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In the Supreme Court of Ohio

Crutchfield Corp.,

Appellant,

v.

Joseph W. Testa, Tax Commissioner of Ohio,

Appellee.

Case No. 15-0386

On Appeal from the Ohio Board of Tax Appeals

BTA Case Nos. 2012-926, 2012-3068, 2013-2021

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I. STATEMENT OF INTEREST OF AMICUS CURIAE

The Council On State Taxation ("COST") is a nonprofit trade association based in Washington, D.C. Formed in 1969 as an advisory committee to the Council of State Chambers of Commerce, COST has grown to an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multi-jurisdictional businesses.

As COST's membership is comprised of multistate taxpayers, COST is very concerned when a state attempts to tax out-of-state businesses with no physical presence in the state. COST files this reply *amicus* brief to challenge the Commissioner's application of Ohio's bright-line test under R.C. 5751.01(I)(3) to out-of-state businesses lacking a physical presence in Ohio. For a state to tax on an entity located outside of the state, the state must have substantial nexus with the entity's in-state activities. COST has no issue with the Commissioner using the bright-line test to exclude out-of-state businesses that fall below the threshold from the Commercial Activities Tax ("CAT"); however, the Commissioner cannot automatically subject out-of-state businesses with sales above the $500,000 threshold to the tax merely based on that factor (the "sales-factor presence").[1] The Commissioner must still find that an out-of-state business has sufficient nexus under the Commerce Clause to be subject to Ohio's taxing jurisdiction.[2]

Congress alone has the power to regulate interstate commerce. Absent congressional action, the states cannot do anything to unduly burden interstate commerce.[3] The history of the dormant Commerce Clause dates back to *Gibbons v. Ogden*, 22 U.S. 1, 6. L.Ed. 23, 9 Wheat. 1

[1] The bright-line test also has a greater than $50,000 in payroll or greater than $50,000 in property test, along with more than any one factor representing more than 25% of an entity's business in Ohio. COST's concern is with the Commissioner asserting an out-of-state businesses is subject to the CAT if it is over the $500,000 sales threshold (or 25% of a business's sales).

[2] The Due Process Clause and an entity having the requisite "minimum contacts" can also be an issue; however, that issue is not before this court in this case.

[3] Congress can even remove an industry's Commerce Clause protection, which it has done to the insurance industry under the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015.

(1824). "We do not find, in the history of the formation and adoption of the constitution, that any man speaks of a general *concurrent power*, in the regulation of foreign and domestic trade, as still residing in the States. The very object intended, more than any other, was to take away such power. If it had not so provided, the constitution would not have been worth accepting." *Id.* at 7 (italics in original). Accordingly, R.C. 5751.01(I)(3)'s enactment and application to impose the CAT, specifically the sales-factor presence bright-line test for the CAT, must be scrutinized to determine if it passes constitutional muster under the dormant Commerce Clause.[4]

Many COST members make sales in Ohio, have no physical presence in Ohio, have no property or payroll in Ohio, and are adversely impacted if the CAT responsibility is imposed without receiving any meaningful benefits from Ohio. COST's membership is composed of multistate taxpayers seeking to comply with a myriad of state tax laws. The Board of Tax Appeals ("BTA") decision allowing Ohio to subject businesses with no activities performed in the state to the CAT has significant repercussions on COST's membership. COST adopted a policy position on when a state has jurisdiction to impose its business activity tax, such as the CAT.[5] That policy states, in part, the following:

> In order for a State or locality to impose a business activity tax on a business, that business must have a physical presence in the jurisdiction. Congress must recognize physical presence as the jurisdictional standard for business activity taxes. Physical presence should be defined to include quantitative and qualitative *de minimis* thresholds. Congress must also prohibit unreasonable attribution of nexus. Finally, Congress must preserve and modernize P.L. 86-272. …
>
> Determinations of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens—economic as well as administrative—only on businesses that receive meaningful benefits or

[4] The majority of the U.S. Supreme Court recently reaffirmed its acceptance of the dormant Commerce Clause when it clarified that the dormant Commerce Clause's protections not only applied to businesses engaged in interstate commerce, but also applied to individuals earning income derived from interstate commerce. *Comptroller of Treasury of Maryland v. Wynne*, 135 S.Ct. 1787, 191 L.Ed.2d 813 (2015).
[5] The full COST Policy Position, *Jurisdiction to Impose Business Activity Tax – Constitutional,* is available at: http://cost.org/uploadedFiles/About_COST/Policy_Statement/JurisdictionToImposeBusinessActivityTax-Constitutional.pdf.

protections from that government. In the context of business activity taxes, this guiding principle means that businesses that are not physically present in a jurisdiction and are therefore not receiving meaningful benefits or protections from the jurisdiction should not be required to pay tax to that jurisdiction.

COST is uniquely situated to provide this Court with guidance on the negative implications of asserting nexus over out-of-state companies that do not have access to Ohio's political process. While Ohio was the first state to adopt a sales-factor presence test, other states have subsequently adopted factor-presence nexus statutes.[6] Thus, this is a case of national importance not only because Ohio was the first state to adopt a variation of the Multistate Tax Commission's ("MTC") factor-presence nexus model rule,[7] but also because Ohio is now the first state to have the constitutionality of the sales-factor presence portion of the MTC's factor-presence nexus rule before its highest court.

