OHIO STATE TAX DEVELOPMENTS – FALL 2022

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I. Commercial Activity Tax

A. Cash Discounts and Returns & Allowances: Cash discounts and returns and allowances are excluded from taxable gross receipts. The Department's regulation states that to qualify for the exclusion, the discounts must be given to the taxpayer's customer, not the customer's customer. Additionally, in the Commissioner's view, taxpayers must distinguish cash discounts from certain advertising rebates, which do not qualify for the exclusion under the Commissioner's view. There have been several recent appeals involving situations in which the Department has allowed certain types of rebates, chargebacks, bill-backs, and trade promotional allowances to be excluded from taxable gross receipts. Conversely, the Department's interpretation of whether discounts attributable to merchandising, advertising, and promotion programs are excludable has been more mixed.

In *R.J. Reynolds Tobacco Company v. McClain* (BTA Case No. 2021-1731), the taxpayer offered certain discounts to wholesalers, including term discounts, retail discounts, and promotion allowances. These were described as temporary price adjustments related to the buy-in period allowed subsequent to price increases, and discounts for tax stamping, promotion, freight, and other allowances. The taxpayer argues that those discounts qualify for the exclusion from taxable gross receipts for cash discounts or returns & allowances. The case is scheduled for a hearing on May 10, 2023.

In *Altria Group, Inc. v. McClain* (BTA Case No. 2021-694), the taxpayer, a manufacturer and wholesaler of tobacco products, argues that wholesaler off-invoice and retailer off-invoice allowances are not "realized" by the taxpayer and thus are not taxable gross receipts, or in the alternative, that they qualify for the exclusion for cash discounts or returns and allowances. The Commissioner's position is that the discounts do not qualify for the exclusion because additional obligations and services must be provided to earn these off-invoice allowances, and that the allowances are meant for the purchaser's customer, not the purchaser. The case is scheduled for a hearing March 14, 2023.

In *AmerisourceBergen Corporation v. McClain* (BTA Case No. 2020-1407), the Commissioner issued an assessment to Amerisource that included Ohio Commercial Activity Tax ("CAT") computed on rebates, discounts, chargebacks, and other purchase price adjustments that Amerisource, a pharmaceutical drug

distributor received from its suppliers. Amerisource contends that those amounts are mere downward adjustments to the purchase price that Amerisource pays to its suppliers and thus not included in taxable gross receipts under O.R.C. § 5751.01(F). Specifically, at the time Amerisource enters into a contract with a supplier, there is insufficient information to calculate an accurate purchase price; therefore, the contract contains a mechanism for the parties to adjust the purchase price based on subsequent events. In the alternative, Amerisource argues that the amounts qualify for the exclusion for cash discounts under O.R.C. § 5751.01(F)(2)(bb).

The Commissioner, by contrast, interprets gross receipts broadly. Gross receipts are defined under O.R.C. § 5751.01(F) as "the total amount realized by a person, without deduction for the cost of goods sold or other expenses incurred, that contributes to the production of gross income of the person…" The Commissioner looks to the definition of "gross income" under Internal Revenue Code ("IRC") § 61 to support its position that gross receipts is meant to encompass all sources of income not specifically excluded from the definition. The Commissioner's position with respect to the cash discounts received by Amerisource, is that Amerisource did not provide a sufficient description of each discount type in order to determine whether the amounts qualified for the exclusion. The parties settled this matter in May 2022.

The Higbee Company v. Testa (BTA Case No. 2018–310) involves a national retailer (dba Dillard's) that receives amounts from vendors in the form of payments and product discounts in exchange for advertising featuring the vendors' products. The Commissioner assessed Dillard's and included these amounts in gross receipts for purposes of the CAT as "amounts realized from the taxpayer's performance of services for another." Dillard's argues that the amounts received from the vendors are merely reductions in the cost of merchandise and that the amounts are not taxable gross receipts that contribute to the production of gross income. Dillard's also argues that receipts from revenue sharing from its proprietary credit card programs should not be sourced based on the locations of the credit card users. The parties settled this matter in March 2021.

B. Receipts from Services: Under O.R.C. § 5751.033(I), gross receipts from services and all other gross receipts are sourced based on the proportion that the purchaser's benefit in the state with respect to what was purchased bears to the purchaser's benefit everywhere with respect to what was purchased. The physical location where the purchaser ultimately uses or receives the benefit of what was purchased shall be paramount in determining the proportion of the benefit in the state.

