IN THE SUPREME COURT OF OHIO

CRUTCHFIELD, INC.,	:	
	:	
Appellant,	:	
	:	Case No. 15-0386
v.	:	
	:	Appeal from the
JOSEPH W. TESTA,	:	Ohio Board of Tax Appeals
Tax Commissioner of Ohio,	:	Case Nos. 2012-926
	:	2012-3068, 2013-2021
Appellee.	:	

MERIT BRIEF OF AMICI CURIAE, OHIO MANUFACTURERS' ASSOCIATION, OHIO STATE MEDICAL ASSOCIATION, OHIO DENTAL ASSOCIATION, AND OHIO CHEMISTRY TECHNOLOGY COUNCIL, IN SUPPORT OF APPELLEE JOSEPH W. TESTA, TAX COMMISSIONER OF OHIO

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STATEMENT OF INTEREST OF AMICI CURIAE

In June 2005, the General Assembly adopted a tax reform package – House Bill 66 ("H.B. 66") designed to address the economic malaise that had afflicted Ohio for many years. In adopting H.B. 66, the General Assembly sought to replace Ohio's antiquated tax system that "kills jobs and hinders economic growth" with one that promotes investment in the equipment and technology Ohio workers need to be efficient, productive, and competitive in the global economy.[1]

A critical component of this tax reform bill was a multi-year phase out of Ohio's tangible personal property tax and the corporation franchise tax. Every major study of Ohio's tax system over the past 40 years has acknowledged the anti-competitive nature of the tangible personal property tax and has called for adjustments to or wholesale elimination of this tax.[2] With its many loopholes, the corporation franchise tax was largely ineffective in generating revenue. Its net worth component also placed undue burden on capital-intensive and start-up businesses.[3] H.B. 66 replaced both the tangible personal property tax and the corporation franchise tax with a new commercial activity tax (the "CAT"). The CAT is a broad-based, low rate tax that applies to virtually all business activity in Ohio with annual gross receipts of $150,000 or more.

Another important component of this tax reform package is the significant reduction in Ohio's personal income tax. The top marginal rates, especially when combined with local income taxes, likewise provided an impediment to capital formation. Under H.B. 66, Ohio's

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[1] *Hearing on H.B. 66 Before the Fin. and Appropriations Commt. of the Ohio House of Representatives, 126th Gen. Assembly (March 8, 2005)* (testimony of David W. Johnson, President and CEO, Summitville Tiles, Inc. and Chairman of the Ohio Manufacturers' Association).

[2] *Id.* See generally, Bahl, Taxation & Economic Development: A Blueprint for Reform in Ohio (1996), 55 (hereinafter *Bahl*).

[3] *Bahl*, at p. 54.

high personal income tax is reduced 4.2 percent annually for five years. The 21 percent personal income tax reduction is especially important to the thousands of Amici's members who are small business owners, as they essentially pay their business tax through their personal income tax. This reduction was also funded by the CAT.

Amici, The Ohio Manufacturers' Association, Ohio State Medical Association, Ohio Dental Association, and Ohio Chemistry Technology Council, are statewide associations that represent diverse segments of Ohio's economy. Collectively, Amici represent approximately 75,000 members, virtually all of whom conduct business in Ohio. Despite their diversity, Amici's nearly 75,000 members have at least two things in common – they are Ohio taxpayers subject to Ohio's CAT, and they are all vitally concerned with reversing Ohio's economic malaise. As CAT taxpayers, they have a critical and substantial interest in ensuring that this tax is applied fairly and equitably. As business persons in Ohio, their economic vitality is inextricably tied to the economic climate of the state.

The decision of the Board of Tax Appeals upholding the "bright-line presence" test for nexus found in R.C. 5751.01(H) and (I) is important to all businesses in Ohio. This Court's resolution of the issue will have far-reaching implications for economic development in Ohio, fairness among business taxpayers, certainty for Ohioans regarding their tax obligations, and stability for recipients of tax dollars so that they can budget and spend appropriately.

