

CAT 2005-02 - Commercial Activity Tax: Nexus Standards - September, 2005; May, 2011

This is version 2 of this release. The purpose of this information release is to describe the nexus standards the Department of Taxation will apply to determine whether a person is subject to the Commercial Activity Tax (CAT).

The limitations and extent of this state's jurisdiction to impose tax is an evolving area and this information release is not intended to be an all encompassing or all inclusive description of this subject.(1)

This information release may be modified by changes in either federal or state laws or by decisions of the U.S. Supreme Court, the Ohio Supreme Court, the Ohio Courts of Appeals, or the Ohio Board of Tax Appeals.

This information release may also be modified and reissued to incorporate nexus guidelines that may be published from time-to-time by agencies such as the Multistate Tax Commission or to clarify the Department's position. Where no conflict exists between this information release and the Department's previously published positions relating to nexus, those positions will remain in effect. Taxpayers may wish to consider the nexus considerations discussed in this Information Release before determining whether they should file as a Combined Taxpayer or as a Consolidated Elected Taxpayer.

ISSUES ADDRESSED

- I. What is the nexus standard the Department of Taxation will use to determine whether a person is subject to Ohio's CAT?
- II. What is bright-line presence, and what impact does it have?
- III. When is this information release effective?
- IV. What are the registration and filing requirements for a person subject to Ohio's taxing jurisdiction?
- V. Once bright-line presence is established, how long does the filing requirement last?

DEFINITIONS

The following definition is used in this information release:

"Person" means, but is not limited to, individuals, combinations of individuals of any form, receivers, assignees, trustees in bankruptcy, firms, companies, joint-stock companies, business trusts, estates, partnerships, limited liability partnerships, limited liability companies, associations, joint ventures, clubs, societies, for-profit corporations, S corporations, qualified subchapter S subsidiaries, qualified subchapter S trusts, trusts, entities that are disregarded for federal income tax purposes, and any other entities. "Excluded persons include nonprofit organizations or the state, its agencies, its instrumentalities, and its political subdivisions.

"Nexus" as used in this information release has the same meaning as "substantial nexus" that is used in R.C. Chapter 5751.

ISSUES DISCUSSED

I. What is the nexus standard the Department of Taxation will use to determine whether a person is subject to Ohio's CAT?

Ohio law provides that a person is subject to the Ohio CAT under any set of circumstances allowed by the Constitution of the United States. Specifically, R.C. 5751.01(H) sets forth the legal standard used by the Department of Taxation to determine whether a person is subject to the Ohio CAT. A person is subject to Ohio's CAT when the any of the following applies. The person:

- Owns or uses a part or all of its capital or property in this state [5751.01(H)(1)]; or
- Holds a certificate of compliance with the laws of Ohio authorizing the person to do business in this state [5751.01(H)(2)]; (2) or
- Has bright-line presence in Ohio[5751.01(H)(3)]; or

- Otherwise has nexus with Ohio to an extent that the person can be required to remit the CAT under the Constitution of the United States. [5751.01(H)(4)]

II. What is bright-line presence, and what impact does it have?

A. Notwithstanding the provisions of R.C. 5751.01(H)(4), the Department of Taxation, in its administration of the CAT, will only enforce nexus against persons who possess bright-line presence as set forth in R.C. 5751.01(I)(1)-(5), and discussed below. Consequently, even if a person has nexus under the Constitution of the United States, if the person lacks bright-line presence the Department of Taxation will not assert that such person is required to be a taxpayer (this does not apply to a person that is required to be part of a consolidated elected taxpayer group).

B. Bright-line presence is a method of determining whether nexus exists that relies entirely upon quantitative criteria. Bright-line presence is defined in R.C. 5751.01(I). A person has "bright-line presence" in this state if any of the following applies. The person:

(1) Has at any time during the calendar year property in this state with an aggregate value of at least \$50,000. For the purposes of bright-line presence, owned property is valued at original cost and rented property is valued at eight times the net annual rental charge.

(2) Has during the calendar year payroll in this state of at least \$50,000. Payroll in this state includes all of the following:

- (a) Any amount subject to withholding by the person under section 5747.06 of the Revised Code;
- (b) Any other amount the person pays as compensation to an individual under the supervision or control of the person for work done in this state; and
- (c) Any amount the person pays for services performed in this state on its behalf by another.