II. STATEMENT OF THE FACTS

COST adopts by reference the statement of the case and facts set forth in the Merits Brief of Crutchfield Corp. ("Crutchfield" or "Appellant").

III. LAW AND ARGUMENT

A. Introduction

For a state to impose a tax on an out-of-state business, the business's activity in the state must have "substantial nexus" with the state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S.

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[6] Alabama (H.R. 49, 1st Spec. Sess. (enacted Aug. 11, 2015)) ($500,000), California (Cal. Rev. & Tax. Code § 23101(b)) ($500,000, indexed for inflation), Colorado (Colo. Code Regs. § 39-22-301.1(2)(b)) ($500,000), Connecticut (Conn. Gen. Stat. § 12-216a(a), Informational Publication 2010 (29.1), must exceed $500,000), Michigan (Mich. Comp. Laws § 208.1200(1)) ($350,000). New York (NY Tax Law § 209.1(b)) ($1,000,000), Ohio (Ohio Rev. Code § 5751.01(I) ($500,000)), Oklahoma (2010 Sess. Laws S.B. 6143) ($500,000), Tennessee (H.B. 644, 109th Gen. Ass., enacted May 20, 2015) ($500,000), and Washington (Wash. Rev. Code § 82.04.067) ($250,000). As can be seen from the states' different thresholds, the MTC model has not been uniformly adopted.

[7] For the MTC model statute regarding Factor Presence Nexus Standard for Business Activity Taxes, *see* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.

374, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977).[8] When an entity is wholly intrastate, there is no question the entity has substantial nexus with the state. But when an entity is engaged in interstate commerce, the dormant Commerce Clause of the U.S. Constitution is implicated. States are prohibited from taxing interstate commerce in a way that impedes the free flow of commerce between states. "The broad inquiry subsumed in [this] constitutional requirement * * * is whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state—that is whether the state has given anything for which it can ask [in] return." (Quotations omitted.) *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 24-25, 128 S.Ct. 1498, 170 L.Ed.2d 404 (2008).

Physical presence can be created not just with activities of a business's employees, but also by agents and independent contractors. *See Tyler Pipe Indus. v. Washington Dep't of Revenue*, 483 U.S. 232, 250, 107 S.Ct 2810, 91 L.Ed.2d 199 (1987) (finding that although the taxpayer had no property or employees in the state, the taxpayer's use of independent contractors created substantial nexus for the taxpayer). "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 maintain a market in this state for the sales." *Id.*, *quoting Tyler Pipe Indus. v. State, Dep't of Revenue*, 105 Wash.2d 318, 323, 715 P.2d 123 (1986). Before *Tyler Pipe*, in 1960, the Court determined independent contractors working in-state for an out-of-state company were treated the same as employees and created nexus. *Scripto, Inc. v. Carson,* 362 U.S. 207, 80 S.Ct. 619, 4 L.Ed.2d 660 (1960). The U.S. Supreme Court reaffirmed the dormant Commerce Clause requires physical presence in a state before the state can subject a multistate taxpayer to that state's tax again in *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d

[8] A state can sustain a Commerce Clause challenge to a state tax as long as the "tax is applied to an activity with substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit,* 430 U.S. at 279.

91 (1992). The dormant Commerce Clause restricts a state from imposing a business activity tax,[9] such as the CAT, on out-of-state businesses unless the out-of-state business has substantial nexus with in-state activity.

Although the MTC in 2002 undertook a uniformity project to create a bright-line presence rule for substantial nexus for business activity taxes, "factor-presence nexus" rules are only constitutional if used by a state to restrict its taxing authority. The MTC rule cannot expand taxing authority beyond the protections of the Commerce Clause. Once a state chooses to tax out-of-state business, the Commerce Clause is implicated regardless of what a state's law avers.

Amicus asserts, under the dormant Commerce Clause, the sales-factor presence rule under R.C. 5751.01(I)(3) cannot be used to impose the CAT on out-of-state businesses whose only contact with Ohio are sales made and delivered to customers located in Ohio. This is so regardless of whether the business engages in remote, internet marketing. The Commissioner and the BTA ignore U.S. Supreme Court precedent and requisite Commerce Clause principles in subjecting Crutchfield to the CAT. This Court must overturn the BTA's decision to prevent the imposition of Ohio's CAT from infringing on Crutchfield's constitutional rights.

B. Proposition of Law No. 1: Crutchfield Has No Substantial Nexus with Ohio; Thus, Ohio Cannot Impose the CAT on Crutchfield.

Part of the substantial nexus test for out-of-state businesses that lack a physical presence in the state is that such business must have "activities performed in th[e] state on behalf of the taxpayer [ ] significantly associated with the taxpayer's ability to establish and maintain a market in the state for the sales." *Tyler Pipe Indus. v. Washington Dep't of Revenue*, 483 U.S. 232, 250, 107 S.Ct. 2810, 97 L.Ed.2d 199 (1987). The U.S. Supreme Court in *Tyler Pipe,* addressing

[9] Business activity taxes are taxes imposed on a business (*e.g.,* Ohio's CAT, state corporate income taxes, etc.) and excludes transactional excise taxes such as the states' sales and use taxes that are primarily imposed on the buyer (with the duty to collect imposed on sellers).

