused to where the property is received by the purchaser. "In the case of delivery of tangible personal property by motor carrier or by other means of transportation, the place at which such property is ultimately received after all transportation has been completed shall be considered the place where the purchaser receives the property. For purposes of this section, the phrase "delivery of tangible personal property by motor carrier or by other means of transportation" includes the situation in which a purchaser accepts the property in this state and then transports the property directly or by other means to a location outside this state. Direct delivery in this state, other than for purposes of transportation, to a person or firm designated by a purchaser constitutes delivery to the purchaser in this state, and direct delivery outside this state to a person or firm designated by a purchaser does not constitute delivery to the purchaser in this state, regardless of where title passes or other conditions of sale." R.C. 5751.033(E).

1. Transportation by Motor Carrier

Lexmark Int'l, Inc. v. Testa, Tax Comm'r Final Determinations (July 15, 2014 and Sept. 22, 2015). Taxpayer sells printer cartridges and other products to Dell, which Dell resells to consumers. Products are shipped to a Dell-approved third-party logistics center in Ohio operated by CEVA Logistics. Lexmark shipped the products already packaged in Dell boxes. Upon notification from Dell that the product has been sold, CEVA Logistics moves product from the receiving area to the shipping area of the warehouse – title passes to Dell when product is moved to the shipping area. Dell and Lexmark monitor inventory at the logistics center through a shared portal.

A common carrier retained by Dell would then pick up the products from the CEVA Logistics facility and ship the product to Dell's customers, only 4% of which are in Ohio. The Lexmark products generally spent less than 48 hours in the CEVA Logistics facility. The Tax Commissioner found that CEVA Logistics acted on Dell's behalf in accepting and shipping the products.

The Tax Commissioner determined that Dell received the property in Ohio upon the products being moved to the shipping area of the warehouse. Taxpayer asserted that its receipts must be sourced to the products ultimate destination after all transportation is complete – *i.e.,* Dell's customer's location. But the Tax Commissioner rejected this position based upon the facts above and since Lexmark did not know the identity and location of Dell's customer when the product was delivered to the distribution facility. Thus, Dell received the products in Ohio at the CEVA Logistics facility – subsequent shipment to Dell's customer was not where the product was received by Dell. Case was appealed to BTA, but settled prior to an opinion being issued.

Gilster-Mary Corp. v. Testa (BTA Case No. 2015-822). Taxpayer is a Missouri corporation which manufacturers store-brand food products for sale to national grocery store chains. At issue are deliveries by taxpayer to its customers' Ohio distribution centers, which the customer then ships to its stores in and outside Ohio. Taxpayer claims that receipts from the sale of products shipped by the customer to its stores outside Ohio must be excluded. During the administrative appeal, the Tax Commissioner requested "information detailing: 1) all merchandise ***initially*** received by [taxpayer]'s customers in Ohio, but ***ultimately*** received by the same customers outside Ohio; and 2) all merchandise ***initially*** received by [taxpayer]'s customers outside Ohio, but ***ultimately*** received by the same customers in Ohio." Taxpayer apparently did not provide this information and the Tax Commissioner affirmed the assessment.

2. <u>Direct Delivery Outside Ohio</u>

Rubberlite, Inc. v. Testa, Tax Comm'r Final Determination (Dec. 29, 2014). The purchaser picked up the products at Rubberlite's West Virginia facility and transported the products to Ohio (not via common carrier). The Tax Commissioner rejected the taxpayer's contention that the property had been delivered outside Ohio based upon precedent arising under similar sales factor apportionment provision for Ohio franchise tax. *See House of Seagram, Inc. v. Porterfield*, 27 Ohio St.2d 97 (1971); and *Dupps Co. v. Lindley*, 62 Ohio St.2d 305 (1980). Case was appealed to BTA, but settled prior to an opinion being issued.