In *Defender Security Company v. Testa*, Defender, an authorized dealer for ADT Security Services, sold and installed security equipment and obtained contracts for security monitoring services, which it sold to ADT for a fee. Defender filed refund claims arguing that ADT, as the purchaser of the contracts, receives the benefit of Ohio-based contracts at its principal place of business outside Ohio. The BTA upheld the Final Determination by the Ohio Department of Taxation (the "Department") that the receipts from Ohio-based contracts are situsd to Ohio,

holding that "[t]he contracts would not exist without property in Ohio to be monitored and equipment located within such property in Ohio by which the monitoring is performed." The BTA also noted that several examples in the regulations supported its conclusion, including examples involving receipts from appraisal services, architecture services, and engineering services, all of which are sourced to Ohio if the property tied to such services is located wholly in Ohio. *See* Case No. 2016–1030 (BTA 2018). The Ohio Court of Appeals affirmed this decision and Defender Security appealed the decision to the Ohio Supreme Court.

On September 29, 2020, the Ohio Supreme Court reversed the Court of Appeals, holding that Defender's receipts from selling security contracts to ADT should have been sourced to ADT's principal place of business, which was outside Ohio. Importantly, the Court rejected the Commissioner's argument that Defender must, in essence, look through ADT's location and source the receipts to the location where ADT's residential customers received the benefit of the security contracts. Thus, the Court drew a clear distinction between the services that Defender provided to ADT (sitused to ADT's location) and the security monitoring services provided by ADT (sitused to the location of ADT's residential customer). *Defender Sec. Co. v. McClain*, Slip Opinion No. 2020-Ohio-4594 (Ohio Sept. 29, 2020).

C. Receipts from Agency Relationships: Amounts acquired by an agent on behalf of another in excess of the agent's commission, fee, or other remuneration are excluded from taxable gross receipts. However the Department's position is that a lack of agency is presumed unless the agency relationship is explicitly stated in the contract. There are several cases pending at the BTA in which a taxpayer is seeking to establish that an agency relationship exists:

- In *Production Services Management v. McClain* (BTA Case No. 2021-2452), the taxpayer argues that management fees received from its principal, General Motors, are excluded under the agency exclusion. Specifically, the taxpayer argues that the Commissioner erroneously includes the reimbursable costs received from General Motors for reimbursing taxpayer for the cost of purchasing tooling on behalf of General Motors, because the taxpayer is merely a conduit in transferring the payments to the suppliers on behalf of General Motors. The taxpayer also argues that vendor rebates and discounts that it received for General Motors from third-parties qualify as cash discounts. The case is scheduled for a hearing February 15, 2023.

- In *Apple, Inc. v. McClain* (BTA Case No. 2020-1371), Apple argues that it is entitled to exclude a portion of its receipts from sales of various digital products such as eBooks, Apps, music, news service, and movies sold through its App Store and other digital content stores. Specifically, Apple argues that 70% of the receipts from those sales should be excluded because Apple acted as an agent of the developers of those products in making the sales. Apple also argues that certain of its other sales were made to

Qualified Distribution Centers such as Best Buy and PC Connection and thus should be excluded from taxable gross receipts to the extent those goods were ultimately sold outside Ohio. The parties resolved the case prior to the hearing.

- In *Cavaliers Holdings, LLC v. McClain* (BTA Case No. 2020-55), the taxpayer enters into event agreements with promoters for events at Q Arena in Cleveland. The taxpayer enters into fixed fee contracts or formula-based fee contracts, which include a minimum fixed fee plus a percentage of receipts from ticket sales. In exchange, the taxpayer provides a lease to use the arena as well as ticket selling and other ancillary stadium services. For both types of contracts, the Commissioner assessed CAT on all ticket sales (not just the rental fee).

  The taxpayer is arguing that for fixed fee events, only the rental fee is included in taxable gross receipts. For formula-based contracts, the taxpayer argues that only the portion of ticket sales they retain after paying promoters is included in taxable gross receipts. In each case, the taxpayer argues that it did not realize gross income equal to 100% of the ticket proceeds. Alternatively, the taxpayer argues that it is entitled to exclude amounts that it received as an agent under O.R.C. § 5751.01 (F)(2)(l). The Commissioner takes a broader interpretation of gross receipts, and argues that the taxpayer does not qualify as an agent because the contract does not explicitly name the taxpayer as an agent. The parties settled this matter in April 2022.

