In the Supreme Court of Ohio

Mason Companies, Inc.,	:	
	:	Case No. 15-0794
	:	
Appellant,	:	
	:	Appeal from the Ohio
v.	:	Board of Tax Appeals
	:	
Joseph W. Testa,	:	
Tax Commissioner of Ohio,	:	
	:	BTA Case Nos. 2012-1169,
Appellee.	:	2012-2806

THIRD MERIT BRIEF OF MASON COMPANIES, INC.

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TABLE OF CONTENTS

TABLE OF CONTENTS (cont'd)

Page

TABLE OF CONTENTS (cont'd)

TABLE OF AUTHORITIES

Cases **Page(s)**

TABLE OF AUTHORITIES (cont'd)

Cases **Page(s)**

TABLE OF AUTHORITIES (cont'd)

Cases **Page(s)**

<u>TABLE OF AUTHORITIES (cont'd)</u>

Cases **Page(s)**

Cases **Page(s)**

Constitutional Provisions

Federal Statutes

State Statutes

Ohio Revised Code

TABLE OF AUTHORITIES (cont'd)

State Statutes **Page(s)**

Other Authorities

Appellant Mason Companies, Inc. ("Mason" or "Appellant") respectfully submits this Third Merit Brief in support of its appeal, as well as in opposition to the cross-appeal filed by the Tax Commissioner of Ohio (the "Commissioner") which erroneously insists, as he did in his unsuccessful motion to dismiss, that Mason failed to preserve its "as applied" Commerce Clause challenge.

I. INTRODUCTION

There is no dispute that under the four prong test of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977), a company must have a "substantial nexus" with a state in order for the state to impose its tax obligations. The "substantial nexus" standard that applies to taxes measured by gross receipts—the Ohio Commercial Activity Tax ("CAT") is just such a tax—is well-established. Specifically, in a line of decisions spanning 50 years and culminating with *Tyler Pipe Indus., Inc. v. Washington Dep't of Revenue*, 483 U.S. 232, 107 S.Ct. 2810, 97 L.Ed.2d 199 (1987), the Supreme Court has made clear that where a tax is measured by gross receipts:

> *the crucial factor* governing nexus is whether *the activities performed in this state on behalf of the taxpayer* are significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales.

(Internal citation omitted.) (Emphasis added.) *Tyler Pipe*, 483 U.S. at 250-251; *see* Merits Brief of Appellant Mason Companies, Inc. ("Applt. Br.") at 2, 25-30. Frederick Church, the Commissioner's witness on the history, structure, and purpose of the CAT, confirmed unequivocally that the CAT is the same type of tax as one at issue in *Tyler Pipe*. (Supp. 833 – 834, 837).

The Supreme Court has never overruled, limited, or even questioned the application of *Tyler Pipe* to taxes measured by gross receipts, and it continues to be applied by courts around the country. As a result, the "bright-line presence" provision of the CAT statute on which the

Commissioner relies is unconstitutional both on its face and as applied. This is so because, under the Commissioner's interpretation of R.C. 5751.01(I)(3), Mason must pay the CAT solely because it obtains $500,000 in gross receipts from sales to Ohio residents, and without regard to whether any activities are performed in the taxing state either directly or on Mason's behalf. If the Commissioner's position is upheld, a state statute will have eclipsed the Constitution and settled Supreme Court precedent.

Instead of acknowledging and grappling with the application of the *Tyler Pipe* standard to this case, the Commissioner and his *amici* instead rationalize that the $500,000 "bright-line presence" serves indirectly as an irrefutable "proxy" for an in-state presence, allowing them to presume conclusively the existence of undefined in-state activities even if the evidence contradicts that assumption. (Tax Commissioner's Merit Brief ("Commissioner Br.) at 4). Nor is there any definition for the term of art coined by the Commissioner for this concept—a so-called "substantial economic presence"—in the CAT statute, in any CAT regulations, in U.S. Supreme Court precedent, or in any of the briefs filed by the Commissioner and its *amici*. In truth, it is simply another way of stating that a company receives $500,000 or more in gross receipts from Ohio consumers, thus completing a chain of reasoning that is manifestly circular: "Mason has $500,000 in gross receipts from Ohio and therefore has a substantial economic presence in Ohio because it has $500,000 in gross receipts from Ohio."

What the Commissioner cannot, but must, admit is that the gross receipts threshold in the "$500,000 in sales equals significant economic presence equals Commerce Clause substantial nexus" is wholly arbitrary. There is no legal protocol or economic formula to explain how $500,000 was selected; no source for its selection; no explanation for why $500,000 was selected instead of $250,000 or $1,000,000; and certainly no decision of any court, state or federal, that invites (let alone establishes) such a trip-wire approach to Commerce Clause jurisprudence. It is but one state's legislative judgment addressing but a single state's concerns exported to the nation at large. It is neither fixed by the Constitution nor enacted by Congress pursuant to Congress' overarching Commerce Clause powers. In the end, the test embodies, at most, a lesser "minimum contacts" standard of jurisdiction that might be seen under the Due Process Clause of the U.S. Constitution perhaps, but not the different, and more exacting, "substantial nexus" standard of the Commerce Clause. *See Comptroller of the Treasury of Maryland v. Wynne*, __ U.S. __, 135 S.Ct. 1787, 1798-1799, 191 L.Ed.2d 813 (2015) ("the fact that a State has the jurisdictional power to impose a tax says nothing about whether that tax violates the Commerce Clause"). And although there are reasonable interpretations of the CAT statute that could avoid this unconstitutional gross receipts-only standard, the Commissioner refuses even to consider them, instead insisting on an interpretation of R.C. 5751.01(I)(3) that renders it unconstitutional, both on its face and as-applied to Mason.

In what can best be described as a diversionary tactic to sidestep *Tyler Pipe*, the Commissioner goes on at length about an alternative and amorphous theory of "virtual" presence that results solely from selling product over the Internet. It is not only a theory that sails on uncharted waters, it soon founders on the evidentiary record. In the end, the undisputed facts, confirmed by experts presented by *both* sides, is that Mason is the archetypal "plain vanilla" direct marketer who sells to a national marketplace from one location in Chippewa Falls, Wisconsin. It does nothing more than communicate with customers across the United States by mail, common carrier, via telephone, and over the Internet. Its communications originate in Wisconsin, are national in distribution, and are geographically agnostic. Mason neither owned nor leased property in Ohio; it had no one acting on its behalf in Ohio; and it did not use any third parties in Ohio for any purpose. (Applt. Br. at 8). In selling over the Internet, it is Mason's customers who reach out to the company to visit its Wisconsin-based web sites. They do so at the time of their choosing, entirely on their own terms, and using their own technology. (Applt. Br. at 9 – 13). For all of the Commissioner's reliance on hyperbole and jargon, the slender thread on which the Commissioner relies is to deem one modality of communication—the transmission of information in electronic form across the world wide web—to create an undefined "virtual equivalent of physicality" wherever that information is requested and received by a consumer. It is an argument that falls apart in the telling.

Indeed, the only thing clear about the Commissioner's amorphous and undefined "virtual presence" theory is that, if it is approved, its reach would be as far as the $500,000 in gross receipts threshold of the CAT—in other words, limitless. All fifty states and thousands of localities would, as a consequence of it being upheld, have tax authority over every company that sells online, whether or not it or its representatives perform any activities within their respective geographic areas. Such a theory of boundless and borderless taxing and regulatory authority would apply equally to Ohio companies doing business online and confronted with potential tax and regulatory requirements in other jurisdictions. Approval of the Commissioner's limitless nexus concept would lead quickly, as one of the Commissioner's supporting *amici* hope, to many jurisdictions—state and local—following suit. The resulting system would entangle Internet and other interstate sellers in a "welter of complicated obligations," unduly burdening interstate commerce in violation of the dormant Commerce Clause. *See Quill Corp. v. North Dakota,* 504 U.S. 298, 313 n.6, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992).[1]

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[1]It must also be noted that the Commissioner takes extreme liberty with the record in the service of his hyperbole about why Mason must be taxed. For example, he claims that Mason "physically placed tracking devices on users' computers in Ohio," an apparent reference to digital cookies, when the record is clear that Mason never used cookies to track anyone. (Commissioner's Br. at 6; Applt. Br. at 11). Rather, they were small bits of data that allowed users to add items for to their virtual shopping carts. (Applt. Br. at 11 – 12). He also states, falsely, that Mason "hired contractors who hosted Mason's web site, or parts thereof, on servers in Ohio." (Commissioner's Br. at 6). An apparent reference to a company called Akamai, the

Against this backdrop, it is imperative to recognize something the Commissioner fails even to mention: that, under the Commerce Clause, it is the role and prerogative of Congress—the federal body entrusted by the Framers with the regulation of interstate commerce—to strike the proper balance between the interest of states in seeking to impose tax obligations on companies doing business across state lines with the fundamental constitutional objective of a national marketplace free from overly burdensome state taxation. It is a balancing act that should play out on a national stage, not in local legislatures each weighing independently their need for revenue against the impact of their tax laws on the flow of interstate commerce. Only in this way can uniform standards create a level and predictable playing field. If sales level is determined to by Congress to be the *sine qua non* of tax jurisdiction, it can establish a uniform sales level standard, not a patchwork of different approaches which would inexorably result from fifty states (and thousands of localities) each with their own take on the subject. Indeed, federal legislation regarding the proper nexus standards to apply in the area of business activity taxes like the CAT, introduced by Ohio Representative Steve Chabot (R-OH), is currently pending before the House of Representatives. H.R. 2584, Business Activity Simplification Act of 2015 (114th Cong. 2015 – 2016).

Finally, while making a series of novel and unsupported arguments in defense of the CAT, the Commissioner never acknowledges that the constitutionality of the CAT's gross receipts "bright-line presence" provision has been in doubt from the time of its enactment. Indeed, the Ohio legislature specifically carved out the related section, R.C. 5751.01(H)(3), for independent constitutional review. According to Mr. Church, the Commissioner's CAT expert and historian, the legislature perceived the constitutionality of the

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trial testimony made clear that Mason only used Akamai to fend off international cyber-attacks, and not to store data. (Applt. Br. at 10).

$500,000 gross receipts standard of R.C. 5757.01(I)(3) as an open question for which it did not know the answer. (*See* Suppl. at 843, 844, 849). The Legislature, it thereby seems clear, viewed R.C. 5751.01(I)(3), as segregable from the remainder of the CAT statute and capable of independent evaluation and invalidation. R.C. 5751.31 (authorizing a targeted challenge to "bright line presence" standards only). Such a ruling would not render the remainder of the CAT ineffective. R.C. 1.50 ("If any provisions of a section of the Revised Code or the application thereof to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of the section or related sections which can be given effect without the invalid provision or application, and to this end the provisions are severable.").