STATEMENT OF THE CASE AND FACTS

Amici adopt the Statement of the Case and Facts set forth in the Ohio Tax Commissioner's Brief on the Merits.

ARGUMENT

PROPOSITION OF LAW:

A taxpayer that has neither property nor employees within Ohio, but which exploits the market in Ohio such that it has more than $500,000 in gross receipts from the sale of tangible goods shipped into Ohio, has "bright-line presence" as defined in R.C. 5751.01(I)(3) and therefore has substantial nexus with Ohio for purposes of the Commerce Clause of the Constitution of the United States.

A taxpayer that does not have a physical presence in Ohio may nevertheless have "bright-line presence" if its sales within the state exceed $500,000 annually. "Bright-line presence" is considered to be substantial nexus sufficient for purposes of the Commerce Clause of the Constitution of the United States. Because Appellant had tens of millions of dollars from sales of tangible goods delivered in Ohio to Ohio customers, it has substantial nexus with Ohio and is subject to the CAT. Appellant's arguments to the contrary should be rejected and the decision of the Board of Tax Appeals, being reasonable and lawful, should be upheld.

Ohio's Previous Tax Structure

Prior to 2005, Ohio's tax structure was essentially unchanged since the 1930s. At that time, Ohio's economy was driven by agriculture and manufacturing. Its tax structure reflected that economy. The major taxes were the real property tax, the sales and use taxes, the tax on tangible personal property used in business, and the corporation franchise tax measured on net worth. Both agriculture and manufacturing received exemptions from the sales tax for business inputs, since the tax was intended to apply to household consumption. However, both the franchise tax and the tangible personal property tax, especially, hit capital-intensive industries harder than others and had to be paid whether the entity made, or lost, money. Thus, the manufacturing sector paid an inordinately high level of state tax when compared with other segments of the economy.

As services made up a larger share of Ohio's economy over the years, the inequality in the state tax burden between manufacturing and other segments of the economy was exacerbated. Many service sector concerns operate without a significant investment in capital; hence, their tangible personal property and net worth franchise tax liabilities were minimal. Many of these services operate on slender margins or can manipulate their finances to minimize income; as a result, little income tax was generated. In addition, many of these new service entities were organized as pass-through entities that were not subject to the franchise tax. As the demand for state services grew, the only recourse was to raise existing tax rates on existing taxpayers. In many cases, that meant an increasing tax burden for Ohio manufacturers.

Paradoxically, Ohio continued to add exemptions from, and exceptions to, the various taxes during this time. As a result, Ohio was saddled with a number of taxes that had high nominal rates, but struggled to raise sufficient levels of revenue for governmental operations. The discrepancies between taxpayers and economic segments also increased and compliance with the existing taxes became more complicated.

Calls for Reform

During the 1960s, calls for reform in Ohio's tax structure began. Over the years, various band-aids were applied to Ohio's tax structure in order to attempt to reduce its inequalities. Differences in the assessment rate applied to various types of business tangible personal property were reduced or eliminated, and the over-all assessment percentage was reduced. In the early 1970s the net income tax base for the franchise tax and the personal income tax were enacted on the basis that they were perceived as "more fair" because they were based on ability to pay. Ohio's intangibles tax on investments was repealed during the early 1980s. A cap of $150,000 was placed on the franchise tax liability of a taxpayer as measured by net worth in the early 1990s.

At the same time, Ohio continued to enact exemptions from, or exceptions to, the various taxes, thereby creating increasing disparity and complexity.

With the dawn of a new millennium, calls for tax reform increased. Dr. Ned Hill of Cleveland State University independently conducted a study that examined the impact of state tax policy on Ohio's economy and called for the elimination of the tangible personal property tax and existing dual-based franchise tax, to be replaced with a broad-based, low-rate tax based on payroll. The study also showed how capital-intensive segments of the economy, such as manufacturing, construction, and mining, paid anywhere from 3 to 11 times more state taxes than did members of many service industries.