- In *Willoughby Hills v. Testa*, Willoughby purchased fuel products from Sunoco for resale and claimed it was the agent of Sunoco for purposes of selling the fuel products. Willoughby never took title to the fuel, which was shipped F.O.B. the loading facility of Sunoco directly to the retail gas station. Willoughby drafted the balance owed from the gas station, retained its commission and remitted the remaining balance owed to Sunoco, and argued that only the commission was a taxable gross receipt for purposes of the CAT. The BTA found Sunoco's "purported control over Willoughby insufficient to establish an agency relationship." In doing so, the BTA looked to the entirety of the distribution agreement between Willoughby and Sunoco. Specifically, the BTA found that Willoughby maintained control over its own employees and equipment. (The BTA found this despite the fact that under the sales agreement between Willoughby and Sunoco, Willoughby had to act in Sunoco's "best interests" by complying with Sunoco's "minimum standards" which dictate its business operations). *See* Case No. 2015–1069 (BTA 2015). The Ohio Supreme Court affirmed the BTA's decision on November 7, 2018. 155 Ohio St. 3d 276 (2018).

D. Scope of Taxable Gross Receipts. *Drummond Financial Services, Inc. v. McClain* (BTA Case No. 2020-700) involves a registered credit service organization (doing business as LoanMax) that offers lending services to consumers with a poor credit

history. Drummond assists borrowers by issuing a guaranty on the borrower's behalf to a third party lender. The borrower in turn pays a finance charge to Drummond and grants a security interest in a motor vehicle to the lender. Drummond earns CSO recovery income, which Drummond claims is the loan repayment collected from the borrower. Drummond also earns repo sale proceeds, which are the proceeds from repossessed motor vehicles. Drummond is arguing that CSO recovery income and repo sale proceeds are not taxable gross receipts under O.R.C. § 5751.01(F) because the proceeds are not amounts realized and don't represent accessions to wealth. Rather, Drummond argues these amounts are reimbursements of expenses. In the alternative, Drummond argues that the amounts qualify for the interest exclusion under O.R.C. § 5751.01(F)(2)(a), or repayment of principal on a loan under (F)(2)(e).

The Commissioner interprets gross receipts broadly and analogizes these amounts as costs of goods sold or other expenses occurred. The Commissioner also disputes the exclusions for interest or repayment of principal because Drummond is not a lender. The hearing for this case took place on August 30, 2022. The parties are preparing post-hearing briefs which are due by the end of this year.

Ultimate Delivery of TPP: The CAT statute provides that receipts from sales of tangible personal property ("TPP") are sourced to the place at which the TPP is received. In the case of delivery by any means, sales of TPP are sourced to the location where the TPP is ultimately received after all transportation has been completed. In the most recent BTA case filed, the taxpayer, MGF Sourcing, argues that its receipts should be sourced based on the Ohio apportionment of the affiliates who received the particular merchandise shipped and delivered by MGF. Meanwhile, the Commissioner argues that situsing should be based on the location of the affiliates' distribution centers in Ohio, on the premise that the distribution center is the ultimate destination for MGF, not the affiliates' retail locations.

MGF provides services to assist customers in the design, manufacturing, and delivery of goods. MGF made two types of sales: In the first type of sale (Type 1), title to merchandise passed from MGF to former affiliates at their distribution centers in Ohio and merchandise were sold at the affiliates retail locations throughout the U.S. In the second type of sale (Type 2), title to merchandise passed from MGF to former affiliates outside Ohio, then the affiliates brought the items into the Ohio distribution center and hired a service provider to deliver merchandise from the distribution center to retail stores throughout the U.S. MGF originally sourced the receipts for Type 1 sales based on the affiliates' respective Ohio CAT apportionment percentages, and MGF did not pay CAT on Type 2 sales.

