taxnotes® state

Volume 111, Number 7 ■ February 12, 2024

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Reprinted from *Tax Notes State*, February 12, 2024, p. 493

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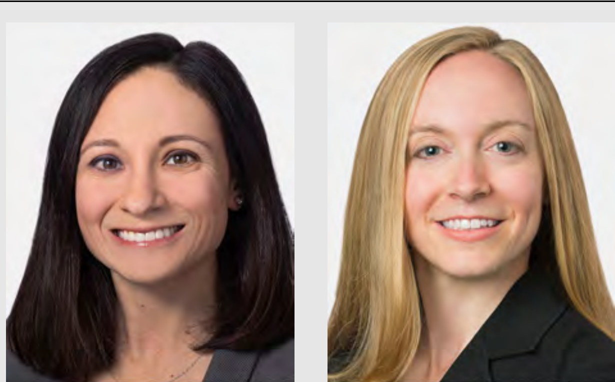
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In this installment of SALT Insights, Ferrante and George discuss recent rulings regarding Ohio's commercial activity tax in which the state's supreme court interpreted key sourcing provisions in a taxpayer-friendly manner.

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Gross receipts taxes are infamous in the taxpayer community. While the rates are generally low, they are flawed in that they impose tax on an extremely broad base of activities, tax all types of corporate entities and businesses (including unprofitable ones), and result in pyramiding and multiple taxation.[1]

The Ohio commercial activity tax (CAT) is a gross receipts tax imposed as a privilege tax on all types of business activity in the state, including retailing, providing services, manufacturing, distributing, and wholesaling.[2] All types of business — including C corporations, limited liability companies, partnerships, and trusts — with taxable gross receipts of more than $150,000 that have nexus (including a bright-line economic presence nexus of at least $500,000 in taxable gross receipts) are subject to the CAT for years before 2024.[3] CAT is generally imposed at a 0.26 percent rate on taxable gross receipts over $1 million for years before 2024.[4]

As deficient and troublesome as gross receipts taxes generally are, recent developments in Ohio have improved the CAT landscape and fostered some fairness to its sourcing rules. These cases are a welcome surprise demonstrating that some good can arise in the gross receipts tax context. While taxpayers may still be subject to the inefficient CAT, the inequity may not be as impactful as expected.

Recent Ohio litigation demonstrates the good — specifically, a few recent rulings interpreting the CAT's big three sourcing rules for services, intangible property, and tangible personal property. These rulings reject unsupported Ohio Department of Taxation positions attempting to overreach and instead apply the law as written — even going so far as to imply that if the agency

[1] *See, e.g.*, Richard D. Pomp, "Resisting the Siren Song of Gross Receipts Taxes: From the Middle Ages to Maryland's Tax on Digital Advertising," State Tax Research Institute (July 2022).

[2] Ohio Rev. Code Ann. sections 5751.02(A), 5751.01(F).

[3] Ohio Rev. Code Ann. sections 5751.01(A), (D), (H). Ohio Department of Taxation, Info. Release CAT 2023-01 (revised Aug. 2023) ("Taxpayers with $3 million or less in taxable gross receipts in 2024 and $6 million or less in 2025 will not be required to file a return with the Department of Taxation.").

[4] With exceptions for taxpayers with gross receipts greater than $1 million but at least $4 million. *See* CAT 2023-01. For tax years 2024 and 2025, the exclusion amount increases to $3 million and $6 million, respectively. *Id.*; Ohio Rev. Code Ann. sections 5751.03, 5751.01(R).



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does not like the result, it can take it up with the legislature.[5]

These cases unfortunately had to go deep into litigation to reach the right results, but the good news is that taxpayers now have favorable precedent to rely on.

### Court Rejects Overly Broad Approach

The Ohio Supreme Court has consistently taken a commonsense approach to interpreting the law and facts in tackling difficult CAT sourcing issues.

In *Defender Security*, the court interpreted the law governing the sourcing of service receipts.[6] The court rejected the department's look-through approach as not indicative of where the benefit of the service is received. The department attempted to look through to the taxpayer's customer's customers, but the court held that the situs of gross receipts received by the taxpayer from sales of security monitoring service contacts to a purchaser who had Ohio customers was not Ohio, but instead was at the purchaser's physical location outside the state — even though the purchaser's customers may have used and received the benefits of the monitoring services in Ohio.