Washington's gross receipts tax, did not find that sales alone to customers in the taxing state were sufficient to establish the State's taxing power. Rather, the Court imputed physical presence through the taxpayer's use of independent contractors.

In *Tyler Pipe*, the taxpayer enlisted independent contractors in the state to act as salespeople for the taxpayer. *Id.* at 249. Although the taxpayer had no property or employees in the state, the U.S. Supreme Court found the use of independent contractors to foster the taxpayer's market share and customer relations, which, in turn, created substantial nexus for the taxpayer. *Id.* The Court did not focus on Tyler Pipe's Washington sales, which were substantial. Rather, the Court focused on the activities performed on behalf of Tyler Pipe by others in Washington. If sales in a state were enough to create substantial nexus with the State of Washington, the U.S. Supreme Court clearly had no need to address in *Tyler Pipe* whether the activities of the independent contractors created substantial nexus for Tyler Pipe in Washington.

The same holds true here. Crutchfield performed no activities in the state. Crutchfield has no employees or independent contractors in Ohio that establish or maintain its market in the State. The only connection between Crutchfield and Ohio are its sales delivered by common carriers. As Crutchfield has not performed any activities in Ohio, nor has it used any entity in Ohio to assist it in establishing or maintaining its marketplace in the State, Crutchfield does not have substantial nexus with Ohio as required under the dormant Commerce Clause before it can impose a business activity tax on Crutchfield.[10] Thus, the BTA decision allowing Ohio to impose the CAT on Crutchfield is unconstitutional and should be reversed.

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[10] A leading state tax law treatise commented that a state could not impose a two percent gross receipts tax on nonresident hospitals providing medical care to a state's resident patients. Walter Hellerstein, *State Taxation* ¶6.10 (3d ed. & Supp. 2015) (citing *Mercy Med. Ctr. v. Anderson*, No. C4-93-11658 (D. Minn. June 22, 1995)).

C. Proposition of Law No. 2: The U.S. Constitution's Dormant Commerce Clause Protects Businesses' Gross Receipts Dissociated from Any In-State Activity from Being Subject to a State's Gross Receipts Tax.

The U.S. Supreme Court was clear in *Complete Auto* that the test for whether a taxpayer had sufficient contacts with a state requires the activity conducted by the taxpayer to have substantial nexus with the state.[11] What constitutes substantial nexus varies by the type of tax a state is imposing. For use taxes that are complementary to the states' sales taxes, the U.S. Supreme Court in *Nat'l Geographic v. Cal. Bd. of Equalization*, 430 U.S. 551, 558, 97 S.Ct. 1386, 51 L.Ed.2d 631 (1977), allowed a state to impose a collection and remittance responsibility on out-of-state businesses even when they are conducting unrelated operations in the taxing state. "[S]uch dissociation does not bar the imposition of the use-tax collection duty." *Id.* at 560. In contrast, a state is more restricted on when it can tax the income of a multijurisdictional corporation. "[T]here must be a rational relation between the income attributed to the taxing State and the intrastate value of the corporate business." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 772, 112 S.Ct. 2251, 119 L.Ed.2d 533 (1992). "[W]e have not abandoned the requirement that, in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax." *Id.* at 778 (citing *Quill*, 504 U.S. at 306-308). "[I]f the value [a] State [wishes] to tax [is] derived from a discrete business enterprise, then the State could not tax even an apportioned share of that value." (Quotations omitted.) *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 26, 128 S.Ct. 1498, 170 L.Ed.2d 404 (2008) (citing *Mobil Oil Corp. v. Commr. of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980) and *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159,103 S.Ct. 2933, 77 L.Ed.2d 545 (1983)).

[11] "We note again that no claim is made that [1] *the activity is not sufficiently connected to the State* to justify a tax, or [2] that the tax is not fairly related to benefits provide the taxpayer, or [3] that the tax discriminates against interstate commerce, or [4] that the tax is not fairly apportioned." *Complete Auto,* 430 U.S. at 287 (emphasis added).

Thus, the U.S. Supreme Court applied different limits on the imposition of sales/use taxes and corporate income taxes based on out-of-state businesses' activities in the state. The same is true with gross receipts taxes; sales dissociated with in-state activity are not subject to taxation. *Norton Co. v. Dep't of Revenue of Illinois*, 340 U.S. 534, 71 S.Ct. 377, 95 L.Ed. 517 (1951).

> Where a corporation chooses to stay at home in all respects except to send abroad advertising or drummers to solicit orders which are sent directly to the home office for acceptance, filling, and delivery back to the buyer, it is obvious that the State of the buyer has no local grip on the seller. Unless some local incident occurs sufficient to bring the transaction within its taxing power, the vendor is not taxable. … Of course, a state imposing a sales or use tax can more easily meet this burden, because the impact of those taxes is [local]. Cases involving them are not controlling here, for this tax falls on the vendor.