II. LAW AND ARGUMENT
REPLY IN SUPPORT OF APPELLANT'S APPEAL:

> **Proposition of Law 1**: R.C. 5751.01(I)(3) is unconstitutional on its face. According to its plain terms, the gross receipts "bright-line presence" provision of R.C. 5751.01(I)(3) requires that the CAT be imposed on a company solely because the company meets a statutory threshold of $500,000 in annual gross receipts from interstate sales to Ohio consumers, irrespective of whether the company has the in-state presence required under the "substantial nexus" standard for state taxes established by the Supreme Court under the Commerce Clause. *E.g.*, *Tyler Pipe*, 483 U.S. at 250-251; *Commonwealth Edison*, 453 U.S. at 626; *Std. Pressed Steel*, 419 U.S. at 562; *Gen. Motors*, 377 U.S. at 447-448.

A. The Commissioner Mischaracterizes The Requirements Of A Facial Constitutional Challenge, All Of Which Appellant Satisfies.

The Commissioner asserts that Appellant advocates a "wholly new, unsupportable standard" for a facial constitutional challenge. (Commissioner Br. at 30). That assertion is incorrect. As demonstrated in Applt. Br. at 19 – 24, Appellant meets all of the requirements for a facial challenge. It is the Commissioner who falls short in his understanding of the standards applicable to a facial challenge.

To begin, the Commissioner omits the most basic rule of constitutional review. As this Court has made clear, a facial challenge requires the Court to review "only the text of the statute itself" without regard to any "extrinsic facts." *Global Knowledge Training, L.L.C. v. Levin*, 127

Ohio St.3d 34, 2010-Ohio-4411, 936 N.E.2d 463, ¶¶ 17, 18 (citing *Cleveland Gear Co. v. Limbach*, 35 Ohio St.3d 229, 231, 520 N.E.2d 188 (1988)). R.C. 5751.01(I)(3), as interpreted by the Commissioner and the Board of Tax Appeals, imposes the CAT based *solely* on a company making annual sales of at least $500,000 of tangible goods.[2] Appellant contends, without reference to any outside facts, that R.C. 5751.01(I)(3), so construed, violates the in-state activity requirement of "substantial nexus" established by the *Tyler Pipe* line of cases.

Ignoring the straightforward nature of this challenge, the Commissioner fixates on the "no set of circumstances" test of *United States v. Salerno*, 481 U.S. 739, 745, 107 S.Ct. 2095, 95 L.Ed.2d 697 (1987), which has been applied to certain facial challenges. The Commissioner fails to acknowledge, however, that neither the U.S. Supreme Court nor this Court has ever applied the *Salerno* test in a dormant Commerce Clause case. (Applt. Br. at 21-23).[3] Nor does the Commissioner distinguish, or otherwise offer any response to, the cases cited by Appellant in which both this Court and the Supreme Court have declined to apply the *Salerno* standard to a Commerce Clause challenge. *See Columbia Gas Transm. Corp. v. Levin*, 117 Ohio St.3d 122, 2008-Ohio-511, 882 N.E.2d 400, ¶¶ 43, 53-78 (not applying *Salerno* to a Commerce Clause claim after applying it to a Due Process claim); *Emerson Elec. Co. v. Tracy*, 90 Ohio St.3d 157, 159-160 735 N.E.2d 445 (2000) (not applying *Salerno* to a Foreign Commerce Clause claim); *Kraft Gen. Foods, Inc. v. Iowa Dept. of Revenue and Fin.*, 505 U.S. 71, 82–83, 112 S.Ct. 2365, 120 L.Ed.2d 59 (1992) (Rehnquist, J. dissenting) (arguing that the Court should have applied *Salerno* to a foreign Commerce Clause claim).

[2]As discussed in Proposition of Law 3, Section A, *infra*, it is the Commissioner who argues that the only possible interpretation of R.C. 5751.01(I)(3) is that it applies regardless of whether the company engages in any activity in Ohio.

[3]The decisions of this Court in *Wymsylo v. Bartec, Inc.*, 132 Ohio St.3d 167, 2012-Ohio-2187, 970 N.E.2d 898, and *Arbino v. Johnson & Johnson*, 116 Ohio St.3d 468, 2007-Ohio-694, 880 N.E.2d 420 (Commissioner Br. at 28), did not involve a Commerce Clause challenge .

This is not to say, however, that *Salerno* is no longer good law. Rather, Appellant contends (1) that the "no set of circumstances" test adds little to the analysis of a true facial challenge under the dormant Commerce Clause, which simply requires evaluating the plain language of a statute—*e.g.*, a provision making gross receipts of $500,000, alone, the basis for CAT liability—against constitutional requirements, and (2) that this test is a poor fit for dormant Commerce Clause cases, in particular.[4] In a long line of cases, including most recently in

[4]The Commissioner cites cases from other jurisdictions which cited *Salerno* in the context of Commerce Clause challenge, but they are distinguishable and only serve to make Appellant's point. *See* Commissioner Br. at 28-29. First, the Commissioner cites a series of federal court cases in which the *Salerno* standard was applied to challenges alleging that *federal* statutes were inconsistent with Congress's power under the affirmative Commerce Clause, not cases involving a challenge to a state statute under the dormant Commerce Clause. *See, e.g., United States v. Trent*, 2008 WL 2897089, at *5 (S.D. Ohio July 24, 2008) (challenge to federal sex offender registry statute); *Rancho Viejo, LLC v. Norton*, 323 F.3d 1062, 1077-78 (D.C. Cir.2003) (challenge to federal Endangered Species Act); (federal child support recovery act); *United States v. Van Buren*, 599 F.3d 170 (2d Cir. 2010) (federal sex offender registry statue); *United States v. Sage*, 92 F.3d 101, 106 (2d Cir. 1996) (Child Support Recovery Act of 1992). Challenges to federal statutes typically involve plaintiffs who hypothesize facts which they claim demonstrate that Congress exceeded its authority to regulate based on the Commerce Clause. Such challenges are summarily rejected under *Salerno*. *See, e.g., Sage*, 92 F.3d at 106 ("We therefore need not address Sage's claim that the Act might be invalid in one highly improbable scenario.") Dormant Commerce Clause analysis is entirely different, calling upon the court to evaluate the express requirements of a state statute against the *Complete Auto* factors to determine if the law presents a danger of unduly burdening interstate commerce. Indeed, here, there is only one factual situation at issue, and but one question: Do sales alone establish the substantial nexus required under the Commerce Clause?

The remaining cases cited by the Commissioner (Commissioner Br. at 28-29) further illustrate the limitations of the *Salerno* test in dormant Commerce Clause analyses. In *Gov't Suppliers Consolidating Servs., Inc. v. Bayh*, 975 F.2d 1267 (7th Cir. 1992), the Seventh Circuit set forth the *Salerno* standard, but then proceeded to apply Commerce Clause standards to the plain terms of the statute, finding the law to be facially unconstitutional. *Id.* at 1283-85 (applying the *Complete Auto* factors and the "compensatory tax doctrine"). Likewise, the New York Court of Appeals, citing *Salerno* in *Moran Towing Corp. v. Urbach*, 99 N.Y.2d 443, 787 N.E.2d 624, 757 N.Y.S.2d 513 (2003) and *Overstock.com, Inc. v. New York State Dept. of Taxation & Fin.*, 20 N.Y.3d 586, 987 N.E.2d 621, 965 N.Y.S.2d 61 (2013), nevertheless properly determines the constitutionality of the statute without resort to an external set of facts. *See Overstock.com, Inc.*, 20 N.Y.3d at 595 ("We are bound, and adjudicate this controversy, under the binding precedents of [the U.S. Supreme] Court, the ultimate arbiter of the meaning of the Commerce Clause."). Finally, the New Jersey Supreme Court, after noting the controversy

Comptroller of the Treasury of Maryland v. Wynne, 135 S.Ct. at 1801-1805 (*see* Applt. Br. at 22), the U.S. Supreme Court has never applied *Salerno* to a facial challenge brought against a state statute under the dormant Commerce Clause. This is so because *Salerno* cannot supplant the review of a statute's plain terms under *Tyler Pipe's* "substantial nexus" standard.

Indeed, the Commissioner himself is guilty of misapplying *Salerno*. In arguing that the *Salerno* standard defeats Appellant's challenge, the Commissioner asserts that the gross receipts "bright-line presence" provision of R.C. 5751.01(I)(3) can be constitutionally applied to a company having "brick and mortar retail establishments" in Ohio. (Commissioner Br. at 29 – 30). This purported constitutional "application" of R.C. 5751.01(I)(3) is not properly an application of the relevant statutory provision at all. A brick-and-mortar retailer is obligated to report and pay the CAT based on multiple *other provisions* of the CAT statute, *not* as a result of the "application" of the gross receipts "bright-line presence" provision at issue here. *See, e.g.*, R.C. 5751.01(H)(1) (statutory "substantial nexus" through owning capital in the state), (H)(2) (statutory "substantial nexus" by having a certificate to do business in the state), (I)(1) (statutory "bright-line presence" through property of at least $50,000 in the state), (I)(4) (statutory "bright-line presence" by having at least 25% of all property, payroll, and receipts in the state). Appellant's challenge asserts that the requirement on the face of the statute that a company must pay CAT based *solely* on gross receipts from Ohio customers of at least $500,000, without regard to any in-state activities, violates the *Tyler Pipe* substantial nexus standard. Appellant need not go beyond the face of the statute.

The Commissioner compounds his error by failing to address the Supreme Court's most recent guidance regarding facial challenges. Last term, in *City of Los Angeles v. Patel*, __ U.S.

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surrounding *Salerno*, construed the state statute at issue in *Whirlpool Properties, Inc. v. Dir., Div. of Taxation*, 208 N.J. 141, 26 A.3d 446 (2011), without applying *Salerno. Id.* at 466-468.

__, 135 S.Ct. 2443, 2451, 192 L.Ed 435 (2015), the Court rejected an argument similar to the one advanced by the Commissioner here:

> Moreover, the City's argument *misunderstands how courts analyze facial challenges*. Under the most exacting standard the Court has prescribed for facial challenges, a plaintiff must establish that a law is unconstitutional in all of its applications. *Washington State Grange v. Washington State Republican Party*, 552 U.S. 442, 449, 128 S.Ct. 1184, 170 L.Ed.2d 151 (2008). But when assessing whether a statute meets this standard, the Court has considered only applications of the statute in which it actually authorizes or prohibits conduct. *** *The proper focus of the constitutional inquiry is the group for whom the law is a restriction, not the group for whom the law is irrelevant*.

(Emphasis added.) (Citation omitted.) Hypothesizing a retailer that is obligated to pay the CAT for reasons other than its sales level cannot defeat a facial challenge to the plain terms of R.C. 5751.01(I)(3).

B. The CAT Is A Tax Measured By Gross Receipts, Not A Sales Tax Or An Income Tax.

It is important to note from the outset that the CAT is levied on "each person * * * for the privilege of doing business in this state" and is measured by gross receipts. R.C. 5751.02(A); *Ohio Grocers Assn. v. Levin*, 123 Ohio St.3d 303, 2009-Ohio-4872, ¶¶ 43-49. The statute further makes clear that the CAT "is not a transactional tax and is not [a tax on net income] subject to Public Law No. 86-272." (Brackets added) *Id.; see* 15 U.S.C. § 381 (limiting authority of states to impose corporate net income taxes in accordance with P.L. 86-272). This Court held in *Ohio Grocers* that the CAT is not a sales tax. 2009-Ohio-4872, ¶¶ 50. The testimony of the Department official responsible for advocating enactment of the CAT in 2005, Frederick Church, confirmed that the CAT is neither an income tax nor a sales tax, but is a tax measured by gross receipts. (Suppl. at 833, 834, 837 (the CAT is the same kind of tax as the business and occupation tax at issue in *Tyler Pipe*, and is not an income tax)).