Tax Reform Enacted

Finally, in early 2005, true tax reform was proposed and accomplished. The goals of tax reform were:

- Eliminate tax on investment and shift to a greater reliance on the taxation of consumption, consistent with the second and third bullets, below;
- Broaden the over-all business tax base;
- Reduce over-all business tax rates;
- Provide a more stable and predictable flow of revenue; and
- Simplify compliance.

The result was H.B. 66 - a comprehensive overhaul of Ohio's tax system. As enacted, the bill:

- Eliminated the tangible personal property tax on new investment in manufacturing and phased out the tax on all general business property over 4 years;
- Phased out the corporation franchise tax for most corporations over 5 years;

- Phased in a 21% reduction in personal income tax rates ratably over 5 years (the last reduction was delayed 2 years in 2009 in an effort to balance the state budget, but was implemented in 2011), a reduction enjoyed by the owners of pass-through entities; and
- Enactment of the commercial activity tax ("CAT"), a broad-based, low-rate tax measured by gross receipts from virtually all business activities and entities.

House Bill 66 became law in June 2005. Although generally opposed to gross receipts taxes because of their compounding nature, most manufacturers and many other taxpayers soon found that the savings from replacing the onerous and complex taxes on tangible personal property and corporation franchise with the extremely broad-based, low-rate and comparatively simple CAT made up for the policy misgivings regarding a gross receipts tax. In addition, compliance costs were slashed as taxpayers no longer had to undertake the arduous process of preparing personal property tax returns or corporation franchise tax reports.

Results of Tax Reform

Due to the phased implementation of the provisions of House Bill 66 and the general economic slowdown that has gripped the country over the past few years, questions have been raised regarding the effectiveness of the tax reform efforts. Indeed, the effort was worthwhile.

- In 2009, Ohio won Site Selection magazine's "Governor's Cup" for an unprecedented fourth consecutive year. The Governor's Cup is awarded annually to the state having the most major business expansions in the nation.
- Following intervening years of strong showings, Ohio finished second in Site Selection magazine's "Governor's Cup" in both the total number of economic development projects, as well as the number of projects per capita, in both 2013 and 2014.

- A January 2009 Ernst & Young study indicated that Ohio's business tax burden rated between 18th and 23rd best on 3 different scales of comparison. Another Ernst & Young study conducted for the Ohio Business Development Coalition showed that Ohio had the lowest effective tax rates on new capital investment in the Midwest.
- The Small Business & Entrepreneurship Council's Business Tax Index in 2008 rated Ohio's state tax system as 14th best nationally.
- In March 2010 the Federation of Tax Administrations released an analysis of new data from the U.S. Census Bureau showing that for FY 2009, Ohio's per capita state tax burden was the 16th lowest; as a percentage of personal income, the burden was the 18th lowest.
- In April 2011, Ernst & Young and the Council on State Taxation issued a report entitled "Competitiveness of State and Local Business Taxes on New Investment" in which they concluded that Ohio had the third lowest rate of state and local taxation on new business investment. The report laid this result directly at the feet of the 2005 tax reform law.
- In early 2013, Site Selection Magazine honored Ohio as having the 5th most favorable tax climate for mature firms and the 3rd most favorable tax climate for new firms for fiscal year 2012.
- Finally, according to the Ohio Department of Taxation, Ohio is one of only 6 states that do not tax corporate profits, and one of 10 that do not tax business personal property.

The major tax reforms approved by the Ohio General Assembly in 2005 led to significant improvements to a tax system that was for many years widely regarded as obsolete. As previously mentioned these reforms reduced overall tax rates, eliminated tax on investment, and broadened the tax base, all of which have provided more stable and predictable revenues, simplified compliance and provided fairness among business segments.

The most competitive aspects of the CAT are its broad base, its low rate, its broad application to virtually all business entities, and its simplicity. The CAT treats everybody the same. Taxpayers within and without Ohio are subjected to the same sourcing rules. With respect to receipts from sales of tangible personal property, if the property is ultimately received by the purchaser in Ohio, then the receipts associated with that transaction are sourced in Ohio. If the property is received by the purchaser outside Ohio, then the receipts are sourced outside Ohio. The success stories referenced earlier in this brief could not have happened with a different tax. For the CAT to remain workable, a broad base and a low rate are critical.