During audit, the Department sitused 100% of MGF's Type 1 and Type 2 sales to Ohio. According to the Notice of Appeal, for Type 1 sales, the Audit Division stated the affiliates' Ohio distribution centers were the place where the affiliates ultimately received MGF's merchandise after all transportation had been completed. For Type 2 sales, the Audit Division concluded that the location where title passed had no bearing on where Ohio law sitused the sale, and relying on

O.R.C. § 5751.033(E), concluded that the affiliate's Ohio distribution centers were the place where the affiliates ultimately received MGF's merchandise after all transportation had been completed.

The taxpayer argues that this sourcing methodology is inconsistent with O.R.C. § 5751.033(E) and the Ohio Supreme Court's interpretation of the statute, as set forth in *House of Seagram v. Porterfield*, 27 Ohio St.2d 97 (1971) and *The Dupps Company v. Lindley*, 62 Ohio St.2d 305 (1980). Additionally, the taxpayer points to the Tax Commissioner's Final Determination in *Butler Color Press, Inc*. on November 25, 2016 where the Commissioner found the taxpayer's fulfillment center "merely an intermediate point on the flyers' journey to their pre-set location." The case is scheduled for a hearing January 12, 2023. *See MGF Sourcing US, LLC v. McClain* (BTA Case No. 2021-2268).

In *BP America Inc. v. McClain* (BTA Case No. 2021-632), the issue is whether sales of gas that occur at pipeline meters in Ohio should be sourced to Ohio when the purchasers plan to take the gas outside Ohio. The purchasers include Philadelphia Gas Company, Boston Gas Company, New Jersey Natural Gas Company, and Brooklyn Union Gas Company. The Commissioner's position is that the sales are properly sitused to Ohio because the purchasers receive the product in Ohio, notwithstanding the fact that the purchaser's customers may receive the product elsewhere. The taxpayer also argues that pass-through charges that it receives for shipping natural gas on pipelines should be removed from taxable gross receipts because the taxpayer acted as an agent. The case is scheduled for a hearing October 4, 2022.

In *CSX Transportation, Inc. v. McClain* (BTA Case No. 2021-575), the taxpayer argues that it is not a "motor carrier" subject to O.R.C. § 5751.033(G), which situses receipts from transportation services by motor carriers in proportion to the mileage traveled on roadways and railways in Ohio. Instead, the taxpayer argues that that it is a railroad not covered by subsection (G), but rather subject to the catch-all provision in subsection (I) of the statute providing that "all other receipts" are sitused to the physical location where the purchaser ultimately uses or receives the benefit of what was received. The case is scheduled for a hearing February 23, 2023.

XPO Logistics Inc. v. McClain (BTA Case No. 2021-533) involves a related issue. The taxpayer sitused its receipts from transportation services based on the mileage ratio under O.R.C. § 5751.033(G). The auditor disallowed from the ratio miles driven by third party motor carriers subcontracted by the taxpayer. The parties settled this matter in June 2022.

VVF Intervest, LLC v. McClain (BTA Case No. 2019-1233) involves a manufacturer of bar soap and other personal products. The products are manufactured and stored at VVF's Kansas City facility before an agent transports the products to an Ohio logistics center, the products are then shipped from the logistics center to multiple states. The Commissioner found that the products were

ultimately received in Ohio, while VVF argued that either (1) the receipts should be sourced to Kansas where the goods are transferred to a shipping agent, or (2) the receipts should be sourced to the location of the ultimate retailers that receive the goods, 97% of which are outside Ohio. A hearing was held on February 14, 2022.

In *GameStop, Inc. v. McClain* (BTA Case No. 2019-700), however, the Commissioner found that a GameStop affiliate that sold products to GameStop at its Kentucky distribution center must situs its sales to Ohio in a proportion equal to GameStop's total Ohio sales. Although the affiliate did not keep records of the location to which its goods were shipped, the Commissioner found that its estimation approach was a "reasonable, consistent, and uniform alternative." GameStop also challenged the Commissioner's refusal to allow a retroactive consolidated return election, which would allow it to exclude all intercompany receipts. The parties settled this matter in September 2021.