Norton, 340 U.S. 537.

Following the U.S. Supreme Court's decision in *Norton*, the Washington Supreme Court in *B.F. Goodrich Co. v. State of Washington*, 38 Wash.2d 663, 231 P.2d 325 (1951), reversed the Washington Department of Revenue's unconstitutional attempt to apply the State's gross receipts tax, the B&O tax, to sales made directly from an out-of-state office. Even though B.F. Goodrich had an office in Washington, sales that were not solicited, serviced, or shipped from a Washington location were held not to be subject to Washington's gross receipts tax because such sales were dissociated from Washington. Crutchfield's facts are similar to *Norton's* and *B.F. Goodrich's*—Crutchfield has no sales operations (or other service operations) in Ohio.

In this case, the Commissioner has not identified any transactions connected to Ohio by Crutchfield having a person or office in Ohio. The U.S. Supreme Court's decision in *Norton* is still controlling. As stated by the Court in *Norton*, "[t]he only items that are so clearly interstate in character that the State could not reasonably attribute their proceeds to the local business are orders sent directly to [the out-of-state location] by the customer and shipped directly to the customer from [the out-of-state location]. Income from those we think was not [constitutionally]

subject to [Illinois' gross receipts] tax." *Norton,* 340 U.S. at 539. "[A business] can avoid taxation on some Illinois sales only by showing that particular transactions are dissociated from the local business and interstate in nature." *Id.* at 537. With Crutchfield having no in-state offices, employees, or agents making sales in Ohio, all of its sales are dissociated from Ohio.

Two subsequent cases to *Norton* addressing whether sales in Washington were dissociated are distinguishable from Crutchfield's facts. In *General Motors Corp. v. State*, 377 U.S. 436, 84 S.Ct. 1564, 12 L.Ed.2d 430 (1964), the U.S. Supreme Court held General Motors failed to prove its out-of-state wholesaling activity was disassociated from its district managers and others assisting retail dealers in the State. As noted in *Tyler Pipe*, "*General Motors* is not a controlling precedent." *Tyler Pipe,* 483 U.S. at 242. In *Std. Pressed Steel Co. v. Washington Dep't of Revenue*, 419 U.S. 560, 95 S.Ct. 706, 42 L.Ed.2d 719 (1975), an out-of-state taxpayer proffered no evidence that a salesperson's activity was dissociated from sales in Washington. As Crutchfield has no offices or salesperson in Ohio, clearly all its sales are dissociated from Ohio.

The dissociation test used in *Norton* is still good law. The U.S. Supreme Court knows how to overrule its prior decisions that no longer support the principle in an underlying case. In the same year that *Norton* was decided, the U.S. Supreme Court issued a decision in another Dormant Commerce Clause case, *Spector Motor Serv., Inc. v. O'Connor*, 340 U.S. 602, 71 S.Ct. 508, 95 L.Ed. 573 (1951). The Court in *Spector* held that "there is … long-established precedent for keeping the federal privilege of carrying on exclusively interstate commerce free from state taxation. To do so gives lateral support to one of the cornerstones of our constitutional law—*McCulloch v. Maryland,* [17 U.S. 316, 4 L.Ed. 579 (1819)]." *Spector,* 340 U.S. at 610. In 1977, the U.S. Supreme Court overruled *Spector* in its landmark *Complete Auto* decision. *Complete Auto,* 430 U.S. at 288-89. If the Court had also determined that *Norton* outlived its usefulness,

which it has not, it would have stated so in *Complete Auto*. Since the Court did not make such statements overruling *Norton*, this Court must apply *Norton* to determine whether the CAT passes constitutional muster on sales made outside Ohio and delivered to customers in the State.

In conclusion, whether a state is imposing a use tax, income tax, or gross receipts tax, all three types of taxes require the entity to have some form of physical presence in the state. In the absence of activities in the state, sales in Ohio dissociated from the State cannot be taxed.

D. Proposition of Law No. 3: State Court Decisions Relying on Economic Nexus Are Distinguishable and Are Not Binding On This Court.

While the U.S. Supreme Court has not affirmed that a state can impose a tax without any activities performed in the state, cases in other states applying an "economic presence nexus" standard can be distinguished.[12] While the term "economic presence nexus" is cited for the proposition that physical presence is not needed, *amicus* disagrees.[13] When some form of economic nexus has been upheld, albeit constitutionally deficient, there was still a relationship or connection between the out-of-state company and a business operating in the taxing state.

The lead economic presence nexus case is *Geoffrey, Inc. v. South Carolina Tax Commr.*, 313 S.C. 15, 23, 437 S.E.2d 13 (1993), which was decided one year after *Quill*. *Geoffrey* involved the licensing of intellectual property ("IP") held by a separate corporation ("IP Holding Company") affiliated with an entity that had a brick-and-mortar store in the state. *See Geoffery*, 313 S.C. 15. The IP Holding Company had no physical presence in South Carolina, yet the South

[12] Although the majority of the economic presence nexus cases have been decided by the highest court of the state, this Court is not bound by those decisions. This is true even where there is near unanimity among other states. *See Trolio v. McLendon*, 9 Ohio St.2d. 103, 107, 224 N.E.2d 117 (1967) (Although highly persuasive, th[e] circumstance [where there is near unanimity among other states] is not binding upon us.").