C. The *Tyler Pipe,* In-State Activities Standard Of "Substantial Nexus" Renders The CAT's Gross Receipts "Bright-Line Presence" Provision Unconstitutional.

The Supreme Court's development of the in-state activities standard of substantial nexus under the Commerce Clause, for taxes like the CAT, occurred in connection with its recurring review of the Washington Business and Occupation ("B&O") Tax.[5] In its Merit Brief, Appellant traced the development of the in-state activities requirement of substantial nexus for state taxes measured by gross receipts through a series of cases, beginning in 1956 and continuing through the U.S. Supreme Court's landmark 1987 decision in *Tyler Pipe.* The Commissioner in his brief fails to confront the central issue: that the Supreme Court has never overruled, limited, or questioned the principle set forth in *Tyler Pipe* and prior cases.

In *Field Ents., Inc. v. Washington,* 352 U.S. 806, 77 S.Ct. 55, 1 L.Ed. 2d 39 (1956) (*per curiam*), *aff'ing Field Ents. v. Washington,* 47 Wash.2d 852, 289 P.2d 1010 (1955), the Supreme Court affirmed, *per curiam*, a ruling of Washington's highest court upholding the constitutionality of the B&O Tax as applied to the gross receipts of a publisher headquartered in Illinois, but engaged in substantial business activities in the state. *See* 47 Wash.2d at 856 (company's in-state office, managers, office employees and 175 salespeople in Washington were "decisive factors in establishing and holding the market in this state for its publications."), *aff'd* 352 U.S. 806 (citing *Norton Co. v. Dept. of Revenue of Illinois,* 340 U.S. 534, 71 S.Ct. 377, 95 L.Ed. 517 (1951)).

The Court reviewed again the constitutionality of the B&O Tax in *Gen. Motors Corp. v. Washington*, 377 U.S. 436, 447-448, 84 S.Ct. 1564, 12 L.Ed.2d 430 (1964), *overruled, in part, on other grounds, Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue,* 483 U.S. 232

[5]Like the CAT, the B&O Tax is imposed on the privilege of engaging in business activities in the state and is measured by gross receipts. *Tyler Pipe,* 483 U.S. at 234-35 (*citing* Wash.Rev.Code § 82.04.220 (1985)).

(1987). The decision in *General Motors* is significant because it formed part of the basis for *Complete Auto*'s four-pronged Commerce Clause test. *See Complete Auto*, 430 U.S at 279 and n.8. The Court in *General Motors* emphasized that for a non-domiciliary company, "we look to the taxpayer's business activities within the State" to determine the constitutionality of the tax. *General Motors*, 377 U.S. at 447-448; (Applt. Br. at 27 – 28).

The B&O Tax was again challenged in 1975. *Std. Pressed Steel Co. v. Washington Dept. of Revenue*, 419 U.S. 560, 95 S.Ct. 706, 42 L.Ed.2d 719 (1975). The Court found that a company based in Pennsylvania with an office in California had nexus through the in-state activities of a Washington employee whose in-state work "made possible the realization and continuance of valuable contractual relations" for the company. 419 U.S. at 562 – 563.

After the Supreme Court issued its opinion in *Complete Auto* confirming "substantial nexus" as a requirement for the constitutionality of all state taxes (*see* 430 U.S. at 279 and n. 8), the Court decided *Dept. of Revenue v. Assn. of Washington Stevedoring Cos.*, 435 U.S. 734, 750, 98 S.Ct. 1388, 55 L.Ed.2d 682 (1978). In upholding the B&O Tax, the Court recited the four requirements for state taxes under *Complete Auto* and the cases upon which it relied, including *General Motors.* 435 U.S. at 750. Explaining how each requirement was satisfied, the Court noted the "obvious nexus between Washington and respondents; indeed, respondents conduct their entire stevedoring operations within the State." *Id.*

In 1987, the Court capped its review of the B&O Tax in *Tyler Pipe.* 483 U.S. 232. The out-of-state company challenging the tax had no presence of its own in Washington, but retained an independent contractor in the state which employed multiple salespeople who "acted daily on behalf of Tyler Pipe in calling on its customers and soliciting orders." *Id.* at 250. Although the Commissioner tries in his brief to minimize the level of in-state presence deemed sufficient by the Supreme Court to support the gross receipts tax in *Tyler Pipe* (*see* Commissioner Br. at 5), the Court emphasized that "[t]he activities of Tyler Pipe's agents in Washington have been substantial." 483 U.S. at 249 – 250. Furthermore, despite the Court's finding that the company sold a "large volume of cast iron, pressure and plastic pipe and fittings, and drainage products" in the state, 483 U.S. at 249, the Court focused not on sales levels or gross receipts, but on the company's in-state presence (not the volume of its sales) as the "crucial factor" in establishing "substantial nexus" for a tax measured by gross receipts 483 U.S. at 250 – 251.

The Commerce Clause substantial nexus requirement that a company must engage in activities in the state—directly or by persons acting on its behalf—remains the law of the land. The Supreme Court has neither overruled *Tyler Pipe* nor ever questioned its holding. Indeed, in 1992, the Court cited *Tyler Pipe* (and *Std. Pressed Steel*) with approval in *Quill,* 504 U.S. at 313, n.7, and 314. Lower courts continue to cite and apply *Tyler Pipe.* (*See* Applt. Br.at 29 – 30). (collecting cases); *see also Avnet, Inc. v. Washington Dep't of Revenue*, 187 Wash. App. 427, 442 – 443, 348 P.3d 1273, 1280 (2015) (B&O Tax) ("to establish nexus, the instate activities of an out-of-state company must be substantial") (Citation omitted)).

There is no decision, by the U.S. Supreme Court or any other court, in which a state gross receipts tax assessment has been sustained against a company that, like Appellant, engaged in no activities in a state, either directly or through a third-party.

D. The Commissioner's Proposed Justifications For The Gross Receipts, "Bright-Line Presence" Provision Of The CAT Statute Must Be Rejected.

1. <u>The Commissioner Cannot Circumvent Established Limits On State Taxing Power Under The Commerce Clause By Declaring That Gross Receipts Of A Certain Level Show, By Proxy, An Undefined "Substantial Economic Presence" In Ohio.</u>

Relying on the testimony of Frederick Church, the Department of Taxation official who advocated adoption of the CAT in 2005, the Commissioner asserts that the $500,000 gross receipts "bright-line presence" standard of the CAT represents a "proxy" or "measuring stick" for a taxpayer's assumed in-state activities. (Commissioner Br. at 4, 35).[6] The Commissioner further claims that there is a "growing recognition that a significant economic presence in the forum state is an indicator of substantial business activity in the state, sufficient for dormant Commerce Clause purposes." (*Id.* at 4). Not only do these self-serving claims have no support in the law, the Commissioner's definition of "economic presence" is circular and simply means that a company has crossed the $500,000 sales threshold, nothing more.

First, the Commissioner's theories are fundamentally at odds with *Tyler Pipe*. A company can make sales to in-state customers with or without engaging in activities—directly, or through third-parties—in a state. Indeed, although the Court noted that the company made substantial sales in the state, 483 U.S. at 249, the Court emphasized that in-state activities of its representatives, not sales levels, were the "crucial factor" in determining substantial nexus. *Id.* at 250 – 251.

The Commissioner claims that his "proxy" theory reflects a "modern trend," but he cites no case, at any level, that endorsed the concept of gross receipts as a "proxy" for in-state activity. There is no such case. Indeed, none of the corporate income tax cases cited by the Commissioner or his supporting *amici* endorse this sales-level "proxy" theory of nexus, and none concern a statutory nexus provision based on gross receipts. The absence of such authority is understandable. Since merely making interstate sales and therefore realizing gross receipts does not alone establish state taxing authority, a state may not magically imbue the receipts with some greater significance by deeming them a "proxy" for something else. Actual evidence of more—

[6]Although the Commissioner repeatedly cites to Mr. Church's testimony as if Appellant stipulated to the statements made by Mr. Church, it is important to note that Appellant did not stipulate to the accuracy or relevance of Mr. Church's testimony, only that it could be admitted before the Board in lieu of requiring Mr. Church to testify, again, to the same matters on which he was examined, and vigorously cross-examined, in an earlier proceeding.

namely, in-state activities by or on behalf of the out-of-state company—is required. Here, Appellant has affirmatively disproved any such in-state activity.

Moreover, the $500,000 level of gross receipts that the Commissioner claims is a "proxy" or "measuring stick" for assumed in-state activities is nothing more than subjective legislative judgment with no particular significance other than the fact that it was chosen as a tax liability cut-off, and with no guarantee that it will remain static over time because it is tethered only to a given legislature's abstract judgment. A different state or locality might set the threshold at a lower or higher level. For example, Washington recently adopted a threshold of $267,000 for imposing the B&O Tax on out-of-state wholesalers making sales into the state. *See* "New Nexus Standard for Wholesale Sales – Effective Sept. 1, 2015," http://dor.wa.gov/content/getaformorpublication/publicationbysubject/taxtopics/nexusstandards.aspx. There certainly is nothing in the Constitution or decisions of the Supreme Court that provides any guidance as whether $5,000, $500,000, or $500,000,000, for that matter, constitutes a Commerce Clause proxy for in-state activities. Indeed, such an approach is entirely alien to Commerce Clause jurisprudence for a simple reason: If receipts, which are the very object and substance of all interstate commerce, are, without more, a basis for asserting state tax authority, then the dormant Commerce Clause would impose no limits at all.[7]

[7]The Commissioner defends his imposition of the CAT on retailers engaged in no in-state activities by reciting the familiar principle that the purpose of the Commerce Clause was not to relieve businesses engaged in interstate commerce from paying their "just share of the state tax burden." Commissioner's Brief at 33 (*citing Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938)). Such a truism does not meaningfully advance the analysis. Instead, it is a principle that the U.S. Supreme Court took into consideration when fashioning the four-part test in *Complete Auto*, not a separate rule of decision. Indeed, the Supreme Court cited the concept that interstate commerce must "pay its way" in *Quill*, only to then find that the state lacked the authority to impose a use tax collection obligation on retailers with no physical presence in the state under the substantial nexus requirement. *Quill*, 504 U.S. at 310 n. 5.