Electrolux Home Products, Inc. v. McClain (BTA Case Nos. 2020-798, 799) involves a wholesaler of goods that shipped its products to Sears' regional distribution center in Ohio. Electrolux claims the goods were then shipped outside Ohio, and, thus, were ultimately received by the customer outside Ohio in accordance with O.R.C. § 5751.033(E). Electrolux also claims that the Commissioner's requirement that the wholesaler have knowledge of the ultimate destination at the time of shipment is not required by the statute. The Commissioner's position is that because Electrolux does not have knowledge of the ultimate destination at the time of shipment, the receipts from the sale of the goods must be sourced to the location of the distribution center in Ohio. The parties settled this matter in April 2021.

Greenscapes Home and Garden Products, Inc. v. Testa involves a wholesaler of lawn and garden products that made sales to big box retailers such as Home Depot and Lowes. Greenscapes sells its products to retailers by loading its product onto the retailers' preferred mode of transportation at its Georgia location while also providing a ship-to address to the truck driver. The product becomes the customer's property as it crosses the dock to the truck. Because Greenscapes could not prove that any of the products with a ship-to address in Ohio were ultimately shipped outside Ohio, the BTA sustained the Commissioner's assessment with respect to those receipts. *See* Case No. 2016–350 (BTA 2017). Greenscapes appealed the BTA decision to the 10th Circuit Court of Appeals, where it is also arguing that it lacks nexus with Ohio because its only connection to Ohio is through a common carrier paid for by its customers. The Ohio Court of Appeals for the 10th Appellate District affirmed the BTA's ruling on February 7, 2019. The 10th District Court of Appeals affirmed the Board's decision in *Greenscapes Home and Garden Products, Inc. v. Testa*, 2019-384, and the Ohio Supreme Court did not accept Greenscapes' appeal for review. Greenscapes filed new appeals at the BTA for periods in 2017-2018, which settled in April 2020. (After Greenscapes filed its initial appeal at the Court of Appeals, the Ohio General Assembly recently restored an appeal as of right for all BTA decisions to the Ohio Supreme Court.) *See* BTA 2019-1514 et al.

Finally, *Mia Shoes, Inc. v. McClain* involves a footwear wholesaler headquartered in Miami (Mia) that sells its products to customers such as DSW and Macy's, which have distribution centers in Ohio. The BTA found that Mia failed to meet its evidentiary burden to establish that Mia's products were ultimately delivered to retail locations outside Ohio. Mia's evidence consisted of detail providing the percentage of each customer's retail locations that were in Ohio. Mia appealed the BTA decision to the Ohio Supreme Court, where it was dismissed for failure to file a brief. *See* Case No. 2019-1241. Mia Shoes has filed a subsequent appeal involving similar issues. *See* BTA Case No. 2021-1381.

E. Situsing of Intellectual Property. In *NASCAR Holdings, Inc. v. McClain,* Case No. 2015-0578, the BTA analyzed the sourcing of various types of revenue earned by NASCAR, including broadcast revenue and media revenue. The Commissioner used Nielsen ratings data to compute an audience ratio which it used to determine the proportion of receipts situsedto Ohio. NASCAR's position was that these receipts were properly situsedto Florida where it claimed it received the intangible revenue stream. The BTA held that this revenue was governed by O.R.C. §5751.033(F), which situses various types of intellectual property based on the amount of use of such property in the state. The BTA found that NASCAR's situsing methodology was not reasonable. NASCAR appealed the decision to the Ohio Supreme Court, and oral argument was held on January 25, 2022.

F. Auto Finance Receipts: In *Hyundai Motor Finance Company v. Testa*, Case No. 2015–785 (BTA July 6, 2015), the BTA considered whether the following types of receipts are subject to CAT:

- Receipts from the sale of vehicles held for lease at the end of the lease term: Receipts from the disposition of capital assets (within the meaning of IRC § 1221) or property used in a trade of business (within the meaning of IRC § 1231) are excluded from tax. Hyundai took the position that vehicles that it owned and leased to consumers constituted property used in its trade or business under IRC § 1231. The Department claimed the sales of vehicles are not property covered by IRC § 1231 because the vehicles are dual purpose property (simultaneously available for either lease or sale) and thus not § 1231 assets. Hyundai disputed that the vehicles are offered for lease and sale simultaneously.

- Subvention payments from auto manufacturers: Receipts from interest are excluded from tax. The Department claimed that reimbursements received from manufacturers for the difference between market-rate and below-market interest were subsidies, not interest, because Hyundai never borrowed any amount on which interest could be charged. Hyundai also claimed that the subvention payments should be sourced to the manufacturer's headquarters, not the location of the subvention program market.