[13] In addition, in *Couchot v. State Lottery Comm'r*, 74 Ohio St.3d 417, 659 N.E.2d 1225 (1996), this Court found that *Quill's* physical presence test was satisfied based on the in-state purchase of a lottery ticket by an out-of-state resident. ("[T]he physical presence requirement would in any event be satisfied. . . . He purchased his winning ticket in Ironton and redeemed it in Columbus." *Id.* at 425.) Thus, this Court has relied upon a physical presence test for purposes of determining when an out-of-state resident is subject to tax under the Commerce Clause.

Carolina Supreme Court determined it had nexus. *Id.* Similar cases have reached the highest court in other states. *See e.g. Bridges, Sec. of Dept. of Revenue v. Geoffrey, Inc.*, 984 So. 2d 115, 2007-1063 (La. App. 1st Cir. 2008); *Geoffrey, Inc. v. Oklahoma Tax Commr.*, 132 P. 3d 632 (Okla. Ct. Civ. App. 2005); and, *Lanco, Inc. v. Director, Div. of Taxation*, 379 N.J.Super. 562, 879 A.2d 1234 (N.J. Sup. Ct. App. Div. 2005). In addition, the Iowa Supreme Court held a franchisor and franchisee relationship can create substantial nexus. *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W. 2d 308, 321-28 (Iowa 2010).

Amicus questions the legitimacy of those decisions; but, in each of those cases the courts relied upon a quasi-agency relationship or in-state connection between the out-of-state business and an entity with physical presence in the state. While COST adamantly asserts those relationships do not reach the degree of physical presence found in *Scripto* or *Tyler Pipe*, the out-of-state businesses affirming substantial nexus did have some type of relationship with an in-state business entity that enabled those out-of-state businesses to earn revenue in the taxing state. For example, in the South Carolina *Geoffery* case, the IP Holding Company received a royalty of one percent "'of the net sales'" of the brick-and-mortar stores that were operating in South Carolina. That type of relationship is not present in Crutchfield's situation.

Further, the Supreme Court of Oklahoma rejected the idea that receipt of payments from an in-state affiliate alone, even when the affiliate was doing business in the state, was sufficient to create nexus. *See Scioto Ins. Co. v. Oklahoma Tax Comm'r*, 279 P. 3d 782, 786-88 (Okla. 2012). *Scioto* involved a captive insurance company that was wholly owned by Wendy's International, an Ohio-based corporation. *Id.* at 783. The insurance company held intellectual property that it licensed to Wendy's International. *Id*. Wendy's International, in turn, sublicensed the IP to individual Wendy's restaurants in Oklahoma. *Id*. The insurance company only received

income from Wendy's International; however, the income from Wendy's International was a percentage of the gross sales of the individual Wendy's restaurants in Oklahoma. *Id*. The *Scioto* court determined the insurance company did not have sufficient activity in the state, even though the receipts were ultimately based on sales from in-state businesses. *Scioto* at 783. The court found Wendy's International was required to pay the insurance company, and noted that the insurance company was not a shell entity. The court acknowledged an earlier economic presence decision in *Geoffrey Inc.*, 132 P. 3d 632, but concluded that the insurance company had no contacts with the state, and to subject it to tax would offend due process.[14]

Although Crutchfield's facts are distinguishable from *Scioto*, the court's decision in *Scioto* is instructive. The indirect receipt of income by an out-of-state business from an in-state business is insufficient to create nexus; rather, an out-of-state business must receive income directly from the in-state business. And Crutchfield's facts are even stronger, as its receipts come solely from unrelated third-party customers. Also notable in *Scioto* is that the court found that the facts failed to meet the lower Due Process standard. Thus, considering Crutchfield's stronger facts, this Court should conclude that the higher Commerce Clause standard is not satisfied.

The Oklahoma Supreme Court is not alone in limiting a state's ability to assert economic presence nexus. In *Griffith v. ConAgra Brands, Inc.*, 229 W.Va. 190, 728 S.E.2d 74 (2012), the West Virginia Supreme Court of Appeals concluded that substantial nexus was not present based on ConAgra licensing its trademarks to entities selling ConAgra's trademark brands to wholesalers and retailers in West Virginia. *Id*. at 200. The Court determined that the use of IP by unrelated entities was insufficient to establish nexus—even where that same court had previously determined that substantial nexus could be established through an economic presence nexus

[14] The *Scioto* court did not address the Commerce Clause because it involved an insurance company. Under the McCarran-Ferguson Act, Congress removed insurance companies' Commerce Clause protection. *See* fn 3.

standard. *Id.*; *see Tax Comm'r of West Virginia v. MBNA Am. Bank, N.A.*, 220 W.Va. 163, 173, 640 S.E.2d 226 (2006) ("West Virginia *MBNA* Case"). Specifically, the court noted that ConAgra did not produce the products bearing its trademarks and names, that it did not dictate how the licensees distributed those products, and that the licensees did not own or operate any retail stores in the state and only sold the products through wholesalers and retailers in the state. *ConAgra*, 229 W.Va. at 200. Thus, the West Virginia Supreme Court of Appeals refused to apply its economic nexus standard where receipts from the licensing of IP was too remote. *Id.* As with *Scioto*, Crutchfield 's connection with Ohio is even more tenuous than that rejected in *ConAgra*.

