In the

Supreme Court of Ohio

OHIO GROCERS ASSOCIATION, et al.,	:	Case No. 2008-2018
Plaintiffs-Appellees,	:	On Appeal from the Franklin County Court of Appeals, Tenth Appellate District
v.	:	
WILLIAM W. WILKINS [RICHARD A. LEVIN], in his official capacity as Ohio Tax Commissioner,	:	Court of Appeals Case No. 07AP-813
Defendant-Appellant.	:	

BRIEF OF *AMICUS CURIAE* MULTISTATE TAX COMMISSION IN SUPPORT OF DEFENDANT-APPELLANT, RICHARD A LEVIN, SUCCESSOR TO WILLIAM W. WILKINS, OHIO TAX COMMISSIONER

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FILED
APR 06 2009
CLERK OF COURT
SUPREME COURT OF OHIO

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INTEREST OF *AMICUS CURIAE*

Amicus curiae Multistate Tax Commission respectfully submits this brief in support of Defendant-Appellant, Ohio Tax Commissioner. The Multistate Tax Commission supports the view of the Tax Commissioner, and the trial court below, that the Ohio Commercial Activity Tax may be properly considered a franchise tax imposed on the privilege of doing business in the state, and not a sales tax or other excise tax imposed on sales or retail transactions.

The Commission is the administrative agency for the Multistate Tax Compact, which became effective in 1967 when the required minimum threshold of seven states enacted it.[1] Today, forty-seven states and the District of Columbia participate in the Commission. Twenty of those jurisdictions have adopted the Multistate Tax Compact by statute. Another twenty-eight have joined the Commission as either sovereignty or associate members.[2] The purposes of the Compact are to: (1) facilitate proper determination of State and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes, (2) promote uniformity or compatibility in significant components of tax systems, (3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration, and (4) avoid duplicative taxation.[3]

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[1] *See, United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978), upholding the validity of the Compact.

[2] *Compact Members*: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. *Sovereignty Members*: Georgia, Kentucky, Louisiana, Maryland, New Jersey, West Virginia and Wyoming. *Associate Members*: Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont and Wisconsin.

[3] Compact, Art. I.

The Commission files this brief in furtherance of the Compact's purposes, in particular to promote uniformity or compatibility in significant components of state tax systems and to facilitate convenience and compliance in tax administration. Perhaps one of the most basic aspects of a tax system is how its structure should be classified in terms of tax type. Many legal and administrative implications flow from the characteristics of a particular tax structure. These implications include the appropriate constitutional nexus standards to apply, *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992) (physical presence required for sales and use tax nexus); whether receipts from returns on federal obligations, or other items that states are prohibited from taxing directly, nonetheless may be included in the measure of the tax base, *Werner Machine Co., Inc. v. Director of Division of Taxation,* 350 U.S. 492 (1956) (income from tax-exempt federal bonds may be included within the measure of a state franchise tax); and whether certain federal statutory limitations on state taxation apply (*e.g.,* 15 U.S.C.A. § 381, et. seq., commonly known as P.L. 86-272, which applies only to state taxes on or measured by net income). Clearly, an incorrect tax classification can have serious unintended consequences.

Because a particular tax structure calls for particular set of administrative and legal implications, it is important for efficiency and compliance that states share a common understanding of the terms used to classify these structures. To the extent a sales tax in one state is not distinguished from a gross receipts tax in another, or a franchise tax in one state is not distinguished from a direct tax in another, we diminish our common understanding and create administrative difficulties for both taxpayers and tax administrators. The relevance of other states' case law, taxpayers' ease of

compliance, and in general the ability to engage in meaningful tax research and discourse would all be negatively impacted.

This case presents the important question of how a particular tax structure, a tax imposed on the privilege of doing business in a state and measured by gross receipts, should be classified. In classifying this tax, the Ohio Court of Appeals' opinion reflected confusion in its use of the terms "excise tax", "gross receipts tax", and "franchise tax." That confusion led directly to the appellate court's erroneous ruling that the CAT is an unconstitutional excise tax on the sale of food rather than a permissible franchise tax. The failure to properly classify Ohio's franchise tax is particularly troubling because it confused the measure of the tax and the imposition of the tax. Such confusion could deprive a state legislature of its ability to adopt legitimate tax systems where only the indirect economic impacts, and not the legal imposition of the tax, falls on an item protected from direct taxation. The interest of the Multistate Tax Commission in this case is thus two-fold: to support a clear and common understanding of tax structure classifications among the states, increasing compliance and administrative efficiency in multistate taxation; and to reaffirm the important principle that the legal incidence of a franchise tax should not be confused with its measure, even if the putative economic effects of the tax fall on an item that may not be taxed directly.