The R.C. 5751.01 Nexus Provisions

The Board of Tax Appeals ("BTA") held that Appellant, having more than $500,000 in taxable gross receipts from sales of tangible personal property delivered to customers in Ohio, satisfied the "bright-line presence" test for nexus under R.C. 5751.01(H) and (I). Not only is that decision reasonable and lawful, but the Appellant has "nexus aplenty" for purposes of the Commerce Clause of the United States Constitution. Therefore, the BTA's decision should be upheld by this Court.

The CAT is imposed upon each person with taxable gross receipts for the privilege of doing business in Ohio, including persons having substantial nexus with this state. R.C. 5751.02. A person has taxable gross receipts if the receipts are sourced to Ohio under the rules set forth in R.C. 5751.033. *See* R.C. 5751.01(G). Under R.C. 5751.033(E), receipts from the sale of tangible personal property are sourced to Ohio if the property is received in Ohio by the purchaser after all transportation has ended.

R.C. 5751.01(H)(3) provides in part that a person has "substantial nexus with this state" if the person has bright-line presence in the state. R.C. 5751.01(I) provides:

"A person has 'bright-line presence' in this state for a reporting period and for the remaining portion of the calendar year if any of the following applies. The person:

"(1) Has at any time during the calendar year property in this state with an aggregate value of at least fifty thousand dollars * * *.

"(2) Has during the calendar year payroll in this state of at least fifty thousand dollars. * * *.

"(3) Has during the calendar year taxable gross receipts of at least five hundred thousand dollars.

"(4) Has at any time during the calendar year within this state at least twenty-five per cent of the person's total property, total payroll, or total gross receipts.

"(5) Is domiciled in this state as an individual or for corporate, commercial, or other business purposes."

In this case the basic facts are not in dispute. Appellant has neither property, nor payroll, in Ohio. The Appellant is not domiciled in Ohio. The Appellant does have millions of dollars of gross receipts from the sale of tangible personal property received by purchasers within Ohio. Clearly, Appellant has "bright-line presence" within Ohio. On the face of R.C. 5751.02, Appellant is liable for the CAT on its taxable gross receipts. Based upon these uncontroverted facts and the plain language of the statute, the BTA found that Appellant was liable for the CAT on its taxable gross receipts. That decision is reasonable and lawful, and it should be affirmed.

For its part, Appellant does not contest the facts, or the substance of the law. Instead, it argues that the "bright-line presence" standard is an insufficient basis for imposing the CAT under the Commerce Clause of the Constitution of the United States. It argues that for Commerce Clause purposes, a taxpayer must have substantial nexus with a state before the state may impose a tax liability. Further, it asserts that a taxpayer may only have substantial nexus with a state by having some sort of physical presence within the state. Stated another way, a taxpayer must have property within a state, or it must have people acting upon its behalf, within a state, in order to have a physical presence.

Amici agree generally with the arguments raised by the Tax Commissioner in its brief and will not repeat them here. However, Amici do wish to make two points with respect to the Appellant's arguments.

Article I, § 8, clause 3 of the Constitution of the United States expressly authorizes Congress to "regulate Commerce with foreign Nations, and among the several States." Ever since the Court decided *Gibbons v. Ogden*, 22 U.S. 1, 9 Wheat. 1, 6 L.Ed. 23 (1824), the Court has recognized that this provision contains not only an affirmative grant of power to Congress to regulate interstate commerce, but also a negative aspect. This "dormant Commerce Clause" prohibits states from taking action that has the effect of discriminating against, or interfering with, interstate commerce, even if Congress has not taken any affirmative action. *Oklahoma Tax Comm'n. v. Jefferson Lines, Inc.*, 514 U.S. 175, 179, 115 S.Ct. 1331, 131 L.Ed. 2d 261 (1995). A tax that either provides a direct commercial advantage to local business or subjects interstate commerce to the burden of "multiple taxation" may be found to discriminate against interstate commerce. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458, 79 S.Ct. 357, 3 L.Ed. 2d 421 (1959).