The second line of economic nexus standard cases involve financial institutions issuing credit cards (hereinafter "Credit Card Companies"). *See Capital Bank One v. Comm'r of Revenue*, 453 Mass. 1, 13 899 N.E.2d 76 (Mass. 2009); *MBNA Am. Bank, N.A. v. Indiana Dept of State Rev.*, 895 N.E. 2d 140, 142-44 (Ind. 2008) ("Indiana *MBNA* Case"); West Virginia *MBNA* Case at 171-73. In the *Capital One* case, the court noted that the typical credit card transaction involved "a Massachusetts customer presenting a 'Capital One' Visa-branded or MasterCard-branded credit card in payments for goods and services" and "the cardholder or merchant [swiping] through a card reader located at the merchant's place of business." *Capital Bank One*, 453 Mass. at 5. While Capital One did not perform any in-state activities in Massachusetts, it did have relationships with in-state merchants and banks accepting "Capital One" branded credit cards. *Id.* COST disagrees with the finding that this level of in-state activity satisfies the Commerce Clause substantial nexus standard. However, the distinguishing feature in this case was Capital One's relationship with in-state businesses (*i.e.* with in-state merchants and

in-state banks), which the court appears to have considered when determining that the Capital One had substantial nexus that satisfied the Commerce Clause.[15]

The aforementioned cases do not represent the only perspective from state courts on this issue. The Tennessee Supreme Court in *J.C. Penny Nat'l Bank v. Johnson*, 19 S.W. 3d 831 (Tenn. Ct. App. 1999) followed *Quill.* That court held that physical presence was required directly with the credit card issuer before the Tennessee Department of Revenue could assert nexus over the issuer. *Id.* at 841-42. Because the entity issuing the credit cards lacked a physical presence in Tennessee, the court concluded that it lacked the level of activities performed in the State required by the Commerce Clause's substantial nexus requirement. *Id.*

Crutchfield, in contrast to any of these purported "economic presence nexus" cases, did not have—not was it required to have—an affiliation with any in-state business for it to complete its transactions with its customers located in Ohio. The common thread among all of the economic nexus cases is an out-of-state business's relationship with some in-state business to assist it in making sales to customers in the state. In the IP holding company cases and in the franchisee case, it was the existence of a relationship with an affiliate or franchisee; in the credit card company cases, it was the relationships that the Credit Card Companies had with in-state merchants and banks. Crutchfield, however, is just an out-of-state seller and maintains no relationships with any in-state businesses for it to make sales to Ohio customers.

All of these cases finding the taxpayer had economic presence nexus with the taxing state are income tax cases.[16] Importantly, the CAT is not an income tax, it is a gross receipts tax based on a taxpayer's activity in Ohio. Income taxes are not synonymous with gross receipts

[15] Although the courts in the Indiana and West Virginia *MBNA* cases did not discuss the credit card transaction process, it can be assumed that was the general process used by MBNA in those cases as well. Thus, while not specifically called out by the courts in those cases, it is reasonable to assume that the courts understood the nature of MBNA's relationships with in-state merchants when deciding those cases.

[16] West Virginia also had a business franchise tax which was repealed starting January 1, 2015.

taxes. This difference is key to understanding why a court may find the taxpayers in income tax cases may have substantial nexus, while Crutchfield here does not.

Based on the foregoing, the economic nexus standard cases are distinguishable, and cannot be used to assert Crutchfield has substantial nexus with Ohio. Thus, the BTA decision allowing Ohio to impose the CAT on Crutchfield is unconstitutional and should be reversed.

E. Proposition of Law No. 4: An Entity Must Have Physical Presence with the State for the State to Impose a Tax that is Fairly Related to the Services Provided by the State.

The fourth prong of the *Complete Auto* test (*i.e.,* a tax must be fairly related to the services provided by the state) informs the decision in this case. How can a state that imposes a tax on a business without any activities performed in the state be imposing a tax that is fairly related to the services provided by the State? Crutchfield has no employees or property in Ohio. The U.S. Supreme Court has made it clear the relationship of services provided by the state to the taxpayer does not have to be a one-to-one ratio; however, it is irrational, and constitutionally impermissible, for a business with no property or payroll in the state to be subject to tax in a state that provides no services to the out-of-state business. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 629, 101 S.Ct. 2946, 69 L.Ed.2d 884 (1981).