Nor is the judicial branch in a position to make quasi-legislative distinctions about what gross receipts level would cause a business to "cross the line" from constitutionally-protected (according to the Commissioner, gross receipts $499,999.99 or less) to fair game ($500,000 or greater).[8] Indeed, if there were some constitutional "de minimis" floor, at what level would it be set and on what principled basis? Is it the same for all businesses, or does it vary according to the nature of the business?[9]

Allowing states and localities to set individual sales thresholds—and, necessarily, to adjust them as they choose—would, of course, render business planning for companies engaged in interstate commerce impossible. Although the Commissioner argues that the principal virtue of the $500,000 "bright line" provision of the CAT statute is that it gives businesses "certainty," the patchwork state-by-state approach that would follow would have the opposite effect for companies selling to a national market. The Commissioner simply ignores the fact that a

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[8]The Commissioner suggests that the CAT's gross receipts "bright-line presence" provision is also a proxy for the degree to which a business benefits from government services, systems and infrastructure. *See* Commissioner Br. at 34-36. This claim suffers from the same problems that undercut his "proxy" theory of nexus. Moreover, the degree to which an out-of-state company's tax obligations correspond to government services is the subject of a different part of the *Complete Auto* test, *i.e.*, the "fair relation" test, which is not at issue here. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 199-200, 115 S.C.t 1331, 131 L.Ed.2d 261 (1995) ("the Commerce Clause demands a fair relation between a tax and the benefits conferred upon the taxpayer by the State").

[9]It takes only a moment's reflection to recognize that the gross receipts amount is *not* a valid "proxy" for even the level of sales and marketing activity of a business, let alone for the supposed level of in-state business activity or use of the state's infrastructure, facilities, or services. A foreign boat builder that makes a single sale of over $500,000 to an Ohio customer is subject to the CAT in the same manner as an in-state landlord of multiple properties bringing in rents of over $500,000, or a mail order retailer that sends 25,000 bumper stickers to customers making purchases of $20 each. The artificiality of the sales threshold constitutional proxy rule becomes apparent for mail order and Internet sellers who often make most of their sales during the winter holiday season. They might not know if they are subject to the CAT until the very end of the year if sales reach $500,000. And, even if they reach that level, their statutory "substantial nexus" would be eliminated retroactively under the CAT statute if consumers return sufficient products in January bring the retailer below the $500,000 level for the previous calendar year.

different threshold could apply in *every jurisdiction* having a gross receipts tax, and that those thresholds could change at the whims of each new legislature, city council, or board of county commissioners.

Indeed, the glaring flaw in the "sales level equals substantial economic nexus equals substantial nexus" standard more generally is that, by eliminating the in-state activities requirement, the Commissioner's theory becomes interchangeable with lesser "minimum contacts" analysis under the Due Process Clause. The Supreme Court has, however, made crystal clear that the Commerce Clause substantial nexus requirement is different from, and more exacting than, the minimum contacts analysis. *Wynne*, 135 S.Ct. at 1798 (while a State may, consistent with the Due Process Clause, have the authority to tax a particular taxpayer, imposition of the tax may nonetheless violate the Commerce Clause."); *Quill*, 504 U.S. at 305, 313 and n. 7 ("a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause"). Neither the Commissioner's opposition nor the briefs of its *amici* address these different standards under the separate provisions of the Constitution, despite Appellant underscoring the differences in his brief. (Applt. Br. at 38 – 40).[10]

2. <u>The State Corporate Income Tax Cases Relied Upon By The Commissioner Are Inapplicable And Their Reasoning Flawed.</u>

The Commissioner rests his sales proxy constitutional presence standard on a group of state court decisions concerning corporate income taxes that, in turn, rely largely on the West Virginia Supreme Court's decision in *Tax Commr. v. MBNA Am, Bank, N.A.*, 220 W.Va. 163, 640 S.E.2d 226 (2006). Because the *MBNA* decision and its progeny concern state income taxes

[10]The Court in *Quill* expressly rejected the "economic presence" test as sufficient to meet the requirements of the Commerce Clause for state use taxes. *Id.* at 304, 311-312.

not subject to the *Tyler Pipe* standard, Appellant respectfully submits that they are inapposite. More importantly, the analysis in *MBNA* is fundamentally flawed.

As the dissent in *MBNA* itself observed, "[t]here is no precedential support whatsoever for the conclusions reached by the majority decision. None. None at the state level. None at the federal level." 220 W.Va. at 174 (Benjamin, J., dissenting). Indeed, the majority opinion in *MBNA* demonstrates that the West Virginia court chose expressly to disregard existing precedents and blaze entirely new Commerce Clause territory. The court explained that, as a result of "staggering evolution in commerce from the Framers' time up through today," it would take its own "fresh application of Commerce Clause principles tempered with healthy doses of fairness and common sense." 220 W.Va. at 173. The creative license taken by West Virginia and other state courts following suit in income tax cases[11] conflicts with Commerce Clause precedent, but more importantly is an undertaking that *Tyler Pipe* does not permit. The U.S. Supreme Court has already established the standard for taxes measured by gross receipts.

Moreover, as demonstrated in the Appellant's opening brief, most of the income tax cases relied upon by the Commissioner and the *amici*[12] rest on the position that the *Quill* physical

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[11]For example, in *KFC Corp. v. Iowa Dept. of Revenue,* 792 N.W.2d 308 (Iowa 2010), the Iowa Supreme Court, in finding that the licensing of trademarks by an out-of-state business for use in the state by a related entity was sufficient to establish nexus for corporate income tax purposes, explained that it was striving "simply to do our best to predict how the Supreme Court would decide the issues presented in this case." *Id.* at 323. In this case, the proper standard of nexus for a gross receipts tax case has already been decided by the Court in *Tyler Pipe*.

[12]In *Scioto Ins. Co. v. Oklahoma Tax Comm'n*, 279 P.3d 782, 2012 OK 41(Okla. 2012), cited by the Commissioner, the Court *rejected* the application of the state's corporate income tax to an out of-state company, finding that "due process is offended by Oklahoma's attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer * * * who has a bona fide obligation to do so under a contract not made in Oklahoma." (Citing *Quill*). *Id.* at 784. Likewise, in another case cited by Commissioner, *In re Washington Mut., Inc.*, 485 B.R. 510 (Bankr.D.Del. 2012), the court found that application of the Oregon corporate income tax to certain dividend payments, based solely on the use of intellectual property in the state, would have "devastating consequences to

presence standard should not be "extended" to corporate income taxes, given that the U.S. Supreme Court has never explicitly framed a "substantial nexus" test for income taxes. As discussed *supra* in Section B, however, the CAT is not an income tax, but a tax measured by gross receipts, and the Supreme Court has spoken on such taxes. As previously explained, *Tyler Pipe* reflects the controlling in-state activities standard for taxes measured by gross receipts. As the Washington Court of Appeals recently confirmed, in order to establish substantial nexus for a tax measured by gross receipts, "*the instate activities of an out-of-state company must be substantial*" and must be "associated with the company's ability to establish and maintain the company's market within the state." *Avnet, Inc.*, 187 Wash. App. at 442-43, 348 P.3d at 1280 (Citation omitted).

For the same reasons, the Commissioner's reliance on *Couchot v. State Lottery Comm.*, 74 Ohio St.3d 417, 659 N.E.2d 1225 (1996), is misplaced. (Commissioner Br. at 47 – 48). *Couchot* concerned an assessment of personal income taxes, not a tax measured by gross receipts. The Court's statement, in *dicta*, that the physical presence rule of *Quill* does not extend to a state income tax has no bearing on this case. *Couchot*, 74 Ohio St.3d at 425.

We also note that most of the state corporate income tax cases relied upon by the Commissioner and the *amici* present a materially different factual scenarios. Beginning with *Geoffrey, Inc. v. South Carolina Tax Comm.*, 313 S.C. 15, 437 S.E.2d 13 (1993), state supreme courts have reviewed corporate trademark holding company structures used as a tax avoidance strategy to shift otherwise taxable in-state income to a related entity located outside of the state. *See e.g., KFC Corp.,* 792 N.W.2d at 310; *Geoffrey, Inc. v. Commissioner of Revenue*, 453 Mass. 17, 899 N.E.2d 87 (2009); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 167 N.C. App. 150,

shareholders and to the United States economy" and concluded that the company receiving the dividends did not have substantial nexus with the state. *Id.* at 521.

605 S.E.2d 187 (2004). In these corporate income tax cases, in-state licensees of the out-of-state trademark owner paid royalties for the use of the marks and displayed them on stores and signage within the state. *E.g., A&F Trademark,* 167 N.C. App. At 162; *Geoffrey,* 453 Mass. at 24. Thus, although the out-of-state company trademark holding company/licensor had no presence of its own in the state, it earned income from the in-state use of its trademarks under a contract with a related party that not only allowed it to control the in-state use of the marks, but also provided for payments to the company based on revenue generated by the related company's in-state sales. *See, e.g., Kmart Corp. v. New Mexico Taxation & Revenue Dept.*, , 139 N.M. 177, 188, 131 P.3d 17, 2006-NMCA-026 (2002) ("As the Department argues, the record below supports a conclusion that Kmart Corporation used its stores and employees in New Mexico as local representatives of KPI's goodwill, under a licensing agreement with KPI, to promote both its own sales and the goodwill of KPI's marks."), *rev'd in part and cert. quashed in part, Kmart Corp. v. Taxation & Revenue Dept.*, 2006-NMSC-006, 139 N.M. 172, 131 P.3d 22 (2005); *see also In re Washington Mutual Corp.*, 485 B.R. at 521 ("The majority of courts to address this issue, however, have found a substantial nexus for Commerce Clause purposes only when the intangible property itself generated income for the taxpayer.").[13]

[13]The fact that the U.S. Supreme Court denied a petition for *certiorari* in one or more of the inapposite state income tax cases cited by the Commissioner and the *amici* is, of course, of no import since "denial of a writ of *certiorari* imports no expression of opinion upon the merits of the case." *Teague v*. Lane, 489 U.S. 288, 296, 109 S.Ct. 1060, 103 L.Ed.2d 334 (1989) (collecting cases). While denials of *certiorari* carry no precedential weight, the Court's decisions in *Tyler Pipe* and other B & O and related gross receipts tax cases *are* controlling precedent.

E. The Commissioner's Use Of The Supreme Court's *Quill* Decision As A "Straw Man" Fails.

While failing even to address the application of the *Tyler Pipe* standard, the Commissioner and his *amici* mount an assault on the Supreme Court's decision in *Quill,* armed, again, with inapplicable state income tax cases. This quixotic endeavor is futile.

First, the significance of *Quill* to this appeal is not that it is controlling authority. Mason has never argued that it is. Rather, the "physical presence" standard of substantial nexus reaffirmed by the Court in *Quill* parallels, but does not supplant, the *Tyler Pipe* standard of in-state activities for state taxes measured by gross receipts. As explained in Appellant's Merit Brief, the U.S. Supreme Court's gross receipts tax precedents and sales/use tax precedents, while articulated differently, nonetheless inform one another with regard to the substantial nexus requirement of the Commerce Clause. For example, the Court in *Tyler Pipe* relies on two leading sales/use tax cases for its conclusion that that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are associated with the taxpayer's ability to make and maintain a market in this state for the sales." 483 U.S. at 250 (citing, for example, *Scripto, Inc. v. Carson,* 362 U.S. 207, 80 S.Ct. 619, 4 L.Ed.2d 660 (1960), which like *Tyler Pipe* involved sales representatives operating in the state). Similarly, in *Quill,* the Court cited and relied upon four of its earlier decisions involving state taxes measured by gross receipts. *See Quill,* 504 U.S. at 311 (identifying *Goldberg* and *Commonwealth Edison* as continuing the *National Bellas Hess* line of cases) and 314 (citing *Std. Pressed Steel* and *Tyler Pipe* as cases involving taxpayers who had a physical presence). In short, *Quill* does not dictate the outcome in this case—*Tyler Pipe* does—though *Quill* strongly supports it.