- Receipts from securitization transactions: The Department treated receipts from sales of retail installment contracts to wholly-owned special purpose entities as subject to the CAT. Hyundai argued that the sales of the contracts were financing transactions, not sales, and they did not contribute to gross income. Alternatively, they argued that the receipts should be excluded as interest or receipts from the sale of I.R.C. § 1221 or § 1231 assets.

In a decision issued February 6, 2020, the BTA reversed the assessment against Hyundai and held that: (i) sales of vehicles at the end of a lease term qualify for the exclusion for receipts from the sale of IRC § 1221 or § 1231 assets, (ii) subvention receipts qualify for the interest exclusion, and (iii) receipts from securitization transactions are not taxable gross receipts. In reaching this decision, the BTA relied heavily on the treatment of transactions and payments for federal income tax purposes and accounting purposes in accordance with GAAP.

In *Nissan North America, Inc. v. Testa* (BTA 2016–1076), Nissan argued similar substantive issues as Hyundai, described above. Nissan also contested the Department's denial of Nissan's request to be treated as a consolidated filing taxpayer on a retroactive basis, because the denial (a) is arbitrary and capricious and violates due process of law, (b) violates equal protection to the extent the request was granted to other similarly situated taxpayers, and (c) consolidated filing is consistent with Nissan's federal income tax accounting methods, as required by O.R.C. § 5751.01(F)(4). Finally, Nissan argued that if it is not treated as a consolidated filing taxpayer, the imposition of tax on intercompany transactions is contrary to the statute because such receipts do not result in "gain, profit, or income" or "contribute[] to the production of gross income."

The BTA granted Nissan's request for a retroactive consolidated application, and found that the Commissioner abused his discretion in failing to grant the election. The BTA focused on the fact that Nissan (a) made its request in writing and on the form prescribed by the Commissioner, and (b) Nissan's failure to make the election prospectively was a mistake, which was apparent from the substance of Nissan's return. The case was not appealed by the Commissioner. *See* Case No. 2016–1076; decision issued April 7, 2020.

G. Federal Preemption**:** In *Health Net Federal Services LLC v. Testa*, Health Net was arguing that the imposition of CAT on receipts from TRICARE, the government program providing healthcare to military families, was preempted by Federal law precluding states from imposing premium taxes or similar taxes on health insurance carriers or plan managers with respect to TRICARE receipts. The Commissioner denied Health Net's refund request, taking the position that the CAT was not a similar tax to a premiums tax, and also that the CAT was a broad-based tax similar to the broad-based taxes on income or profit that are carved out of the Federal preemption statute. Health Net was also arguing that its TRICARE receipts were mere reimbursements and not gross receipts that contributed to the production of income. The parties settled this matter. *See* Case No. 2018–495.

H. Sourcing Flight Miles: In *United Parcel Service, Inc. v. Testa* (BTA 2016–917), United Parcel Service ("UPS") argued that the apportionment numerator used to calculate Ohio CAT receipts may only include miles for flights where the origin or destination is in Ohio. UPS argued that taking account flyover miles —where a flight merely passes over Ohio en route to a destination outside the state— was contrary to the statute and violated the Commerce Clause of the U.S. Constitution because those flights had no connection to Ohio and made no use of Ohio facilities, services, or employees. The parties have settled the appeal.

II. SALES AND USE TAXES

A. Nexus: On July 18, 2019, Ohio enacted legislation that created new requirements for certain remote sellers and marketplace facilitators. Effective Aug. 1, 2019, an out-of-state retailer will have substantial nexus with Ohio if, in the current or previous calendar year: (i) it has gross receipts exceeding $100,000 from sales in Ohio; or (ii) it has 200 or more separate sales transactions in O.R.C. § 5741.01(I)(2)(g)-(h). The requirements are the same for marketplace facilitators effective Sept. 1, 2019. The new legislation amends the previous economic nexus standard of $500,000.

B. Ohio Repeals Tax on Employment Services: Effective October 1, 2021, Ohio no longer imposes sales and use tax on a taxpayer's purchases on "employment services" from a service provider. Under former O.R.C. 5739.01(JJ), "employment services" were defined as providing or supplying personnel, on a temporary or long-term basis, to perform work or labor under the supervision or control of another, when the personnel receive their compensation from the provider of the service or a third-party that provided the personnel.