The test for the fourth prong of *Complete Auto* is not whether the taxpayers have received any direct benefits from the state, but "whether the state has given anything for which it can ask [in] return." *Commonwealth Edison,* 453 U.S. at 625 (citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444, 61 S.Ct. 246, 249, 85 L.Ed. 267 (1940). "[T]he test is closely connected to the first prong of the *Complete Auto Transit* test. Under this threshold test, the interstate business must have a substantial nexus with the State before *any* tax may be levied on it." *Id.* at 626 (emphasis in original). To this point, a taxpayer can be expected to contribute to a state for benefits "derived from his enjoyment of the privileges of living in an organized society." *Id.* at

623. Such privileges include “police and fire protection, the use of public roads and mass transit, and the other advantages of civilized society.” *Goldberg v. Sweet,* 488 U.S. 252, 267, 109 S.Ct. 582, 102 L.Ed.2d 607 (1989). Crutchfield is not receiving any of these privileges in Ohio; rather, it is Crutchfield’s Ohio customers that receive those privileges.

An appellate court in Illinois addressed whether a tug boat operating 50 percent of the time in navigable waters in the State could be subject to Illinois’ use tax on the fuel. *Am. River Transp. Co. v. Bower*, 286 Ill.Dec. 397. 813 N.E.2d 1090 (Ill. App. Ct. 2004). Finding no evidence that the fuel was purchased in Illinois (it was all purchased in St. Louis, Missouri) and the tugboats never docked in an Illinois port, the court concluded “the imposition of the use tax in this case does, indeed, run afoul of the commerce clause because it has no relation to any services provided by the state. While [tugboats] plied the waters of this state, Illinois provided no services to those tugboats.” *Id.* at 400. The Court went on further to say:

> The Department relies on *Brown's Furniture, Inc*. and *Town Crier, Inc. v. Department of Revenue*, 315 Ill. App. 3d 286, 733 N.E.2d 780, 248 Ill. Dec. 105 (2000), to support its argument that the imposition of the use tax had a relation to the services provided to ARTCO. However, both of these cases are easily distinguished. Both cases involved out-of-state retail establishments that made substantial deliveries of their products, via their own trucks, to buyers in Illinois. As such, those retailers received the benefits of Illinois's public roads, police protection, and judicial system, as well as other advantages conferred by the maintenance of a civilized society. See *Brown's Furniture, Inc. v. Wagner,* 171 Ill.2d 410, 429, 665 N.E.2d 795 (1996); *Town Crier, Inc*., 315 Ill. App. 3d at 295. Here, ARTCO did not receive any such benefit from Illinois *in relation to its line haul tugboats*. The Department argues that Illinois statutory law provided ARTCO tugboats with protection from polluted waterways and protection of aquatic life. However, these ‘benefits,’ while related to waterways used by ARTCO, fall far short of the benefits that might be enjoyed by a firm sending its trucks to use the roads of this state… In an analogous situation, an aircraft owner does not pay Illinois tax for fuel purchased and loaded out of state yet consumed while flying over this state. This is so even though the aircraft is in Illinois airspace and Illinois provides services to help keep the air clean as well as emergency services and other indicia of ‘civilized society.’

Id. at 400-401.

American River Transp. therefore instructs us that the dormant Commerce Clause requirements are not satisfied merely by when some tangential benefit from state services somehow in some way purportedly inures to Crutchfield. The Court in *American River Transp.* recognized that an out-of-state business must receive a *direct* and *tangible* benefits from the state for a tax to pass muster under the Commerce Clause *because it is the out-of-state business being taxed,* not its purchasers located in the taxing state.

Crutchfield never entered Ohio and only used common carriers to make deliveries to its customers in Ohio; thus, the State is clearly not providing any services to Crutchfield.

F. Proposition of Law No. 5: Departing From the Tyler Pipe Activity Conducted in the State Rule Creates Substantial Compliance Costs for Multistate Businesses, Especially Small Businesses.

In *Quill*, the U.S. Supreme Court recognized that anything but a physical presence rule would be an undue burden on interstate commerce, because of the significant cost of compliance with sales and use tax laws in a multistate environment. The same conclusion applies *a fortiori* in Crutchfield's case. Without a physical presence rule, companies will need to examine these questions on a jurisdiction-by-jurisdiction, corporate-entity-by-entity, and year-by-year basis. Issues with record-keeping are also significant. The number of potential taxing jurisdictions at the state and local level that can impose a business activity tax is staggering. In *Quill,* there were over 6,000 sales and use tax jurisdictions. *See Quill*, 504 U.S. at 313 n.6. And, recent reports show that burden has continued to grow—there now about 10,000 different sales/use tax jurisdictions in the United States.[17]

[17] See Bloomberg BNA tax release issued August 20, 2015; available at: http://www.prnewswire.com/news-releases/bloomberg-bna-launches-new-and-expanded-bna-sales-tax-rates-solution-300131044.html.

Multistate businesses face the prospect of taxation not only in 50 states, but also in thousands of localities authorized to impose corporate income, franchise and other business activity taxes.[18] While there are almost 10,000 sales/use tax jurisdictions, the total estimated amount of differing tax jurisdictions is more than 55,000 in the United States alone.[19] In the absence of a physical presence rule, multistate businesses will face significant costs in trying to determine the jurisdictions in which they face potential tax liabilities and the applicable rules of those jurisdictions.[20] Some may be unable to ascertain accurately their tax liabilities at all. Each multistate business—large or small—must analyze a long list of issues for every jurisdiction where it has a commercial profile.

