

Letting Ohio's CAT Out of the Bag

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This installment of A Pinch of SALT addresses the ramifications to the Ohio commercial activities tax (CAT) of the September 12 decision of the Ohio Court of Appeals in *Ohio Grocers Assn. v. Wilkins* (2008-Ohio-4220). (For the decision, see *Doc 2008-18914* or *2008 STT 174-14*.) Although the decision has been stayed and will be appealed, its final adjudication will likely mean the CAT will no longer apply to receipts from the retail sale of food for consumption off premises, all wholesale sales of food regardless of where consumed, and all sales of food packaging. The decision also increases the likelihood that the state's economic nexus standard will be found unconstitutional. Contrary to a recent column by *State Tax Notes* legal editors Jennifer Carr and Cara Griffith on the *Ohio Grocers* decision, our column concludes that the decision should be upheld and explores its repercussions for Ohio's taxation of food-related industries and for the future of Ohio's CAT nexus standard. (See Jennifer Carr and Cara Griffith, "The Legal Front: Ohio Grocers Score Victory in CAT Challenge," *State Tax Notes*, Sept. 22, 2008, p. 827, *Doc 2008-19661*, or *2008 STT 185-18*.)

Ohio Constitution Protects Sales of Some Food and Food Packaging From Excise Taxes

History of Constitutional Protection

The history behind *Ohio Grocers* and the relevant state constitutional provisions is important and interesting. *Ohio Grocers* involves an assertion by

taxpayers that the state's imposition of CAT on receipts from the sale of food violates two provisions of the Ohio Constitution. The trial court upheld the constitutionality of the tax. On appeal, an intermediate state appellate court reversed the trial court and found the tax unconstitutional as applied to gross receipts from the sales of particular food.

The Ohio Constitution contains two separate provisions limiting the state's ability to impose some types of taxes on sales of food. The provisions are separated by time but are closely linked with one another and with Ohio's tax system.

Section 3, Article XII, the older provision, is a specific grant of authority to the state to generally impose "excise and franchise taxes" but includes, as the only limitation to that broad grant, a prohibition on the levy or collection of an excise tax "upon the sale or purchase of food for human consumption off the premises where sold." That provision was added to the Ohio Constitution in 1936. The important elements of the section 3 limitation are:

- excise tax;
- sale or purchase;
- food;
- human consumption; and
- off the premises where sold.

Thus, the section 3 limitation does not prohibit taxes other than excise taxes (whatever those may be). To be protected by the section 3 limitation, an item must be food and must be for human consumption.

The newer provision, section 13, is more recent. In 1992 Ohio enacted an excise tax on sales of nonalcoholic carbonated beverages and soft drinks by wholesale distributors to retailers (the tax was imposed on container beverages and postmix syrup). During the early 1990s, several other states imposed similar taxes, and the soft drink industry galvanized to fight back. The industry pursued several paths, including lobbying to repeal the legislation and filing court challenges. Taxpayers filed suit, claiming Ohio's excise tax violated the 1936 provision of the state constitution. A court held that soft drinks were food, but that the 1936 provision applied only to sale of food by a retailer to a consumer and did not limit taxation of nonconsumer transactions. (*Cameron Coca-Cola Bottling Co. et al. v. Tracy*, OH Ct. of

Common Pleas, Franklin County, No 93CVH02-729 (July 28, 1993).) The court's holding raised the risk that Ohio could essentially circumvent the constitutional prohibition on taxing food by imposing the tax not at the retail level, but on wholesalers.

Ohio Grocers increases the likelihood that the state's economic nexus standard will be found unconstitutional.