3. <u>Subsequent Transportation into Ohio</u>

R.C. 5751.013 states "[a] person shall include as taxable gross receipts the value of property the person transfers into this state for the person's own use within one year after the person receives the property outside the state." However, this does not apply if the property's receipt outside Ohio was not intended to avoid the CAT. Ohio Admin. Code 5703-29-06

A.H. Jamra Co. Inc. v. Testa, BTA Case No. 2013-4534 (Feb. 26, 2015). The facts are somewhat unclear because the taxpayer was not forthcoming. It appears the taxpayer instructed its supplier to send invoices to an Indiana business address so the supplier could avoid paying CAT. The Tax Commissioner assessed the taxpayer under R.C. 5751.013 based upon the property subsequently transported into Ohio. On appeal, the taxpayer asserted that the goods were actually received in Ohio and, thus, R.C. 5751.013 did not apply. The BTA held that the taxpayer did not meet its burden of establishing the Tax Commissioner erred. Further, the BTA commented that the taxpayer faced a particularly significant burden because it purposely misrepresented the facts in order to gain a tax advantage.

F. Sourcing Gross Receipts from Services

Receipts from the sale of services "shall be sitused to this state 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. 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. If a taxpayer's records do not allow the taxpayer to determine that location, the taxpayer may use an alternative method to situs gross receipts under this division if the alternative method is reasonable, is consistently and uniformly applied, and is supported by the taxpayer's records as the records exist when the service is provided or within a reasonable period of time thereafter." R.C. 5751.033(I).

Ohio Admin. Code 5703-29-17 describes examples for 54 different types of services. Generally, services can be sourced based upon whether the service benefits specific / identifiable property of the purchaser.

- Services ***pertaining to specific property*** are sourced to the property location.

  Examples:

  - Appraisal
  - Architectural
  - Construction
  - Engineering
  - Exterminating
  - Facility Management
  - Real estate broker
  - Security

- If the service does ***not*** benefit specific property, then look to the location where the purchaser's employees use the service. If benefitting multiple locations (or generally benefitting a multistate business) the vendor may use a reasonable, consistent, and uniform method to apportion the receipts.

  Due to difficulty in determining location of benefit received, a vendor may elect to source receipts from the following services to the purchaser's principal place of business, as long as applied in a reasonable, consistent, and uniform manner:

  - Accounting
  - Advertising
  - Agency (not for athletes / entertainers)

- Collection
- Data Processing
- Internet / Web Hosting
- Legal
- Management Consulting
- Market Research
- Membership Fees
- Tax Preparation
- Technical Assistance

The principal place of business is determined in the following order:

1) The branch, division, or business unit where the purchaser primarily receives the service.
2) The primarily location of the management operations for the purchaser's business unit receiving the services.
3) Billing address, if accepted in good faith and the purchaser conducts actual operations at such address.

Moorehead Communications, Inc. v. Testa (BTA Case No. 2015-195). Taxpayer is a large authorized dealer for Verizon Wireless that enters into cellular contracts with consumers on Verizon's behalf. The consumer pays the monthly service fee to Verizon (taxpayer does not receive receipts from the consumer, except for phones, accessories, etc. which are not at issue). Verizon then pays taxpayer commissions based upon the cellular contracts entered into by taxpayer (and its sub-agents). Taxpayer argued that receipts must be sitused to where Verizon, its customer, received the benefit of the taxpayer's agency services. Per administrative rule, taxpayer elected to source receipts to Verizon's principal place of business in New Jersey. The Tax Commissioner disagreed and sitused receipts based upon where Verizon's customers are located because Verizon's benefit was access to the Ohio market.

Fair Issac Corp. Final Determination. Taxpayer (FICO) develops and licenses scoring software to credit reporting agencies (Experian, Equifax & TransUnion). The credit reporting agencies use the software to sell credit scores to customers, primarily lending institutions / banks. The credit reporting agencies, which are not located in Ohio, pay FICO a per-report fee. FICO argued that the receipts must be sitused to where the credit reporting agencies use the software, which is not in Ohio. However, the Tax Commissioner determined that FICO's licensing revenue is sitused to where its customer's customer (the lending institutions) are located. The Tax Commissioner estimated the Ohio portion of its receipts based upon the ratio of Ohio's population to the total United States population.