The effects on small and mid-sized businesses of abandoning the physical presence rule will be severe. Smaller businesses do not have the resources or capability to comply with the multitude of state and local tax laws that are certain to be triggered by the economic nexus standard. For example, one study determined that for firms with $5 million or more in assets, the "average total compliance costs systematically increase with increasing firm size as measured by asset size."[21] Thus, abandoning the physical presence rule will have a disproportionate impact on small and mid-sized corporate taxpayers.

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[18] Based on 2013 figures, Ohio is already a difficult state for multijurisdictional business, allowing over 600 municipalities to impose an income tax. http://www.tax.ohio.gov/tax_analysis/tax_data_series/individual_income/publications_tds_municipal/LG11CY13.aspx.

[19] Per SAP SE, defining a tax jurisdiction as each location with the authority to impose a tax; available at: http://help.sap.com/SAPHELP_470/Helpdata/EN/fa/99bc1c339811d3958d00a0c929f4c9/content.htm.

[20] Sanjay Gupta and Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 NAT'L TAX J. 355, 363 (2002). For the largest 1,000 firms, the ratio of state compliance costs to state income tax expenses is 2.9%, or more than twice the federal ratio of 1.4%.

[21] Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses: A Report to the IRS LMSB Division*, Univ. Mich. Bus. Sch. (Sept. 2002). Firms in the $5 million to $10 million asset category had compliance costs around $35,000, and firms in the $100 million to $250 million category had compliance costs around $243,000. "[C]ompliance costs are regressive in the sense that those costs as a percentage of firm size are higher for smaller firms than they are for larger firms." *Id.*

G. Proposition of Law No. 6: Crutchfield has No Presence in Ohio Sufficient to Allow Ohio to Impose the CAT on Crutchfield.

In *Quill*, the U.S. Supreme Court reaffirmed physical presence was required for a state to establish substantial nexus with a taxpayer to impose taxes. *Quill* addressed a mail order office supply company that had no payroll or property in North Dakota and therefore did not collect and remit use tax from its customers in North Dakota. *Quill,* 504 U.S. at 303. Quill argued its sales to North Dakotan customers were insufficient to require it to collect and remit the tax. *Id.* The State argued that satisfying the "minimum contacts" standard of the Due Process Clause also satisfied the substantial nexus standard under the Commerce Clause. The U.S. Supreme Court disagreed with North Dakota and found Quill's sole activities performed in North Dakota was its delivery of merchandise by mail or common carrier to its customers in North Dakota. It held, citing *Nat'l Bellas Hess, Inc. v. Department of Revenue of State of Ill.*, 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967), as binding precedent, that physical presence was still required to establish substantial nexus under the Commerce Clause. *Quill,* 504 U.S. at 302, 319.

In *Quill*, the U.S. Supreme Court noted Quill had some licensed software (diskettes) in the state; however, the Court concluded, "Quill's licensing of software in this case does not meet the 'substantial nexus' requirement of the Commerce Clause." *Id.* at n. 8.[22] While the Commissioner claims Crutchfield has property in Ohio due to Crutchfield's "software resid[ing] on computers and mobile devices in Ohio," *see* Commissioner's Br. 7, Crutchfield's facts differ fundamentally from those in *Quill*. Crutchfield maintains no software in Ohio. Any software on customers' computing devices was loaded by the customers themselves. Crutchfield's customers did not pay for the software. Even as to cell phone applications, Crutchfield's customers control

[22] The U.S. Supreme Court has also rejected the notion that a federal law, P.L. 86-272, which protects out-of-state businesses only soliciting sales of tangible personal property in a state from the state imposing an income tax on that business, did not have a *de minimis* standard. *Wisconsin Dep't of Revenue v. William Wrigley, Jr. Co.*, 505 U.S. 214, 231-32, 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992).

application's use and can readily delete the software, but they cannot manipulate the software. In effect, the software is no different than the traditional use of a catalog which is shipped to Ohio customers. A customer is free to open the application, equivalent to viewing a catalog, or it can delete it, equivalent to disposing a catalog in the trash.[23] Further, a recent Michigan appellate decision is instructive, holding that the use of software in fulfilling a service is merely incidental to the service and does not equate to tangible personal property (*i.e.,* pre-written software) for sales and use tax purposes. *Auto-Owners Ins. Co. v. Dep't of Treasury*, No. 321505 (Mich. Ct. App. 2015) (finding mere access via a web browser or computer application was not enough to impose a tax on such applications as pre-written software).

Ohio does not have the substantial nexus with Crutchfield required by the dormant Commerce Clause to impose a tax on an out-of-state business. Thus, the BTA decision to impose the CAT on Crutchfield is unconstitutional and should be reversed.

IV. CONCLUSION

For these reasons, the Tax Commissioner's imposition of the CAT on Crutchfield is unconstitutional. Thus, the decision of the Ohio Board of Tax Appeals should be reversed.

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[23] The Court noted in *Quill* that, though over 24 tons of catalogs and flyers mailed by Quill were sent into North Dakota by Quill each year, this only helped demonstrate Quill had a "minimal connection" for Due Process Clause purposes, and it was still insufficient to find substantial nexus under the Commerce Clause. *Quill,* 504 U.S. at 304.

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