ARGUMENT

I. In Structure and Operation, the Ohio CAT is a Franchise Tax Imposed on the Privilege of Doing Business in the State, Measured by Gross Receipts, Not a Sales Tax Imposed on Individual Transactions.

The Ohio Constitution prohibits the imposition of a sales or other excise tax on certain sales, purchases or retail transactions involving food. Sections 3(C) and 13,

Article XII of the Ohio Constitution. This prohibition does not extend to a franchise tax imposed on the privilege of doing business, even if that business involves the sale of food. *Merit Brief of Defendant-Appellant* (hereinafter, "Appellant's Brief") at pp. 17-19. Thus one principal question in this case is whether the Ohio Commercial Activity Tax (CAT) is a prohibited sales tax or a permitted franchise tax.

The trial court cogently ruled that the CAT is structured as a permitted franchise tax imposed on the privilege of doing business in Ohio, and not as a prohibited transaction tax imposed on sales. Furthermore, the privilege upon which the tax is imposed is properly measured by gross receipts, and not by receipts from individual sales or transactions. Thus, the trial court found that the CAT is properly imposed on the privilege of doing business even where the business is that of a grocer, and that the CAT is properly measured by gross receipts even where a portion of those gross receipts are from the sale of food.

In reviewing the constitutionality of a statute, this court has made clear that an appellate court's role is limited. "A court's power to invalidate a statute 'is a power to be exercised only with great caution and in the clearest of cases.' Laws are entitled to a 'strong presumption of constitutionality,' and the party challenging the constitutionality of a law 'bears the burden of proving that the law is unconstitutional beyond a reasonable doubt.'" *Columbia Gas Trans. Corp. v. Levin,* 117 Ohio St. 3d 122, 2008-Ohio-511 at ¶41. *Buckley v. Wilson,* 105 Ohio St. 3d 350, 2005-Ohio-2166 at ¶18, *citing Yajnik v. Akron Dept. of Health, House Div.,* 101 Ohio St. 3d 106, 2004-Ohio-357. In addition, "on review of statutory acts, a court is bound to give a constitutional rather than

unconstitutional construction if one is reasonably available." *United Air Lines, Inc. v. Porterfield* (1971), 28 Ohio St. 2d 97, 100.

With these maxims limiting the role of the courts in passing on the constitutionality of statutes in mind, it is clear that this court is not called upon in this case to decide *vel non* whether the CAT is a franchise tax or a transaction tax. Rather, the Court is simply charged with the narrower task of determining whether it was reasonable for the Ohio legislature to classify the CAT as a franchise tax and not a transaction tax. An examination of the structure of the CAT demonstrates that the legislature's classification of the tax as a franchise tax imposed on the privilege of doing business is the *only* reasonable classification of the tax.

The legislature's classification of the CAT as a franchise tax measured by gross receipts, and not a sales tax on transactions, is correct for two distinct reasons: (a) the CAT is imposed on the privilege of doing business in the state and not on sales or transactions, and (b) the measure of the CAT is gross receipts and not individual sales or transactions.

A. The CAT is Imposed on the Privilege of Doing Business in the State, Not on Sales or Transactions.

First, the CAT is structured as a franchise tax because it is imposed on the privilege of doing business in Ohio. R.C. § 5751.02. Unlike a sales tax, which is imposed on transactions, a franchise tax is imposed on a privilege – in this case, the privilege of doing business within Ohio – granted by the state to the taxpayer. In *Werner Machine Co., Inc. v. Director of Division of Taxation,* 350 U.S. 492 (1956), the U.S. Supreme Court recognized the nature and validity of state franchise taxes, noting that "[c]orporate franchises granted by a state create a relationship which may legitimately be made the

subject of taxation, *Home Ins. Co. v. New York*, 134 U.S. 594, 599-600 (1890); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 162 (1911); *Educational Films Corp. v. Ward,* 282 U.S. 379, 388 (1931); and the statute expressly declares this to be a franchise tax." 350 U.S. at 493.