Second, the Commerce Clause principles which inform the Supreme Court's decision in *Quill* are fully applicable here. As discussed in Section G, *infra*, there is a substantial risk that numerous other jurisdictions will adopt a gross receipts nexus standard if the CAT "bright-line presence" provision of R.C. 5751.01(I)(3), or the Commissioner's "sales equals substantial economic presence equals substantial nexus" theory (or other novel theories), are adopted here. These sweeping nexus theories create the real prospect that interstate sellers will be required to comply with gross receipts taxes in the dozens of state and local jurisdictions that already have such taxes, and the many thousands more jurisdictions that may follow suit. Internet and other interstate sellers with no connection to a jurisdiction (other than customers) would then be potentially required to comply with a myriad of gross receipts taxes having different and varying rates, seller classifications, exemptions, reporting obligations, filing frequencies, and record-keeping obligations. Such an expansion of state and local taxing authority would have a dramatic impact on remote sellers in every state, including Ohio.

Indeed, because gross receipts taxes fall directly on the seller and are not (like sales taxes) collected from the customer, sellers would have incentives to segregate their markets depending upon the cost of the tax and compliance burdens in various jurisdictions. Interstate commerce would be stifled and divided, resulting in the very kinds of undue burdens that the Commerce Clause is designed to prevent. *Quill*, 504 U.S. at 313 n.6.[14] Adherence to a clear rule, although it may appear "artificial at its edges," as the *Quill* court noted, is "more than offset by the benefits of" a rule that "firmly establishes the boundaries of legitimate state authority"—a limitation that Congress has the power and the ability to change in weighing the relative benefits

[14]The Commissioner's statement that "for more than 20 years state courts have sustained the validity of generally applicable privilege of doing business taxes on out-of-state retailers regardless of physical presence," (Commissioner Br. at 49), is not only inaccurate but more importantly misses the point. The U.S. Supreme Court in the *Tyler Pipe* line of cases has established an in-state business activity requirement as a limitation on state power to impose taxes measured by gross receipts. Thus, the "settled expectations" of Internet sellers, contrary to the Commissioner's claim, have not changed.

and burdens. *Id*. at 315 – 318. The same is true with regard to business activity taxes measured by gross receipts.

F. The Commissioner's Argument That, Under *Tyler Pipe*, In-State Activities By, Or On Behalf Of, The Taxpayer Are "Sufficient But Not Necessary" For Substantial Nexus Is At Odds With The Court's Ruling In *Tyler Pipe* Itself And Other Court Decisions.

The Commissioner attempts, in passing, to minimize the in-state activities requirement of *Tyler Pipe*, but his contention fails. The Commissioner asserts that the Court in *Tyler Pipe* "held that the in-state activities of one independent contractor was *sufficient* for non-sales tax nexus, but made no assertion that a physical presence was *necessary* for non-sales tax nexus." (Emphasis sic.) (Commissioner Br. at 38). The Commissioner's "sufficient but not necessary" argument is refuted by *Tyler Pipe* itself, which found that the "crucial factor governing nexus" was the performance of in-state activities on behalf of the company that assisted it to make and maintain a market for sales in the state. 483 U.S. at 250 – 251.

While the language used by the Court emphasizes that the in-state activities performed by Tyler Pipe's multiple sales representatives in the state were the "crucial" element of substantial nexus, the circumstances of the case leave no doubt. Tyler Pipe, itself, had no direct presence in the state through offices, property or employees. As the Court noted, however, the company had a substantial market for sales of cast iron, pressure and plastic pipe and fittings, and drainage products in the state. *Id.* at 249. The Court nevertheless held that the "crucial factor" in establishing the necessary substantial nexus to sustain the constitutionality of the state's gross receipts tax was the performance of substantial in-state activities on the company's behalf by representatives of the company operating *in the state*. Of course, if in-state business activities had not been required, the Court could have readily deflected the company's constitutional challenge—which was premised on a lack of sufficient presence in the state (*see id.* at 240 ("[w]e then consider Tyler's claims that its activities in the State of Washington are not sufficient to subject it to the State's taxing jurisdiction"))—by simply holding that the company's substantial sales in the state were constitutionally sufficient without regard to any in-state activities.[15]

The Court's reliance in *Tyler Pipe* on in-state activities is consistent with the series of earlier cases that likewise emphasized in-state activities as the basis for the substantial nexus prong in the area of gross receipts taxes. Most notable among those decisions is *General Motors*, where the Court reviewed a tax imposed upon a large corporation with a massive interstate business (and sales levels), and held that its "local incidents were sufficient to form the basis for the levy of a tax that would not run contrary to the Constitution." 377 U.S. at 447 – 448. *See* also *Norton Co. v. Dept. of Revenue*, 340 U.S. 534, 537 (1951) (state lacks authority to impose gross receipts tax on company with no "local incident" in the state).

The reasons for the in-state activities requirement run deep within the Commerce Clause itself. The taxing power of the States must have limits, lest interstate commerce be substantially curtailed. The substantial nexus requirement is part of the test devised by the Supreme Court to avoid such undue burdens on interstate commerce, pending Congressional action otherwise. *See Quill*, 504 U.S. at 313, 318. Making sales to customers in a state is not enough. Successfully engaging in interstate commerce and growing a market in a state is not enough. If it were, then every company with the good fortune to sell across state lines would be exposed to the varying tax obligations of potentially thousands of different jurisdictions around the country. Commerce alone cannot be the basis for state taxing and regulatory power under the dormant Commerce

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[15]The Washington Supreme Court had similarly framed Tyler Pipe's argument as "whether its connections with the State of Washington were sufficient to satisfy constitutional standards for the imposition of Washington's B&O tax." *See Tyler Pipe Indus., Inc. v. Dept. of Revenue*, 105 Wash.2d 381, 323, 715 P.2d 123, 126 (1986)

Clause, which *limits* state power over interstate commerce and assigns to Congress the responsibility for its regulation.

G. *Stare Decisis* Requires The Application Of The *Tyler Pipe* Standard.

As noted above, neither *Quill* nor any other case calls into question the in-state activities standard of substantial nexus established in the *Tyler Pipe* line of cases. As a result, as discussed by the Appellant in its Merit Brief, principles of *stare decisis* confirm the conclusion that R.C. 5751.01(I)(3) is unconstitutional.

It is worth noting that, even if there were doubt regarding the viability of the *Tyler Pipe* standard, it must still be followed. As the Supreme Court has made clear, if the "precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions," lower courts "should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions." *Rodrigues de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 484, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989). The strength of this principle is illustrated by *Tenet v. Doe*, 544 U.S. 1, 125 S.Ct. 1230, 161 L.Ed.2d 82 (2005). In *Tenet*, the Court reviewed the continuing viability of a rule established in a Civil War era case. *See id.* at 3 (discussing *Totten v. United States*, 92 U.S. 105, 23 L.Ed. 605 (1875)). The Court of Appeals read an intervening decision as limiting *Totten*, but the Supreme Court disagreed. *Tenet*, 544 U.S. at 8 – 9. Citing *Rodrigues de Quijas*, the Supreme Court chastised the lower court for failing to apply directly controlling precedent, in favor of related authority the lower court construed as undermining it. *Id.* at 10-11.

This is particularly so in the area of Commerce Clause jurisdiction. When deciding whether to overrule the physical presence Commerce Clause requirement for use taxes declared in a prior case, the *Quill* Court noted that even if it were convinced that the prior decision was incorrect under the Commerce Clause, the very fact that it was a Commerce Clause case counselled against overruling the decision because Congress has the power to change the result. As the Court explained, "the better part of both wisdom and valor is to respect the judgment of the other branches of the Government" and defer to Congress. *Quill*, 504 U.S. at 318-319 (quoting *Commonwealth Edison Co.*, 453 U.S. at 638).

H. The Commissioner's Proposed Theories Of Nexus Present A Clear Danger Of Undue Burdens Being Imposed On Interstate Commerce From Conflicting Gross Receipts Tax Obligations In Multiple Jurisdictions.

The Commissioner correctly states that the "substantial nexus" prong of the *Complete Auto* test serves as "a means for limiting state burdens on interstate commerce." *Quill*, 504 U.S. at 313; (Commissioner Br. at 31). Indeed, the substantial nexus test is informed "by structural concerns about the effects of state regulation on the national economy." *Quill,* 504 U.S. at 312.

The Court in *Quill* described the particular burdens that can result from a company being subjected to differing, and potentially conflicting, tax obligations in multiple jurisdictions. The Court explained that the "many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [a company] in a virtual welter of complicated obligations." *Quill*, 504 U.S. at 313 n.6 (citing *Bellas Hess*, 386 U.S. at 759 – 760). Although the Commissioner argues that the CAT is easy to administer (a debatable point),[16] his argument fundamentally misunderstands the nature of the concern expressed by the Court in

[16]The CAT is not so "extraordinarily simple" as the Commissioner suggests. (Commissioner Br. at 32). There are some 36 different exclusions from the definition of "gross receipts." *See* R.C. 5751.01(F)(2). In addition, there is a $150,000 gross receipts threshold, to which these exemptions apply, for determining a company's obligation to report the CAT. R.C. 5751.01(E)(1). Depending upon the nature of a company's business (e.g., sale of goods, provision of services, rental of property, royalty income) there are differing rules for the "situsing" of receipts. R.C. 5751.033. Companies that are part of a corporate family may, or may not, be required to report the CAT together as a combined group, depending upon the ownership structure. R.C. 5751.012. Related companies may have the option of reporting as a consolidated elected group, although this eliminates the $150,000 exemption. R.C. 5751.011, 5751.01(E)(1). Moreover, the CAT must be reported quarterly. R.C. 5751.051(A)(1). As indicated by the multiple underlying Petitions for Redetermination required to be filed by Appellant, appeals from CAT must be filed for each quarterly assessment.

Quill and other court decisions. The issue is not whether a single state's tax obligations are burdensome, but whether a company doing business in interstate commerce would be exposed to differing rates, exemptions, reporting obligations, and record keeping obligations in every state and locality that may impose a similar tax. The gross receipts, "bright-line presence" provision of the CAT (and the Commissioner's other nexus theories) present such a danger of a myriad of conflicting gross receipts tax obligations for companies making sales via catalog, and now the Internet, that was present in *Quill*.