The basis of the court's holding is the statute's plain language. The court observed that under the statute, "the paramount consideration when determining the proportion of the benefit attributed to Ohio is the physical location where the purchaser ultimately uses or receives the benefit of what was purchased."[7] The court meticulously applied this standard to the facts by identifying four key elements of the statute: (1) the purchaser (ADT); (2) what the purchaser purchased (intangible contract rights); (3) the benefit of what was purchased (receipt of payments from Ohio customers for the provision of security services); and (4) where the purchaser uses or receives the benefit of what was purchased (ADT's out-of-state physical locations where its customers' payments were received).

The court further rejected the department's attempt to collapse the two separate transactions arising from the same set of facts. By conflating two transactions, namely, (1) the benefit that the purchaser's purchasers (end users) in Ohio received in some indirect fashion from the provision of the purchaser's services and (2) the benefit that the purchaser received from its purchase of Ohio customer contracts from the taxpayer, the department "failed to properly distinguish between the benefit Ohio consumers [purchaser's purchasers or end users] received from ADT [purchaser] and the benefit ADT received by purchasing consumer contracts from Defender [taxpayer]."[8] The court's conclusion made clear that these two transactions cannot be collapsed to situs under the statute, even if both transactions would not have occurred without the benefits received by the Ohio end users from the provision of the purchaser's services to these end users.

In another recent case, *NASCAR*, the court tackled how to source IP.[9] Here, the court again rejected the department's look-through approach that relied on Ohio television ratings and population based on the specific facts and circumstances of the taxpayer.

The statute at issue sources "gross receipts from the sale, exchange, disposition, or other grant of the right to use trademarks, trade names, patents, copyrights, and similar intellectual property" to Ohio "to the extent the receipts are based on the right to use the property in this

[5] Other well-reasoned gross receipts tax sourcing decisions include those issued by Texas and Washington courts. *See Sirius XM Radio Inc. v. Hegar*, 643 S.W.3d 402 (Tex. 2022) (overturning the court of appeals' decision holding that the state's performance-based sourcing statute for service receipts essentially looks to customer location and relying on the statute's plain language to affirm the taxpayer's method of sourcing its receipts to the location where the taxpayer's performance occurred); *LendingTree LLC v. State of Washington Department of Revenue*, 460 P.3d 640 (Wash. Ct. App. 2020) (interpreting a statute similar to Ohio determining that the Washington statute looks to where the purchaser received the benefit of the service, rejecting the tax agency's argument that the statute allows the DOR to look to the location of the purchaser's purchasers (or end users)).

[6] *Defender Security Co. v. McClain*, 165 N.E.3d 1236 (Ohio 2020). While this case technically involves the "catch-all" sourcing statutory provision, the same provision governs services sourcing. Ohio Rev. Code Ann. section 5751.033(I) ("Gross receipts from the sale of all other services, and all other gross receipts not otherwise sitused under this section, shall be sitused to this state.").

[7] *Defender Security Co.*, 165 N.E.3d at 1241-1242 (quotations omitted).

[8] *Id.* at 1242.

[9] *NASCAR Holdings Inc. v. McClain*, 214 N.E.3d 524 (Ohio 2022).



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state."[10] The court applied this language to NASCAR's various types of intangible gross receipts at issue, including gross receipts earned from broadcasting rights, licensing IP, and sponsorships. The court concluded that none of these receipts are Ohio receipts because:

> None of the sample contracts tied payments to the right to use property in Ohio. Ohio was not even mentioned in the contracts. Rather, the agreements granted broad rights to use NASCAR's intellectual property over large geographic areas — most often the United States and its territories — that include Ohio.
>
> Thus, there are no traceable receipts that are "based on" a right to use NASCAR's intellectual property "in this state." One thing is "based on" another if the second thing is foundational to the first. "In common talk, the phrase 'based on' indicates a but-for causal relationship and thus a necessary logical condition." But nothing in the contracts before us shows any causal connection between any of the receipts and the right to use NASCAR's intellectual property in Ohio.[11]

While the IP sourcing statute appears to use a customer's customer look-through approach, the court cautioned that the taxpayer's specific facts need to warrant using this approach. Otherwise, the department cannot use it. Thus, the court narrowed the scope of the look-through approach to cases in which the taxpayer's facts justified using the approach.

These cases demonstrate that to ensure that the CAT's sourcing rules are reasonably applied on a case-by-case basis, the Ohio Supreme Court is unwilling to expand the tax without imposing practical limits.

### Board of Tax Appeals Follows Court's Lead

Recently, the Ohio Board of Tax Appeals followed suit in *VVF*, narrowly interpreting the sourcing of tangible personal property under the state's ultimate receipt statute and refusing to permit the department's overly broad interpretation.[12] The statute provides that gross receipts from the sale of tangible personal property are sourced to Ohio if the property is received by the purchaser in Ohio. Specifically, "in the case of delivery of tangible personal property by motor carrier or by other means of transportation, the place at which such property is ultimately received after all transportation has been completed shall be considered the place where the purchaser receives the property."[13] Like the supreme court, the board rejected the department's overreach and held for the taxpayer based on the statute's plain language.