(3) Has during the calendar year taxable gross receipts in this state of at least \$500,000. As bright-line presence is satisfied when the person meets any of the criteria, it is entirely possible that a person could have substantial nexus even if it totally lacked property or payroll in this state.

(4) Has at any time during the calendar year within this state at least 25 percent of the person's total property, total payroll, or total gross receipts. Thus, if a person only had \$25,000 worth of property in Ohio, bright-line presence would still exist, despite R.C. 5751.01(I)(1), if the value of its total property everywhere was \$100,000 or less.

(5) Is domiciled in this state as an individual or for corporate, commercial, or other business purposes. Being domiciled in Ohio automatically creates bright-line presence, regardless of the value of the person's property, payroll or sales.

C. The United States Supreme Court has not yet decided whether the physical presence requirement mandated for sales and use taxes by *Quill Corp. v. North Dakota* (1992), 504 U.S. 298, applies to other taxes, such as the CAT. The Court did comment in *Quill* that "...contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today." *Quill*, 504 U.S. at 311. The Court also stated that it had never required physical presence for "other" taxes. Thus, while *Quill* maintained the physical presence requirement for sales and use taxes, the Court was quite clear that it considers the physical presence standard to be an anomaly in constitutional jurisprudence. This has great implications in regards to the CAT. While *Quill* requires physical presence for sales and use tax nexus, the Supreme Court has never applied the physical presence standard to other taxes, such as income, franchise, and gross receipt taxes. Therefore, *Quill's* physical presence requirement does not explicitly apply to a business privilege tax such as the CAT. Furthermore, on the basis of the Court's comments in *Quill*, there is every reason to suspect that the Court would not require physical presence for the CAT.

Other states have also held that the physical presence requirement of *Quill* applies only to sales and use taxes, and not to other taxes. See, e.g., *Lanco, Inc. v. Director, Div. of Taxation* (August 24, 2005), N.J. Sup. Ct. App. Div. No. A-3285-03T1 (corporation business tax), *Geoffrey, Inc. v. South Carolina Tax Comm.* (1993), 313 S.C. 15, cert. denied, 510 U.S. 992 (1993) (corporate income tax), *Koch Fuels, Inc. v. Clark* (1996), 676 A.2d 330

(gross earnings tax on imports), *Gen. Motors Corp. v. Seattle* (2001), 105 Wn. App. 1011 (business & occupation tax), *Steager v. MBNA America Bank, N.A.* (June 27, 2005), WV Circuit Ct., No. 04-AA-157 (corporate income tax), *Bridges v. Autozone Properties, Inc.* (March 24, 2005), La S Ct., No. 2004-C-814 (franchise / capital stock tax – only decided on Due Process grounds, but the court relied heavily upon the reasoning in *Geoffrey*), Indiana Dept. of Rev. (April 1, 2005), Letter of Findings No. 02-0310 (corporate income tax). Indeed, as the New Jersey Superior Court noted in its recent decision in *Lanco*, the weight of authority is moving in the direction of not requiring a physical presence outside the sales and use tax area. "The recent and, in our view, the more persuasive authority leads us to join the jurisdictions which have followed *Geoffrey*. . . ." *Lanco, supra*.

While recognizing that other states have reached the opposite conclusion, the Department believes that the weight of authority as well as Ohio case law supports the conclusion that a physical presence standard would not apply to the CAT. The Ohio Supreme Court has already adopted this so-called "economic presence" standard for income taxes. In the case of *Couchot v. State Lottery Comm.* (1996), 74 Ohio St. 3d 417, non-Ohio residents purchased winning Ohio lottery tickets and were subjected to withholding of Ohio income tax. The taxpayers contended that, among other things, Ohio's attempt to tax their winnings violated the Commerce Clause since they had no physical contacts with the state of Ohio. The Ohio Supreme Court relied upon the language in *Quill* that the physical presence standard applies only to sales and use taxes and does not apply to other taxes such as an income tax. Given that the Ohio Supreme Court has already ruled that the physical presence requirement of *Quill* does not apply to taxes other than sales and use taxes, the Department believes that the use of an economic presence test for the CAT is completely in accord with Ohio law as set forth in *Couchot*.

III. When is this information release effective?

The CAT became effective July 1, 2005 with the first semi-annual return being due February 10, 2006. This Information Release is effective when issued and applies starting with the first semi-annual tax period (July 1, 2005 to December 31, 2005). The Department of Taxation reserves the right to modify and reissue this information release in order to reflect judicial decisions or to clarify the Department's position.