There are already a number of states and major municipalities that have gross receipts taxes. A ruling that gross receipts alone are sufficient to establish nexus could lead to many more states following suit. Indeed, beyond the prospect of every state enacting a business activity tax measured by gross receipts, municipal level gross receipts taxes could mushroom. In addition to the municipal gross receipts taxes identified in Mason's Merit Brief, there are many others already on the books. For example, at least 40 cities in Washington have municipal B&O Taxes, the direct analog to the CAT. *See* Municipal Research Services Center, Business and Occupation Taxes, http://mrsc.org/Home/Explore-Topics/Finance/Revenues/Business-and-Occupation-Taxes.aspx. These local gross receipts taxes are set at different rates and sales thresholds. *See* Ass'n of Washington Cities, City Business (B&O) Rates (Jan. 1, 2015), http://www.awcnet.org/Portals/0/Documents/Legislative/bandotax/botaxrates.pdf. There are several other states that also authorize municipalities to levy gross receipts taxes, including California, Missouri, and South Dakota, among others. (*See* Applt. Br. at 42 (citing San Francisco and Los Angeles gross receipts taxes); *see also,* Missouri Municipal League, Taxation and Revenue in Missouri Municipalities (rev. Jan. 2009), pages 65- 73 (listing Missouri Municipal Business License Fees for hundreds of cities, many of which are based on gross receipts) (*e.g.*, City of Savannah, 5% of gross receipts; City of Crestwood, 0.0125% of gross receipts), http://c.ymcdn.com/sites/www.mocities.com/ resource/resmgr/publications/taxationandrevenue.jan.2009.pdf; South Dakota Dep't of Revenue & Reg., Municipal Tax Information Bulletin (Jan. 2011) at 4-8, http://dor.sd.gov/Taxes/Business_Taxes/Publications/PDFs/bulletinjanuary11.pdf (listing municipalities with gross receipts taxes)).

Furthermore, organizations representing the interests of not only every state (the National Governor's Association, National Conference of State Legislatures), but also over 19,000 cities (the National League of Cities) and 3,600 counties (the National Association of Counties), have submitted an *amicus* brief urging the Court to approve the CAT's expansive gross receipts nexus standard that would allow their members to follow suit and impose local taxes without regard to whether a company engages in activities in the jurisdiction directly, or through third-parties. (*See* Brief of Amici Curiae National Governors Association, *et al.*, at 1-2). The *Quill* Court's concern about the burdens on interstate commerce of divergent tax obligations in more than 6,000 jurisdictions could easily be dwarfed if these localities were free to impose gross receipts tax on any business, without regard to whether it engaged in local activities. *See Quill*, 504 U.S. at 313 n.6.

A nationwide system of gross receipts taxes unlimited in their application by the *Tyler Pipe* standard of substantial nexus could undermine the fundamental objectives of the Commerce Clause in other ways. Because gross receipts taxes are taxes levied directly on the seller, rather than taxes that the seller collects from the buyer, they directly affect the seller's bottom line. A proliferation of gross receipts taxes across thousands of jurisdictions will not only present enormous compliance burdens, but will also result in disincentives for sellers to do business in unprofitable markets. Such a system would promote the very kind of "Balkanization" the

Commerce Clause is designed to prevent. *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 577 117 S.Ct. 1590, 137 L.Ed.2d 852 (1997).

I. Congress Is The Body Which Must Address Any Expansion Of Or Change To Substantial Nexus Principles.

A company's location when engaging in business, either directly or through third-party representatives, remains significant under the Commerce Clause because state borders are a necessary component in defining the limits of state taxing and regulatory authority. Borders are, to a certain extent, artificial as they relate to commerce. A person located in Cincinnati, Ohio can enter into the exact same transaction with a business partner in Louisville, Kentucky as she can with a person in Columbus. The state's authority to regulate these transactions is, however, dramatically different because of the dormant Commerce Clause. Between citizens of its own state, Ohio may impose different—and even remarkably burdensome—tax or regulatory requirements that it cannot impose with regard to a transaction occurring across state lines.

The Framers understood that the authority of States to tax and regulate interstate commerce had to be limited in a manner that respected each State's autonomy within its borders, but also protected commerce occurring across state lines from undue burden. In upholding this core principle, the Supreme Court distilled the four-prong test of *Complete Auto*, in which the "substantial nexus" prong plays a significant role in protecting interstate commerce from undue burdens. *See Quill*, 504 U.S. at 313. By establishing a requirement of in-state activities as the touchstone of "substantial nexus," the Supreme Court could be secure in the knowledge that the Congress may, consistent with the Framers' vision of our federalist system, adopt such measures as are necessary to balance the States' proper tax and regulatory objectives against the goal of a free-flowing national marketplace. *See Quill*, 504 U.S. at 318 (finding that upholding the Commerce Clause physical presence test for use tax collection "is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve").

The exotic and expansive nexus theories advanced by the Commissioner offend these principles because they would dramatically change the conditions under which Internet and other interstate sellers do business in a national market. Indeed, each of the Commissioner's theories represents the kind of change that should only be made through careful legislative consideration and balancing of the competing interests of the States against the potential burdens on the national marketplace. Those kinds of judgments, and the responsibility for regulating interstate commerce, were assigned by the Framers to Congress—not to the Ohio General Assembly, the Commissioner, or even this Court. In the area of Internet taxation, the Congress has previously passed the Internet Tax Freedom Act ("ITFA"), prohibiting states from targeting electronic commerce with discriminatory tax obligations. *See* 47 U.S.C. 151 (note) (2014). A bill to make the ITFA permanent passed the House of Representatives earlier this year. H.R. 235, Permanent Internet Tax Freedom Act (114th Cong. 2015-2016). Even more significant to this appeal, federal legislation regarding the proper nexus standards to apply in the area of business activity taxes, introduced by Representative Chabot (R-OH), is also currently pending before the House. H.R. 2584, Business Activity Simplification Act of 2015 (114th Cong. 2015-2016). In an area where Congress is actively considering legislation, judicial action to expand state authority to impose tax obligations on interstate commerce would be particularly inappropriate.

> **Proposition of Law 2**: The CAT statute is unconstitutional as-applied to Mason by the Commissioner. Imposition of the CAT against Mason, a company with no in-state presence in Ohio, violates the "substantial nexus" standard of the Commerce Clause as established under numerous decisions of the United States Supreme Court. *E.g.*, *Tyler Pipe*, 483 U.S. at 250-251; *Commonwealth Edison*, 453 U.S. at 626; *Std. Pressed Steel*, 419 U.S. at 562; *Gen. Motors*, 377 U.S. at 447-448. Merely obtaining gross receipts in excess of $500,000 annually does not establish constitutional "substantial nexus" under long-standing Supreme Court authority, so applying the CAT based solely on Mason's gross receipts from sales of goods delivered to Ohio customers violates the Constitution.

> In addition, because Mason engaged in no business activities within the State of Ohio sufficient to satisfy the constitutional "substantial nexus" standard, application of the CAT to Mason on any other basis, whether separate from or together with its gross receipts, is also unconstitutional.

A. As Applied to Appellant, The CAT Violates The Commerce Clause Substantial Nexus Requirement.

The Commissioner now seeks to justify the assessment on the grounds that Mason satisfies the *Tyler Pipe* standard through its interstate marketing activities, even though all of the those marketing activities were national in scope and conducted via instrumentalities of interstate commerce from outside of Ohio. As such, they are also inadequate to establish substantial nexus with Ohio. *See Bellas Hess*, 386 U.S. at 758 and n.11 (explaining that state tax administrators "have generally considered an advertising nexus insufficient" to require a seller to "participate in the tax collection system," and citing *State v. Lane Bryant, Inc.*, 277 Ala. 385, 171 So.2d 91 (1965)). No court has held that "advertising nexus" is sufficient for the imposition of a gross receipts tax.

Beyond that fundamental infirmity, the Commissioner's argument that Mason has substantial nexus under *Tyler Pipe* essentially has three parts: (1) Mason has a "substantial economic presence in Ohio"—an argument which fails for reasons explained above; (2) Mason has a "virtual" presence in Ohio by selling over the Internet; and (3) Mason purportedly has "business partners" in Ohio that assist it to make and maintain a market for sales in the state. While the Commissioner drastically distorts the record in an effort to portray Appellant as "present on the computers of Ohio citizens," or "following Ohio consumers around the Internet," or "harvesting data from Ohio customers," even the picture painted by the Commissioner does not include *any* activity sufficient to satisfy *Tyler Pipe*. Moreover, the evidence is uniform that Mason never "targeted" Ohio in any way. What the Commissioner advocates, therefore, is a doctrine of nationwide nexus for all national Internet sellers solely on the basis of Interstate communications.

B. No Activities Were Performed In Ohio On Behalf of Mason That Are Significantly Associated With Mason's Ability To Establish And Maintain A Market In Ohio For Sales.

The Commissioner's brief opens with a melodramatic narrative promising to reveal Mason's "extensive and systematic marketing activities and other commercial activities in Ohio." (Commissioner's Br. at 5 – 7). The lack of any record citations turns out to be the first clue that the Commissioner has both grossly overplayed and misrepresented that factual record of this case.

For example, he speaks ominously of "harvesting locally-produced data"; what he really means is that Mason customers provided it with information when placing order by mail, over the phone, and via the Internet. (Commissioner's Br. at 6; Applt. Br. at 10 – 11) He talks about "local interaction with Mason's website"; what he really means is that consumers communicate with Mason using computers located in their homes. (Commissioner's Br. at 6; Applt. Br. at 9 – 10). He says that Mason sent website visitors "targeted email messages"; what he really means is that Mason sent the same emails to everyone who voluntary provided their email addresses to Mason, and that their names (also voluntary provided) might appear as a salutation. (Commissioner's Br. at 6; Applt. Br. at 12). He claims that Mason "owns property in Ohio that it uses to develop and maintain its market in this state"; what he really means is that Mason's web server sends digital "cookies"—which Mason does not use in any way for marketing or "tracking" purposes and, indeed, never even looks at—to permit its customers to keep items in a virtual shopping cart when they browse Mason's web site. (Commissioner's Br. at 7; Applt. Br. at 11 – 12). He claims that Mason engaged in ominous sounding "data analytics"; what he really means is that Mason based its product offerings and marketing programs on information about the products customers searched for on its web site or purchased from the company. (Commissioner's Br. at 12; Applt. Br. at 10 – 11). In short, the Commissioner's factual recitations simply cannot be trusted.

How far does the Commissioner go? He states, without citation to the record, that "Mason had business partners in Ohio." (Commissioner's Br. at 6). The stated basis for this claim? A single vendor agreement between Mason and a non-Ohio company, Akamai, that Mason engaged to help it fend off international cyber attacks on its web sites hosted in Wisconsin. (Applt. Br. at 10). And although the testimony was clear that Mason did not use Akamai for hosting any part of its web site in Ohio (or anywhere else), the Commissioner simply ignores this evidence, from Mason's most knowledgeable employee, and tells this Court otherwise. (Commissioner's Br. at 6 – 7). In short, he takes a vendor relationship between Mason and Akamai, labels it a partnership, and then misrepresents the nature of the services provided (and where those services were provided). (Applt. Br. at 10).