While the tax was in effect, there were multiple exceptions to taxable employment services, such as permanent contracts of at least one year, and acting as a contractor or subcontractor not under the direct control of the taxpayer. Taxpayers are still claiming these exceptions in years prior to 2021, and there is pending litigation at the BTA involving these issues and implicating earlier court decisions.

Background

Ohio imposed sales and use tax on a taxpayer's purchases of "employment services" from a service provider. However, unlike other states—including Pennsylvania—that only impose sales and use tax on the service fee, Ohio imposed tax on any reimbursement of the wages paid to the supplied personnel by the service provider, plus any markup.

Under former O.R.C. 5739.01(JJ), employment services did not include: acting as a contractor or subcontractor, Medicare and health care services, permanent contracts of at least one year, or employment services supplied by members of an affiliated group to other group members.

Previous Litigation on the Issue of Employment Services

In *Accel Inc. v. Testa*, the Ohio Supreme Court issued a decision in which it determined that some of a taxpayer's purchases of employment services were not subject to Ohio sales tax, because those purchases fell within an exception for services provided under permanent contracts of at least one year ("Permanent Exception"). *See* 2017 WL 6048460 (Ohio Dec. 6, 2017). In this decision, the court held that to qualify for the Permanent Exception, a business purchasing employment services needs to have a written contract in place with a service provider. Additionally, if a business purchasing employment services has a written contract in place with a service provider and the contract does not specify an ending date, the services provided under the contract may qualify for the Permanent Exception, even if the contract does not contain any "magic words" specifying that the employees are being assigned on a permanent basis. However, even if a business purchases employee services on a seasonal or short-term basis, the services may still qualify for the Permanent Exception.

The Ohio Supreme Court's decision in the *Accel* still affects many taxpayers arguing for a sales tax reduction for the purchasing employment services for a period of at least one year. Appeals are currently pending administratively and at the BTA involving the scope of the Permanent Exception.

C. Recent Litigation

1. American Modern Insurance Group filed claims for refund seeking to apply Ohio's multiple points of use (MPU) provisions to purchases of software that it contends were utilized by employees inside and outside Ohio. O.R.C. 5739.033(D) allows a taxpayer to apportion qualifying purchases to Ohio using any reasonable, consistent, and uniform method. According to the Commissioner, sufficient proof of an MPU claim includes a detailed description of the software purchased with a vendor description of the typical use in place of contracts; a list of employee names, position descriptions, and locations at the time of purchase of each license, and the location where the licenses were used. The Commissioner's position is that the taxpayer did not provide sufficient evidence to support its proposed MPU sourcing methodology. The case is scheduled for a BTA hearing January 3, 2023. *American Modern Insurance Group, Inc. v. McClain*, BTA Case No. 2022-507.

2. More Employment Service Contracts Litigation: As we note in Section II.B above, taxpayers have continued to challenge the Department's narrow interpretation of the Permanent Exception for employment service contracts. Complaints filed at the BTA indicate that these challenges are continuing.

   For example, Quality Associates produces store displays, gift sets, and other packaging solutions for national retailers. Quality was assessed use tax on employment services, and is seeking an exclusion for the Permanent Exemption. Additionally, Quality argues that certain employees fall outside

the definition of employment services because they are contractors or subcontractors and do not "perform work or labor under the supervision or control of another" as required by O.R.C. 5739.01(JJ). Quality appealed the Commissioner's Final Determination to the BTA and the case was resolved prior to a hearing. *Quality Associates vs. McClain,* BTA Case No. 2022-502.

Additionally, in *Kal Kan Foods Inc. v. Testa*, Case No. 2015–743 (BTA 2015), the taxpayer claimed a refund on two employment service concepts; the Permanent Exception and acting as a contractor or subcontractor not under the direct control of the taxpayer. In *Kal Kan*, the BTA did not decide the case on the Permanent Exception because it determined that Kal Kan's contract with its service provider was not an "employment services" agreement. Specifically, the BTA stated that an "employment service" agreement must meet three separate requirements—(1) providing personnel; (2) under the supervision or control of another; and (3) the personnel must receive wages from the provider of the service. Here, the BTA found that Kal Kan did not have control over the service provider's workers. The BTA found that Kal Kan and the service provider "purposefully enter[ed] into a contract adopting an on-site management model" at Kal Kan's facilities. The on-site management model allowed the service provider to conduct orientation, performance reviews, and the day-to-day management of the employees it provided to Kal Kan. As a result, Kal Kan did not have control over the service provider's workers, and the BTA decided that the contract between Kal Kan and the service provider was not an "employment services" agreement. The Tax Commissioner appealed to the Ohio Supreme Court. The Ohio Supreme Court affirmed the BTA's decision on December 12, 2018.