The General Assembly has created a special appeal provision to facilitate the review of the constitutionality of the bright-line presence law. R.C. 5751.31 provides that the Tax Commissioner may issue special final determinations on assessments which can only be appealed directly to the Ohio Supreme Court if the petitioner's primary issue is the constitutionality of the bright-line presence provisions contained in R.C. 5751.01(H)(3) and defined in 5751.01(I).

IV. What are the registration and filing requirements for a person subject to this state's taxing jurisdiction?

A person falling within this state's taxing jurisdiction will be required to file returns, and pay the appropriate tax. Information about taxpayer obligations under the CAT is available by calling 1-888-7CATTAX (1-888-722-8829), or from the Department's website by visiting tax.ohio.gov and clicking on "CAT".

The reporting period for a person that becomes subject to this state's taxing jurisdiction begins on the first day of the period in which the person satisfies the bright-line presence criteria.

Example 1:

A person not previously having bright-line presence opens a sales office and employs sales representatives in Ohio in April 2006. By May 31, 2006, the person has over \$50,000 of Ohio payroll, thereby satisfying the bright-line presence standard described in Issue II. The person had only \$20,000 of taxable gross receipts through March 31, 2006. After that date, the person had \$200,000 of taxable gross receipts for the remaining portion of the calendar year. Since the person has under \$1 million dollars of taxable gross receipts in 2006, the person is eligible to be a calendar year taxpayer. If the person chooses to be a calendar year taxpayer, its taxable gross receipts for the calendar year are \$220,000. In contrast, if such person chooses to be a calendar quarter taxpayer, its taxable gross receipts will only be determined from the second quarter, 2006 through the end of the calendar year – \$200,000. (Note: because the taxpayer is under \$1 million in taxable gross receipts, it will still only pay the flat – minimum – tax of \$150).

Example 2:

A person not previously having bright-line presence opens a sales office and employs sales representatives in Ohio on July 2, 2006. The person had no taxable gross receipts in the first quarter of 2006 and had \$30,000 of taxable gross receipts in the second quarter of 2006; after opening the Ohio office, the person has an additional \$1.2 million of taxable gross receipts in 2006. In addition, the person has a payroll in this state of \$40,000 in 2006. The person has taxable gross receipts of at least \$500,000 in 2006, thereby satisfying the bright-line presence standard described in Issue II. Since the person also has taxable gross receipts of at least \$1 million, the person is required to be a calendar quarter taxpayer and must pay the flat – minimum – tax of \$150 on the first \$1 million and the effective tax rate on the remaining \$200,000.

V. Once bright-line presence is established, how long does the filing requirement last?

A person that satisfies the bright-line presence criteria for any part of a calendar year continues to be required to be a CAT taxpayer for the remainder of the calendar year. In addition, a person, regardless of when they meet the bright-line presence standard described in Issue II at any time during that subsequent calendar year, is required to be a taxpayer for the entire subsequent calendar year.

Example:

A person has had bright-line presence with Ohio only because it maintains a sales office in Ohio, generating in excess of \$50,000 in payroll in Ohio. On June 15, 2006 the person closes its Ohio office and will no longer satisfy the bright-line presence criteria in subsequent years. The person will be required to file CAT return(s) for the entirety of 2006 (either one return or four quarterly returns depending upon the total gross receipts of the person), including all gross receipts earned after June 15, 2006. Assuming taxable gross receipts and other factors are still below the qualifying amount (e.g. \$500,000 or 25 percent of the person's total gross receipts), the person's CAT liability could end on December 31, 2006. Such person must cancel its registration by February 9, 2007 to not be subject to the minimum – flat fee of \$150 for calendar year 2007.

If you have any questions regarding this matter, please call 1-888-7CATTAX (1-888-722-8829) (Ohio Relay Services for the Hearing or Speech Impaired: 1-800-750-0750).

Footnotes:

(1) The commercial activity tax nexus standards described in this information release are not identical to the use tax nexus standards described in Information Release ST-2001-01 or the corporate franchise tax nexus standards described in Information Release CFT-2001-02 (available on the Department's web site by visiting tax.ohio.gov and clicking on "Releases").

(2) *Cf.* R.C. 1703.02 for those out-of-state corporations not required to register with the Ohio Secretary of State.