1. Contrary To The Commissioner's Claim, Mason Did Not Have Business Partners Who Acted In Ohio.

As noted above, the Commissioner claims that Mason had "business partners" in Ohio, but points to only one: Akamai. (Commissioner's Br. at 6, 15 – 17). He asserts unequivocally that Akamai "stores Mason's software locally" in Ohio. (Commissioner's Br. at 15). In doing so, he ignores entirely the testimony of Mason's Director of Marketing, Jodi Bresina, the most knowledgeable, informed witness on the subject, who testified unequivocally that this was not the case: "Q. During the tax period, did Mason use Akamai for caching of website related information? A. We started working with Akamai in 2009, and no, we weren't using caching during the tax period." (Hearing Transcript at 26 – 29). While Mason's contract had included a menu of services from which it could select, including caching services, Ms. Bresina's testimony was crystal clear that they were not requested by or provided to Mason.

Likewise, to the extent that the Commissioner argues that websites that present advertisements from Mason much like magazines present advertisements are its partners, there is *no* evidence that Mason used any affiliates[17] running advertisements for Mason on any websites located in Ohio. While Mason did have a contract with a company that arranged for advertising on other sites, it did not target Ohio web sites or Ohio customers and was not advised as to where such advertisers were located. (Applt. Br. at 12 – 13). The location of the sites on which it placed Mason's advertisements was entirely irrelevant to Mason, as is consistent with the geographically agnostic nature of the Internet, and therefore never disclosed to Mason. (Applt. Br. at 12 – 13).

2. Mason's Online Marketing Activities Were Conducted In Interstate Commerce From Locations Outside Of Ohio, And, Therefore, Do Not Constitute Activities Performed On Its Behalf In Ohio Under The *Tyler Pipe* Test.

Although the Commissioner correctly recites the substantial nexus test of *Tyler Pipe* that "the crucial factor governing nexus is whether the activities performed *in this state on behalf of the taxpayer* are significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales," (emphasis added), the Commissioner ignores this requirement. Instead, he argues that online interstate marketing activities conducted from outside of Ohio that increase Ohio sales create substantial nexus because "Mason does all of the same activities" as the sales representatives did in *Tyler Pipe* "in pursuit of its internet sales market in Ohio."

[17]While the Commissioner's Brief refers to the third party websites as "affiliates," in fact the companies that operated the websites were not affiliated with Mason in any way. They are simply third-party web sites that publish the electronic equivalent of national newspaper or magazine advertisements.

(Commissioner Br. at 39). The Commissioner's argument is fundamentally at odds with *Tyler Pipe* itself, and rests on factual contentions that have no support in the record.

For example, the Commissioner makes the false statement that Mason obtained valuable customer data "through the use of tracking devices such as cookies." (Commissioner Br. at 11, 40). The evidence is clear and undisputed that Mason did not use any "tracking devices," and that "cookies" provided shopping cart functionality for web site visitors. Indeed, Mason simply did not use cookies for data collection or marketing purposes. (Applt. Br. at 11 – 12, 15 – 16). In its Merit Brief, Mason explains in detail the process by which consumers visit Mason's web sites using computers and software browsers of their choosing. (Applt. Br. at 14 – 15). As described therein, the connection between the user and Mason is an interstate connection no different in type than the receipt of a catalog by the mails, or a telephone call from an out-of-state location to the user in Ohio; each involves communication between an out-of-state location and an Ohio resident by use of the instrumentalities of interstate commerce, including telephone lines and the Internet where the seller and the buyer are not in the same physical space. (Applt. Br. at 13 – 16). The activity in Ohio is conducted by the user on the user's computer, at the user's (and not Mason's) initiative, and on the user's own behalf, not as an agent or representative of Mason. (Applt. Br. at 13 – 16). There are only two parties to the communication, as confirmed by both parties' experts: Mason and the Ohio computer user, in which the browser, acting on behalf of the user, communicates with the Mason web server located outside of Ohio. Nor does the use of "cookies" transform Mason's Internet marketing into in-state business activity. The Commissioner's assertion that a cookie is a "recording device" and "the primary means of obtaining customer data" is untrue. (Commissioner Br. at 11 – 12; Applt. Br. at 11 – 16).

Similarly, all of the marketing activities relied upon by the Commissioner, including paid search, email marketing, shopping comparison, search ads and display ads, occurred outside of Ohio. (Applt. Br. at 11 – 16). Just as making a sale via the Internet, by telephone or by mail provides a benefit to Mason, the fact that the data obtained by Mason from its customers may have value to Mason does not mean that Mason has engaged in any activities in Ohio. (Applt. Br. at 8 – 10).

3. Mason Had No Tangible Personal Property Or Other Physical Presence In Ohio That Would Satisfy The *Tyler Pipe* Commerce Clause Test.

The Commissioner claims that Mason maintains certain "assets" in Ohio. The "assets" to which the Commissioner refers is digital information electronically transmitted from California or New Jersey to the computers of Ohio persons who visit Mason websites; the information is received, displayed, and sometimes stored as a file on the visitor's computer. Specifically, when a consumer navigates to the address of Mason's server using its URL address, the consumer requests information from Mason, which is the contents of Mason's website. In response, Mason sends digital information, in the form of hypertext mark-up language ("HTML") and the JavaScript language, which is received by the user's computer and converted, by the user's browser, into the visible web page. According to the Commissioner, the information transmitted from Wisconsin to the consumer (whether in Ohio or elsewhere) is tangible personal property of Mason which constitutes a physical presence of Mason in Ohio.

The Commissioner's argument lacks merit for two reasons.

First, electronically transmitted information is not tangible personal property. The case cited by the Commissioner, *Andrew Jergens Co. v. Wilkins*, 109 Ohio St.3d 396, 848 N.E.2d 499 (2006), held that the purchase by a business of prewritten software received on a tape, disc or other medium, constitutes tangible personal property for purposes of the personal property tax. As the Court noted, for purposes of the sales tax, purchases of magnetic tapes that contain software are taxable, because "the medium on which the intellectual effort is transferred is tangible personal property and subject to sales tax." *Id*. at 398, quoting *Community Mut. Ins. Co. v. Tracy*, 73 Ohio St.3d at 371-376, 653 N.E.2d 220 (1995). To similar effect are the other decisions cited by the Commissioner, including *Wal-Mart Stores, Inc. v. City of Mobile* and *Comptroller of the Treasury v. Equitable Trust Co.*, 296 Md. 459, 484, 464 A.2d 248 (1983), and *S. Cent. Bell Tel. Co. v. Barthelemy*. 643 So. 2d 1240, 1246 (La. 1994). In each of these cases, the software was transferred on a tangible medium.[18]

Second, Mason's so-called "assets" (information in binary code) that the Commissioner and its experts refer to as establishing a "presence" of Mason in Ohio have no physical dimension and cannot constitute a physical presence. As explained in Mason's Merit Brief, a digital cookie is not physical property; it cannot be touched and felt and does not occupy any space. (Applt Br. at 14 – 15). Likewise, the storage by Ohio computer users of electronic information on their own computers does not establish a physical presence any more than does the maintenance by Ohio residents of catalogs published by an interstate marketer. See *Quill*, 504 U.S. at 304, 311 - 319. As importantly, it does not establish that either Mason or its agents or representatives engaged in any activities in Ohio. All of the communications between Mason and its Ohio customers occur across state lines.

The Commissioner is unabashed in his advocacy for a new and unlimited concept of substantial nexus, based on ephemera such as "cookies," HTML code, and digital images. He invites this Court to boldly go where no court has gone before, out onto the borderless frontier of Internet nexus. But where the Commissioner would go, the Constitution, and the Supreme Court, wisely dictate that this Court cannot follow.

[18] It is also noteworthy that the case cited by the Commissioner, *Microsoft Corp v. Franchise Tax Bd.*, 212 Cal. App. 4th 78 (2012), stands for the opposite proposition that the Commissioner says it does. In particular, the Court in that case, found that "the trial court erred in concluding that the OEM licenses [to software] pertain to the licensing of tangible personal property." *Id*. at 95.

<u>Proposition of Law 3</u>: The assessments against Mason are invalid under the CAT statute, when its terms are properly construed to avoid constitutional infirmities. Multiple provisions of the CAT statute may be reasonably construed so as to prevent the application of the CAT to Mason, an out-of-state retailer with no physical presence in Ohio, including R.C. 5751.02(A), R.C. 5751.01(H)(3) and (I)(3), and R.C. 5751.01(F)(2)(jj).

A. The Commissioner's Interpretation Of The CAT Statute Renders The CAT's Gross Receipts "Bright-Line Presence" Provision Unconstitutional.

The Commissioner begins his defense of the CAT gross receipts "bright-line presence" provision by insisting that there is no interpretation of the CAT statute that would avoid placing the statute directly at odds with the "substantial nexus" standard of the Commerce Clause. The Commissioner contends that R.C. 5751.02(A), the statutory section that levies "a commercial activity tax on each person with taxable gross receipts for the privilege of doing business in this state," cannot be read to apply solely to those companies that have the requisite substantial nexus under the Commerce Clause because the statute, by its plain terms, requires that the CAT must be applied not only to persons having substantial nexus with the state, but "also to those who do *not* have substantial nexus with Ohio." (Commissioner Br. at 21). The Commissioner fails to recognize that this argument requires that the Court must read the statute to violate the first prong of the *Complete Auto* test, which prescribes "substantial nexus" as the basic constitutional requirement for all state taxes. 432 U.S. at 279; *Commonwealth Edison*, 453 U.S. at 626 (an interstate business "must have a substantial nexus with the State before *any* tax may be levied on it.") (Citation omitted.)[19]

[19]The cliff over which the Commissioner drives the statute is readily apparent. Under R.C. 5751.01(H), the term "substantial nexus with this state" is defined to include any person that: (1) owns or uses capital in Ohio; (2) holds a certificate to do business issued by the state; (3) has so-called "bright-line presence" in the state; and, in addition (4) "*[o]therwise has nexus with this state to an extent that the person can be required to remit the tax imposed under this chapter under the Constitution of the United States*." (Emphasis added.) R.C. 5751.01(H)(1) – (4). The CAT, therefore, purports to extend the applicability of the tax to the limits of the U.S.

The Commissioner's blind insistence that the CAT statute is not susceptible of a reading that would preserve its constitutionality appears driven by a motivation to force this Court to make a constitutional ruling. *See* Commissioner Br. at 24 (refusing to accept any possible limiting construction). Postured in this manner, the CAT's gross receipts "bright-line presence" provision clearly runs afoul of the Commerce Clause substantial nexus test established in the *Tyler Pipe* line of cases for state taxes. But the supposed "legislative objective" of having a clear rule (*see id.* at 25) should give way to a reasonable construction of the statute that preserves its constitutionality. *E.g., SFA Folio Collections, Inc. v. Tracy*, 73 Ohio St.3d 119, 652 N.E.2d 693 (1995). And as discussed in the next section, the statute is not clear. This "all or nothing" approach also contradicts the legislature's provision seeking swift constitutional review of the narrow "bright line" rules, but not challenges to the overarching constitutionality of the CAT. R.C. 5751.31 (authorizing a targeted challenge to "bright line presence" standards only, evincing severability); (Suppl. at 835, 704 – 712).