In analyzing a claim under the Commerce Clause, the Court has adopted a four-pronged analysis. The tax passes muster under this analysis if it

1) is applied to an activity that has a substantial nexus with the taxing state;

2) is fairly apportioned;

3) does not discriminate against interstate commerce; and

4) is fairly related to the services provided by the State.

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 51 L.Ed. 2d 326, 97 S.Ct. 1076 (1977). In this case Appellant complains that the CAT and "bright-line presence" fall short on the first requirement.

In its brief, Appellant relies upon a number of cases for the proposition that with respect to gross receipts taxes, a physical presence is required in order for this first prong of *Complete Auto Transit, Inc.* to be satisfied. Amici recognize that in each of those cited cases, the taxpayer in question did indeed have a physical presence. However, in none of those cases did the Court state that a physical presence was the *sine qua none* for finding that a substantial nexus existed. In point of fact, as the Court itself recognized in *Quill Corp. v. North Dakota*, 504 U.S. 298, 314, 112 S.Ct. 1904, 119 L.Ed. 2d 91 (1992), it has yet to address the question that is presented here: Whether there is a level of economic presence within a state that gives rise to a substantial nexus for purposes of the commerce clause analysis.

Second, in evaluating whether the all-encompassing collection of data by Appellant, which enable it to transact sales of tangible personal property to customers in the Ohio market to the tune of multiples of tens of millions of dollars annually constitutes a substantial nexus with Ohio, the Court should remain mindful of the purpose of the commerce clause. Simply put, the question is whether the imposition of the CAT to this Appellant in any way provides a direct commercial advantage to any local business, or subjects interstate commerce to the burden of multiple taxation. If it does not, then Amici submit that the substantial nexus exists and the statutory scheme is valid.

Appellant has not alleged that the CAT discriminates against it, or that it provides an economic benefit to local business. That is because it can't. All receipts are sourced in the same manner. In the case of receipts from sales of tangible personal property, if the goods are ultimately delivered to the purchaser in Ohio, then the receipts are sourced here. If the goods are ultimately delivered to the purchaser outside Ohio, then the receipts are not sourced here.

That leaves the question of whether Appellant has a substantial nexus with Ohio and what that means. Appellant maintains a market in Ohio that results in sales worth multiple tens of millions of dollars to customers located in Ohio. It does this through the pervasive collection of data about its market and customers that is possible through the use of advanced technology. In fact, the collection of those data and its lightning-fast response to them allows the Appellant to tailor its information and sales efforts to the changing whims of each individual customer and to maximize its sales efforts, all within fractions of seconds. It is difficult to imagine a more substantial nexus with Ohio.

The question to consider is how, exactly, the presence of a single sales representative or employee, is more substantial to Appellant's ability to establish, maintain, and expand its market in Ohio. In today's environment, the use of technology provides a more substantial presence than the mere presence of any individual taking orders by hand and mailing them to the mail office for confirmation. How would a finding of insufficient nexus in this case promote the purposes of the Commerce Clause? The fact is that it does not.

CONCLUSION

The CAT was enacted in 2005 as part of a comprehensive and much-needed reform of the system by which business is taxed in Ohio. Its broad base, low rate, transparency, and ease of compliance and enforcement have all contributed to making Ohio a better place to live and to work. Much of the economic recovery that Ohio has enjoyed is attributable, at least in part, to the CAT.

The Appellant generates tens of millions of dollars from its sales of tangible personal property that is delivered to customers located in Ohio. The Board of Tax Appeals found that the Appellant had substantial nexus as provided in R.C. 5751.01(I) and R.C. 5751.02. That decision is both reasonable and lawful, and it should be affirmed.

Respectfully submitted,

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