Concurrent with that litigation, the soft drink industry also began a campaign to amend the Ohio Constitution to ensure that wholesale sales would be protected from tax. The decision in *Cameron* showed the need for a clear constitutional provision protecting more than sales at the retail level. After a reported \$8 million campaign by the soft drink industry, a new state constitutional amendment was adopted. Section 13 was proposed by initiative petition and was approved by the electorate in November 1994. Section 13 prohibits the state from levying or collecting sales or other excise taxes “(1) upon any wholesale sale or wholesale purchase of food for human consumption, its ingredients or its packaging; (2) upon any sale or purchase of items sold to or purchased by a manufacturer, processor, packager, distributor or reseller of food for human consumption, or its ingredients, for use in its trade or business; or (3) in any retail transaction, on any packaging that contains food for human consumption on or off the premises where sold.”

Constitutional Protection Applies to Ohio's CAT

In *Ohio Grocers*, the state argued that the application of the CAT to receipts from food sales did not violate the Ohio Constitution because the CAT is not a prohibited excise tax but a franchise tax imposed on the privilege of doing business in the state. Therefore, the state asserted, the tax is not imposed on individual sales and is not a transactional tax. In anticipation of such a lawsuit, the CAT legislation states that the CAT is not a transactional tax (OH R.C. section 5751.02(A)). The trial court held that the CAT is an excise tax but that it is not levied or collected on the sale or purchase of food. Reversing the trial court, the appellate court held that the CAT when applied to gross receipts from the wholesale sale of food violates section 13 and, as applied to the retail sale of food for human consumption off premises where sold, violates section 3 of the Ohio Constitution.

The appellate court ultimately held that regardless of the name or category of a tax (franchise, excise, sales), how the tax is imposed is what determines its constitutionality. The court found that because the CAT is applied solely to the gross

receipts (without modification or changes) from the sales of food, it is the type of transactional tax prohibited by sections 3 and 13. That the CAT is not imposed and collected when the sale is made did not change its fundamental character, according to the court. In a refreshingly astute summation of what would seem to be obvious, the court held that “if the legislature is prohibited from collecting a tax on the individual sale, it logically follows the legislature would be prohibited from collecting a tax on the aggregate of those same sales.”

In making its determination, it was important to the court that the inclusion of gross receipts from sales of otherwise exempt food was not just one factor being considered to determine tax liability, but was “the *only* factor being used” (emphasis in original). Upholding the tax — which Carr and Griffith argue would be the right result — would be to allow the same type of tax that the 1994 amendment sought to prevent, only under a different name. A sales tax on wholesalers, like the CAT, is not imposed on the ultimate consumer. A sales tax, like the CAT, is sourced on a transaction-by-transaction basis. A sales tax, like the CAT, is sourced based on the location of the customer, not the taxpayer. Voter-adopted constitutional provisions deserve far more deference than a mere nomenclature change.

The scope of *Ohio Grocers* does not affect just grocery stores. Any taxpayer involved with sales of food or packaging related to food should consider the implications of this case. The 1994 constitutional provision protects a much broader range of sales and products than the traditional retail sales tax exemption for food statutorily adopted by many states. Together, the two Ohio state constitutional provisions protect:

- retail sales of food for human consumption off the premises where sold;
- all wholesale sales of food for human consumption (regardless of where consumed);
- all wholesale sales of ingredients for food for human consumption (regardless of where consumed); and
- all sales of packaging for food for human consumption (regardless of where consumed or whether at wholesale or retail).

The only food-related transactions not protected by the constitutional provisions are retail sales of food (but not the packaging) to be eaten where purchased (such as in a restaurant) and sales of food not for human consumption.

If the appeals court decision in *Ohio Grocers* is upheld, the following are examples of the type of transactions that will not generate gross receipts subject to the Ohio CAT (and taxpayers that have already included the receipts in calculation of CAT should receive a refund for any open year):

- restaurant take-out purchases;

- a manufacturer's sales of corn syrup or flour to a baking company;
- hamburger wrappers used by fast food restaurants, even for food eaten by customers at the restaurant; and
- anything that could be considered food packaging, such as boxes, crates, or bottles.