B. The Constitutional Catch-All Provision Of R.C. 5751.01(H)(4) Undermines The Commissioner's Reading Of The Statute.

It is noteworthy that the inclusion by the General Assembly of the constitutional catch-all provision of R.C. 5751.01(H)(4) undermines another leg of the Commissioner's argument. The Commissioner repeatedly insists that the "bright-line presence" provisions were adopted in order to give the Commissioner clear, objective standards for imposing the CAT that would not require the Commissioner to interpret a "*case-law* legal standard" of substantial nexus. (Emphasis sic.) (Commissioner Br. at 22). Such clear standards, the Commissioner argues, are rendered "entirely meaningless" if the gross receipts "bright-line presence" provisions must be interpreted, as Appellant suggests, so as not to run afoul of the Commerce Clause *Tyler Pipe* test. (*Id.*)

Constitution. The Commissioner then argues that the terms of R.C. 5751.02(A) require that the CAT be applied *beyond* those limits, into constitutionally forbidden territory.

However, the inclusion of the constitutional catch-all in subsection (H)(4) itself requires that the Commissioner interpret case law to determine whether a company has substantial nexus in all of the (arguably more difficult) instances in which none of the so-called “bright-line presence” standards are satisfied. In other words, the General Assembly directed the Commissioner to make difficult judgments about case law standards of constitutional nexus in all instances *other than* those where a different provision of R.C. 5751.01(H) plainly applies.

The Commissioner may believe—as the Board of Tax Appeals did— that he has no discretion to disregard the $500,000 gross receipts, “bright-line presence” provision mandated by the General Assembly, but the constitutional catch-all provision shows that the General Assembly did not intend to divorce the CAT statute entirely from constitutional standards.

C. Reasonable Interpretations To Retain The CAT Statute’s Constitutionality, But Invalidate The Assessments, Are Available.

Mason argues that, by its terms, R.C. 5751.02(A) imposes the CAT on each person “with taxable gross receipts for the privilege of doing business in this state,” and that the term “doing business” means “engaging in any activity,” thus rendering the statute consistent with the *Tyler Pipe* line of cases. (Applt. Brief at 46 – 47). The Commissioner never addresses this argument, but instead insists that the CAT statute is “unambiguous and clear on its face,” requiring the Court to “apply the statute’s plain terms.” (Commissioner Br. at 25). Upon close scrutiny, however, the CAT statute is not a model of clarity, but can be read to require that the *Tyler Pipe* test must be satisfied to permit imposition of the CAT.

For example, the Commissioner’s distinction between the taxability of persons and the taxability of gross receipts (Commissioner Br. at 23 – 24) breaks down quickly when exposed to the light of statutory language. Under R.C. 5751.02(A), the CAT tax is “levied . . . on each person with taxable gross receipts for the privilege of doing business in this state,” which is defined as "engaging in any activity." In other words, the taxability of a person engaged in business activities is not separate from, but is rather *dependent upon,* having taxable gross receipts as well as business activity in the state. Thus, any exclusion from taxability for a "person" who is engaged in business in the state also depends upon the exclusion from taxation of the underlying receipts. This linkage may explain, in part, why the General Assembly included the language which makes clear that persons on which the CAT is levied include both those who have, and those who do not have, substantial nexus with the state—taxability under the CAT statute is driven, as a statutory matter, by the taxability of the receipts.

In addition, the Commissioner's argument that R.C.5751.02(A) requires taxation of persons without regard to whether they have substantial nexus itself renders all of the subparts of both R.C.5751.01(H) and (I) effectively meaningless, because whether a person has "substantial nexus with this state" would make no difference whatsoever in evaluating whether the person must pay the CAT.

Finally, the language of former R.C. 5751.01(F)(2)(jj) is also ambiguous. It provides that excluded from the definition of "gross receipts" are "[a]ny receipts for which the tax imposed by this chapter is prohibited by the constitution or laws of the United States or the constitution of this state." The "tax imposed by this chapter" might be prohibited for a variety of reasons, not all of which are dependent upon the nature of the receipts.[20] In the face of the statutory ambiguity, Appellant proposes a possible limiting construction under each of two provisions that might render the statute inapplicable to Appellant but consistent with the Constitution. First, the Court could determine that to have business activities within the state under 5751.02(A), a

[20] R.C. 5751.01(F), on which the Commissioner expends so much effort, does not define the taxability of gross receipts. Rather, the section defines "gross receipts," which are then taxable, under R.C. 5751.01(G) only if they are "sitused" to Ohio under R.C. 5751.033.

person must meet the in-state activities test of *Tyler Pipe*. Second, consistent with the former R.C. 5751.01(F)(2)(jj), the Court could conclude that taxable gross receipts do not include amounts obtained by a company that lacks substantial nexus.

III. LAW AND ARGUMENT RESPONSE TO CROSS-APPEAL:

<u>Proposition of Law:</u> The Commissioner's argument that Mason failed to raise a constitutional challenge to the Board of Tax Appeals ("Board") lacks merit, because, as both the Commissioner recognized in submissions to the Board and the Board itself found, Mason argued in its protest and throughout the proceedings in the Board that the CAT statute, as applied to Mason, violated the Commerce Clause of the U.S. Constitution. This Court has rejected the Commissioner's same argument in connection with its denial of the Commissioner's Motion to Dismiss.

In support of his Cross-Appeal, once again the Commissioner claims that, as "explained in his Motion to Dismiss, Mason *has never challenged the constitutionality of any CAT statute* in these proceedings, until now." (Emphasis sic.) (Commissioner Br. at 2). This is the same argument made in the Commissioner's unsuccessful Motion to Dismiss, and should be rejected for all of the reasons set forth in Mason's detailed opposition.

In his Merit Brief, the Commissioner repeats his false allegation by stating that "Mason did *not* raise a constitutional challenge, whether facial or as-applied, to the statutes that levy the CAT and make it applicable to Appellant." (Commissioner Br. at 26). It is an allegation that contradicts the position taken by the Commissioner both in his original decision in this matter and in motions his lawyers wrote and filed with the Board. It is also contradicted by the Board decisions from which this appeal is taken, which expressly recognize that Mason made an "as applied" constitutional challenge. Indeed, on August 20, 2014, when the instant case was fast approaching a hearing before the Board that fall, the Commissioner filed a motion representing to the Board that "this appeal challenges the *constitutionality* of the Commercial Activity Tax ("CAT") nexus provisions *as applied to the appellant*." (Emphasis added.) (Joint Motion to

Continue Evidentiary Hearing, August 20, 2014 ("Motion to Continue"), at p. 1).[21] Such an acknowledgement of the constitutional issue being presented to the Board was nothing new. Nearly two years earlier, in the parties' successful joint motion to consolidate, the Commissioner likewise admitted that:

> The appeals challenge the constitutionality of the Commercial Activity Tax ("CAT") nexus provisions *as applied to the appellant* under virtually identical assignments of error. The same parties are involved. Both appeals entail *"as applied" challenges* to the constitutionality of the Ohio CAT assessments. Thus, the hearings before the [Board] will entail similar questions of law and fact.

(Emphasis added.) (Joint Motion to Consolidate And To Amend Case Management Schedule, November 2, 2012 ("Motion to Consolidate")).[22]

In fact, the Commissioner himself left no doubt regarding the nature of the constitutional challenge asserted by Mason. In his successful motion to designate Mason's appeal as complex litigation, which was filed for the sole and express purpose of obtaining far-reaching discovery *on Mason's constitutional claim alone,* the Commissioner represented to the Board as follows:

> This appeal challenges *the constitutionality of the Commercial Activity Tax ("CAT") nexus provisions as applied to the appellant*. This issue has not yet been reviewed or decided by any Ohio tribunal or court, and is of great importance to the scope and vitality of Ohio's principal business tax.

(Emphasis added.) (Motion to Designate Case As Complex Litigation, Extend Discovery And To Set a Case Management Schedule, June 12, 2012 ("Motion to Designate"), at p. 2).[23] In that same motion, the Commissioner told the Board that Mason:

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[21] A copy of this motion, written by the same attorneys representing the Commissioner in the instant appeal, is included in Mason's appendix filed in support of its opposition to the Commissioner's Motion to Dismiss as Exhibit 1.

[22] A copy of this motion, also written by the attorneys representing the Commissioner in the instant appeals, is included in the appendix to the Motion to Dismiss as Exhibit 2.

> seeks a determination *that the commissioner's finding that it has substantial nexus with Ohio is an unconstitutional violation of the dormant commerce clause.* In seeking the constitutional invalidation of Ohio tax law, appellant faces the heavy burden of establishing beyond a reasonable doubt that the CAT nexus provisions are unconstitutional * * * . *Discovery of the various means and methods employed by appellant in exploiting the Ohio marketplace will be necessary, as well as the activities conducted by agents on appellant's behalf that might establish a physical presence in Ohio.*

(Emphasis added.) (Motion to Designate, at p. 3).

The Board in fact confirmed that Mason's as-applied constitutional challenge was the focus of the hearing below, during which both Mason and the Commissioner had the opportunity to present testimony and documentary evidence and make a record for appeal on the issue. The Board, however, ruled that it would not decide Mason's as-applied challenge, because as an administrative tribunal it lacked the authority to do so:

> As we stated in *L.L. Bean*, "this board makes no findings with regard to the constitutional questions presented. The parties through the presentation of evidence and testimony and the submission of briefs to this board, have set forth their respecting positions regarding the constitutional validity of the commissioner's application of the statutory provisions in question * * * and we find such arguments may only be addressed on appeal by a court which has the authority to resolve constitutional challenges.""

(Appx. 32).

As demonstrated in the Opposition to Motion to Dismiss, Appellant properly raised and asserted an as-applied constitutional challenge to the CAT as a result of the assessments in the case. The requirement of raising such a challenge is to permit a record to be made for the appellate court to rule on the constitutional challenge. The parties had a full opportunity to make that record. Just as this Court denied the Commissioner's Motion to Dismiss, which the

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[23]A copy of this motion, written by the same attorneys, is included in the Appendix as Exhibit 3.

Commissioner acknowledges in his Brief was based on the same grounds as the Commissioner's cross-appeal, the Court should reject the Commissioner's cross-appeal.[24]

IV. CONCLUSION

For the foregoing reasons, Appellant respectfully requests that the Court reject the Commissioner's imposition of the CAT against Appellant, reverse the decision of the Board of Tax Appeals that affirmed the Commissioner's assessments of CAT against Appellant, and order that the CAT assessments against Appellant be eliminated in their entirety.

Respectfully submitted,

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[24] Mason further relies on the arguments it made in its Opposition to Motion to Dismiss filed June 19, 2015.

CERTIFICATE OF SERVICE

This is to certify that a true copy of the foregoing Third Merit Brief of Mason Companies, Inc.'s Third Merit Brief was sent to the following via the electronic mail and served by U.S. and electronic mail to counsel of record on this 19th day of November, 2015:

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