B. The CAT is Measured by Gross Receipts, Not by Individual Sales or Transactions.

Second, even if this Court were to inquire beyond the imposition of the CAT and consider its measure, the inquiry would show that the measure of the CAT is distinct from a sales or transaction tax. The CAT is measured by the entire gross receipts of the business. Gross receipts is defined as "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 value of any property and any services received, and any debt transferred or forgiven as consideration." R.C. 5751(F). By contrast, a sales tax is based on receipts from individual sales or purchases, on a transaction-by-transaction basis. Indeed, grocers engage in numerous sales transactions involving non-food items, such as stationery, household cleaning products, toiletries, books and magazines. Plaintiffs do not challenge the application of the CAT to the gross receipts from sales of non-food items by grocers. Plaintiffs' bifurcation of the tax base as applied to grocers, if they were to prevail in this case, would raise difficult theoretical and administrative issues as to the correct computation of the CAT. For example, the CAT allows taxpayers to apply unused net operating losses (NOLs) accrued under the former corporate franchise tax to reduce their liability under the CAT. NOLs are not ordinarily "assigned" to distinct segments of the business accruing the losses, and were not so assigned at the time they accrued under the corporate franchise tax.

Bifurcating the CAT tax base between the gross receipts of food sales and the gross receipts of non-food sales would require that the NOLs be apportioned between the food sales and the non-food sales. As the profit margins and cost of goods sold would vary between and among food and non-food items, it is not readily apparent that simply apportioning the NOLs in proportion to the gross receipts of food and non-food items would result in a proper apportionment. It is difficult to think of an apportionment formula that would be both theoretically sound and easily administrable in this context precisely because NOLs are not ordinarily assigned to a specific business segment.

That it is reasonable to distinguish between a tax based on or measured by gross receipts and one based on or measured by individual sales transactions is borne out by expert commentary. In their treatise *Federal Limitations on State and Local Taxation 2d,* Trost and Hartman define a gross receipts tax and differentiate it from a sales tax as follows:

> The division ... between ... sales taxes and ... gross receipts was determined by using a somewhat narrow definition of gross receipts (sic) .... The term "gross receipts taxes" in its broader sense could properly include all sorts of sales taxes .... In its narrower meaning, and the one here adopted, "gross receipts taxes" include only those formally called such and imposed on the recipient of gross income at an annual or some other stated period. The category includes gross receipts taxes whether used as the subject or measure of the tax. The tax may be imposed upon all reported taxable gross income from whatever source derived, or a basic exemption may be allowed each taxpayer. Gross receipts subject to the tax may include not only receipts from sales of goods, but also receipts from such activities as communications and transportation services. The gross income tax ... is on the seller of goods or services, while a retail sales tax, separately stated and collected from the purchaser on a transaction-by-transaction basis is, in essence, a tax on the consumer, although the retail sales tax normally is imposed on the privilege of selling.

2 Charles A. Trost & Paul J. Hartman, *Federal Limitations on State and Local Taxation 2d,* at §9:1 (2003).

Similarly, James A. Amdur defines a gross receipts tax as distinct from a sales tax. A gross receipts tax is:

> [A] tax, other than a sales tax, which is imposed on or measured by the gross volume of business, in terms of gross receipts or in other terms, and in the determination of which no deduction is allowed which would constitute the tax an income tax. The distinction between a gross-receipts tax and a sales tax is that the latter essentially is a transactional tax on the consumer of goods and services separately stated and collected from the purchaser by the seller, while a gross receipts tax is a tax on the business activity of the seller.

James A. Amdur, Annotation, *Constitutionality, Construction, and Application of State and Local Public-Utility-Gross-Receipts-Tax Statutes – Modern Cases,* 58 ALR5th 187, at §2[a] (1998) (quoting Hartman, *Federal Limitations on State and Local Taxation* §8.1 (1981).

Finally, Gelfand & Salsich note the characteristics of a gross receipts tax.