For packaging, the state may have to grapple with additional issues as to where the limit is drawn. For example, are pallets used to transport food crates protected packaging?

Potential Nexus Implications: The CAT Is a Transaction Tax

Of potentially enduring importance for taxpayers beyond the food industry, the court held that in essence, the CAT becomes, in its operation, a transaction tax. By holding that it is a transaction tax, the court brought the CAT one step closer to being the type of tax that *Quill* defines as requiring a taxpayer's physical presence in the taxing state. (See *Quill v. North Dakota*, 504 U.S. 298 (1992), prohibiting a state from imposing the obligation to collect tax on a company having no physical presence in the state.)

In adopting the CAT, Ohio also adopted the controversial Multistate Tax Commission factor-based nexus standard, which asserts that a state has jurisdiction to tax an out-of-state company if the company has one or more of the following in the taxing state during the tax year: more than \$50,000 in property, more than \$50,000 in payroll, or more than \$500,000 in sales. From enactment, the nexus standard has been legally suspect under the commerce clause of the U.S. Constitution. In anticipation of a challenge, the CAT legislation provided an expedited appeals process to quickly resolve that constitutional issue. The anticipated nexus challenge, however, has so far failed to materialize.

If the CAT is a sales tax, its economic nexus rule would violate the *Quill* physical presence standard for imposing sales and use tax reporting, collection, and payment obligations on out-of-state vendors and would therefore be unconstitutional. If the CAT is not subject to the *Quill* physical presence standard, given the lack of clear guidance from the U.S. Supreme Court, the constitutionality of the nexus rule becomes much less straightforward. The holding in *Ohio Grocers* places the CAT in the same realm of taxes covered by the *Quill* bright-line physical presence rule. And the *Grocers* classification of the CAT is not an anomaly. In an earlier opinion that has gone largely unnoticed, another intermediate appellate court found that since the amount of tax owed is tied to the amount of a business's gross receipts, the tax is similar to a sale or consumer tax and not an overhead tax. (*Mosser Const., Inc. v. City of Toledo*, Lucas App. No. L-07-

1060, 2077-Ohio-4910 (Sept. 21, 2007) (construction company succeeding in suit to pass through CAT to city with which it had a preexisting contract that allowed the parties to shift the tax burden to the city in the event of unforeseen law changes for taxes "similar to a sales, consumer, or use tax"). By adopting a business tax that acts more like a sales tax than an income tax, Ohio may have doomed any chance of maintaining an economic nexus standard.

State representatives will surely argue that how the tax is imposed includes on whom it is imposed. Because the CAT is imposed at the business activity level rather than the consumer transaction level, Ohio would argue that the *Quill* physical presence test threshold does not apply. However, although the tax in *Quill* was in the first instance imposed on the consumer transaction, the retailer was equally liable for the tax. Thus, who the tax is imposed on should be as irrelevant as the tax's label. That position — that initial imposition must be irrelevant for constitutional purposes — is further strengthened by the difficulty of determining who the tax is imposed on. Is the imposition of the tax a function of legal burden or economic burden? Ultimately, *Quill* looks at whether the burden is sufficient to interfere with interstate commerce; if it is, the tax is unconstitutional as applied to out-of-state companies.

Outlook for Ohio

Ohio, apparently sharing Carr and Griffith's optimism, has asked the appeals court for a stay that would allow for continued collection of the tax until the appeal is complete. One must wonder whether Ohio plans to collect the tax as long as possible and then follow the path of Alabama, refusing to pay refunds regardless of the obligation to do so. Like most states, Ohio is already experiencing significant budget problems — its tax collections as of July 2008 decreased by 4.8 percent from last year's. Early estimates are that this case could cost the state \$188 million in annual revenue. The Department of Taxation recently issued a notice to taxpayers directing them to continue to pay the tax as imposed and file protective refund claims.

The question remains: Will the state pay those protective claims for refund if the decision is upheld? ☆

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