In *VVF*, the board held that a manufacturer (VVF) that delivered customer sales of its personal care products (such as soap and deodorant) to a distribution center/warehouse in Ohio, where the products were ultimately shipped out of state upon sale to the customer's customer, successfully proved that the products were ultimately received outside Ohio. VVF met its burden of proof by presenting witness testimony (including customer testimony) and sales records reflecting that its products were

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[10] The entire statutory provision reads:

> Gross receipts from the sale, exchange, disposition, or other grant of the right to use trademarks, trade names, patents, copyrights, and similar intellectual property shall be sitused to this state to the extent that the receipts are based on the amount of use of the property in this state. If the receipts are not based on the amount of use of the property, but rather on the right to use the property, and the payor has the right to use the property in this state, then the receipts from the sale, exchange, disposition, or other grant of the right to use such property shall be sitused to this state to the extent the receipts are based on the right to use the property in this state.

Ohio Rev. Code Ann. section 5751.033(F). In this case, however, only the second sentence is at issue. *See NASCAR Holdings Inc.*, 214 N.E.3d at 531 ("The sample agreements provided for fixed payments for the right to use NASCAR's intellectual property. The payments were contingent not on the *amount* of use but, rather, solely *on the right to use* the property. Thus, the tax commissioner properly looked to the second sentence, instead of the first sentence, of R.C. 5751.033(F).") (emphasis in original).

[11] *NASCAR Holdings Inc.*, 214 N.E.3d at 531 (citations omitted).

[12] *VVF Intervest LLC v. Harris*, Case No. 2019-1233 (Ohio Bd. Tax App. Sept. 13, 2023).

[13] Ohio Rev. Code Ann. section 5751.033(E).



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ultimately delivered to the customer's customers outside Ohio.

The board in *VVF* recognized that it had addressed this same question in other sourcing cases with facts similar to the case at hand. When the taxpayers have not prevailed, it has been not on the merits of their sourcing arguments, but because they have lacked sufficient proof.[14] Likewise, and on the same day it issued its *VVF* ruling, the board ruled on a case with similar facts but found for the department. In *Jones Apparel*, the board held that the taxpayer designer/wholesaler did not prove that its sales of products shipped to its retail customers' Ohio distribution center for shipment to customers' retail stores located mostly out of state were non-Ohio gross receipts, in which the taxpayer provided a three-month sample period of sales that was after the audit period in lieu of detailed sales transaction records.[15]

In addition to finding in VVF's favor, the board rejected two department positions.[16] First, the board rejected the department's position that the taxpayer must know the ultimate destination when the product is shipped: "The Commissioner places great emphasis on VVF's records and VVF's subjective knowledge of the time the bars left Kansas. . . . Neither the statute nor case law have imposed a requirement of contemporaneous knowledge of the ultimate destination at the time of transportation."[17] Instead, the board determined that: "Indeed, this Board can contemplate circumstances in which a taxpayer could present evidence that it obtained after transportation was complete that would successfully demonstrate that the goods were ultimately received outside of Ohio."[18]

Second, the board denied the department's attempt to bifurcate a sales transaction that passes through a distribution center into two sales transactions: the first sale to the distribution center and the second sale to the ultimate destination. In *VVF*, the board reasoned:

> VVF sends the goods from Kansas to a third-party facility in Ohio under the title and control of [the customer]. From this Ohio facility, [the customer] again contracts to transport the goods to destinations outside of Ohio based on its customer needs. Ohio does not become the ultimate delivery point simply because the bars are temporarily held here in a distribution center owned by an entirely unrelated third party.[19]

The board's rejection of the department's bifurcation argument, in circumstances in which the ultimate destination was a sale by the customer to its customers, likewise confirms the concept that transitory connections to the state are insufficient to justify sourcing.

### Open Issues and Other Considerations

*VVF* is a welcome and long overdue ruling because it provides taxpayers with guidance on when a transitory presence in Ohio will be sufficient to trigger CAT and how and when to prove ultimate destination. Despite the clarity we now have, lingering questions remain about the statute's interpretation.