> The gross receipts tax is levied upon the total revenues of a business on an annual or other periodic basis. An occupational license tax, which is imposed on ... corporations for the right to do business in the state, is a typical example of a gross receipts tax. The tax is measured as a percentage of the total gross revenues of the corporation during a given period, usually set by state statute.
>
> M. David Gelfand & Peter W. Salsich, Jr., *State and Local Taxation and Finance in a Nutshell* 66 (1985).

II. Even if the CAT Franchise Tax Were Measured by Individual Sales or Transactions, Rather Than by Gross Receipts, the Tax Would Still Be Distinct in Structure and Operation From a Sales Tax Imposed on Individual Transactions.

A state franchise tax may properly include in its measure items that would be exempt if the tax were imposed on those items directly. In *Werner Machine Co., Inc. v. Director of Division of Taxation,* 350 U.S. 492 (1956), the Court upheld a state franchise tax imposed on the privilege of doing business and measured by net worth which included income from tax-exempt federal bonds within the measure of the tax. The Court wrote:

> This Court has consistently upheld franchise taxes measured by a yardstick which includes tax-exempt income or property, even though a

> part of the economic impact of the tax may be said to bear indirectly upon such income or property. See, e. g., Society for Savings v. Coite, (6 Wall.) 594; Provident Institution v. Massachusetts, 6 Wall. 611; Hamilton Co. v. Massachusetts, 6 Wall. 632; Home Ins. Co. v. New York, supra; Educational Films Corp. v. Ward, supra; Pacific Co. v. Johnson, supra.

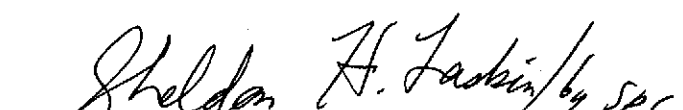
350 U.S. at 494.

Thus, even if the CAT were measured by individual sales transactions, and to the extent receipts from such transactions are included in its measure of gross receipts, the CAT is not a tax on such sales or transactions. This is true notwithstanding that the economic incidence of the CAT may fall upon the purchasers of food from grocers. The authority to impose a tax is determined by ascertaining who bears the legal incidence of the tax, not by the ability of that party to pass the economic cost of the tax to third parties. *Columbus & Southern Ohio Electric Co. v. Porterfield* (1974), 41 Ohio App. 2d 191. *See also, United States v. New Mexico,* 455 U.S. 720 (1982) (New Mexico could impose its gross receipts and compensating taxes on federal contractor even though economic incidence of taxes were borne by federal government, which enjoyed immunity from taxation.); *Accord, Arizona Dept. of Revenue v. Blaze Construction Co, Inc.*, 526 U.S. 32 (1999). A business can pass the economic burden of a tax to its employees, customers or stockholders. But this basic economic fact does not convert the tax to a tax on those employees, customers or stockholders. *Graves v. New York ex rel. O'Keffe,* 306 U.S. 466, 480 (1939)("the theory, which once won a qualified approval, that a tax on income is legally or economically, a tax on its source, is no longer tenable..."). Appellant's Brief amply addresses this concept and its rationale. Appellant's Brief at pp. 36-43.

CONCLUSION

Clearly, the decision of the Ohio legislature to classify and to structure the CAT as a franchise tax on the privilege of doing business, measured by the gross receipts of the business, and not as a transaction tax, is amply supported by the case law and literature regarding the nature of franchise taxes and taxes measured by gross receipts. Applying the maxims requiring courts to uphold the constitutionality of a state statute unless proven to be unconstitutional beyond a reasonable doubt, we respectfully submit that this Court should sustain the constitutionality of the CAT as applied to the gross receipts derived from the sale of food by Plaintiffs.

Respectfully submitted,



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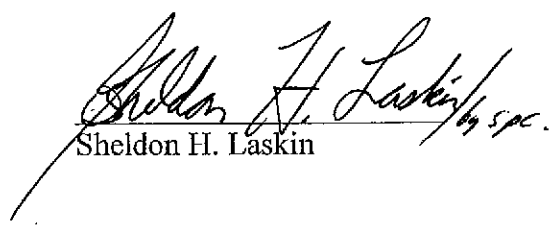

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