One unanswered question is whether this precedent can be relied on when the first stop is not a distribution center. The statute does not impose a strict distribution limitation. If an Ohio customer makes a purchase that it intends to sell in Ohio, is unable to do so, and finds an out-of-state buyer, can the taxpayer claim a refund on the basis that the product was ultimately received outside the state? Presumably, it would depend

[14] *VVF Intervest*, Case No. 2019-1233 at 8 ("In all three cases, we found the . . . taxpayer failed to show Ohio was merely a pit stop not the place where the property was ultimately delivered after all transportation has been completed."). *Greenscapes Home & Garden Prods. Inc. v. Testa*, No. 2016-350, 2017 WL 3183334 (Ohio Bd. Tax App. July 19, 2017) (wholesaler did not show that its sales listing Ohio delivery addresses of its retail customers' distribution centers were delivered outside Ohio for ultimate sale in customers' retail stores); *Mia Shoes Inc. v. McClain*, No. 2016-282, 2019 WL 4013504 (Ohio Bd. Tax App. Aug. 8, 2019) (similar facts and conclusion as *Greenscapes*, and board rejected taxpayer's use of customer's percentage of retail stores in Ohio versus out-of-state as a proxy for products ultimately received outside Ohio); *Henry Rac Holding Corp. v. McClain*, No. 2019-787 (Ohio Bd. Tax App. Nov. 10, 2020) (manufacturer that sells to distributors — some of which are in Ohio — for ultimate sale to customers also lacked proof of products shipped out of Ohio).

[15] *Jones Apparel Group/Nine West Holdings v. McClain*, Case Nos. 2020-53, 2020-54 (Ohio Bd. Tax App. Sept. 13, 2023).

[16] *See, e.g.*, Ohio Department of Taxation, Info. Release CAT 2005-17 at 9 (rev. Apr. 2006).

[17] *VVF Intervest*, Case No. 2019-1233 at 10. *See also Jones Apparel*, Case Nos. 2020-53, 2020-54 at 9-10.

[18] *Jones Apparel*, Case Nos. 2020-53, 2020-54 at 10.

[19] *VVF Intervest*, Case No. 2019-1233 at 11.



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on facts such as the customer's intent at the time of purchase, how much time has passed since the purchase, and whether the customer made a good-faith effort to make an Ohio sale. This can quickly become a fact-intensive inquiry, and one can imagine variations on this fact pattern that would require interpretation of the statutory phrase "after all transportation has been completed."[20]

Also, under the CAT's factor presence nexus standard, the nexus and sourcing inquiries collapse so that nexus depends on where a taxpayer's gross receipts are sourced.[21] Thus, a taxpayer that ships products to an Ohio distribution center that can prove out-of-state destination on all or some sales can make a well-reasoned argument supported by the statute and case law that it is not a taxpayer at all under the CAT's nexus standard if that is its only Ohio activity.[22]

Both *VVF* and *Jones Apparel* have been appealed and are being briefed before the supreme court. The department claims the board erred in rejecting its contemporary knowledge limitation and its sales bifurcation characterization, while the taxpayer in *Jones Apparel* argues — among other errors — that the board erred in finding its representative sample insufficient to prove ultimate destination outside the state. The court should once and for all affirm rejection of the department's unsupported positions, as it has consistently done in other sourcing cases, and further clarify the burden of proof required to prove out-of-state sales.

## Concluding Thoughts

While these decisions involve different taxpayers and facts, they are all consistent with the notion of market sourcing and interpreting the statute's plain language. The Ohio Supreme Court has consistently upheld taxpayer interpretations of a statute's commonsense meaning and rebuffed inapposite department interpretation. As the *NASCAR* court succinctly proclaimed: "But our job is to apply the plain language of the statute. To the extent that the commissioner believes that the statutory language fails to adequately reflect the policies underlying the CAT, he is free to take up that matter with the legislature."[23]

The Ohio decisions confirm that it is critical for taxpayers to keep records to support where their sales are received, used, and ultimately may go. Without these, as the cases show, a taxpayer cannot support its sourcing method.

The important takeaway here is that Ohio courts have recently interpreted the state's key sourcing provisions in a taxpayer-friendly manner. These cases can help resolve audits, assessments, and refund claim denials in some taxpayers' favor. For the entire tax community, it is always a welcome development when a court applies the law in accordance with its commonsense understanding because it creates a system in which taxpayers can comply and states can consistently administer the law. ■

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[20]Ohio Rev. Code Ann. section 5751.033(E).

[21]*Id.* section 5751.01(H), (I) (bright-line presence includes taxable gross receipts of at least $500,000); Ohio Department of Taxation, Info. Release CAT 2005-02 at 9 (rev. Nov. 2019).

[22]Assuming that a taxpayer's gross receipts are under the nexus threshold.

[23]*NASCAR Holdings Inc.*, 214 N.E.3d at 532.



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