In *The Andersons, Inc. v. McClain* (BTA Case No. 2022-241) and *The Andersons Lawn Fertilizer Division, Inc. v. McClain* (BTA Case No. 2022-240), the taxpayer is claiming that the Commissioner erroneously assessed used tax on their purchasing and leasing of employees from employee leasing/staffing agencies because personnel were assigned to the taxpayer on a permanent basis under a contract for at least on year. The case (BTA Case No, 2022-240) is scheduled for a hearing on April 20, 2023.

The taxpayer in *Whirlpool Corp. v. McClain* (BTA Case No. 2021-2765) is also claiming a refund of tax paid on leases of personnel from Kelly Services, Inc. During the periods at issue, the taxpayer paid for contract workers to fill their Ohio manufacturing facilities. The taxpayer claims that the contract provides for an initial one-year term with successive one-year renewal terms and expresses the parties' intent that the contract workers were provided on a permanent basis with no contemplated ending date. Accordingly, the taxpayer seeks a refund of tax paid on the employment services under the Permanent Exception. The case is scheduled for a hearing on January 17, 2023.

3. Vendor of Taxable Services: Uber was assessed sales and use tax as the vendor or co-vendor of taxable transportation services, which are defined to include "all transactions by which . . . the transportation of persons by motor vehicle . . . is or is to be provided, when the transportation is entirely within the state." O.R.C. § 5739.01(B)(3)(r). "'Vendor' means the person providing the service or by whom the transfer effected or license given by a sale is or is to be made or given . . ." O.R.C. § 5739.01(C). Uber argues that it provides access to an app that drivers and riders can use, and thus it is not the vendor of the transportation services; rather, each individual driver that uses the Uber app is the vendor. The Commissioner relies on case law holding that the vendor is the person who "effected the transfer," and found that by settling the price of the transaction, controlling the quality of the services, and receiving payment, Uber had sufficient control over the transaction to effect the transfer, and thus is either a vendor or co-vendor of the transportation services.

   Uber also argues that the assessment violates the Internet Tax Freedom Act by imposing a discriminatory tax on interstate commerce, as well as the Ohio Constitution's Uniformity Clause, because it is treated as a co-vendor for collecting payment for services performed by third parties while other similarly situated companies such as PayPal and Square are not treated as co-vendors.

   The BTA remanded *Uber* to the Commissioner on August 20, 2020. *See Uber Technologies, Inc. v. Testa*, Case No. 2017-2009, 2020-41, 2020-42.

4. Outsourcing of IT Infrastructure: In two recent cases filed with the BTA, taxpayers are arguing that they are entitled to a refund of sales tax paid to Fujitsu for services related to IT infrastructure. Both taxpayers, Comenity and ADS, provide personnel, financial processes and technical infrastructure necessary for the management of the credit card operations of Comenity Bank. These taxpayers contracted with Fujitsu to outsource much of their IT infrastructure. Under this contract, the taxpayers are claiming that they paid tax for services related to Mainframe, Application Servers, Managed Network Services, Network Attached Storage, Co-Location, End-User Support and Service Desk, all of which were either (1) purchases of nontaxable infrastructure services or (2) taxable automatic data processing services, computer services, or electronic information services where the benefit of such services was realized outside of Ohio.

   For the services where the benefit was realized outside Ohio, the taxpayers are claiming that the benefit should be based on the location of credit card account holders because the benefit of such services are realized where the credit card account holders are located, not where the service provider, Fujitsu, is located (i.e., Columbus, Ohio).

The taxpayers are arguing that under O.R.C. § 5741.02, the services purchased from Fujitsu are properly sourced to where the benefit of the service was realized by the taxpayer (both within and without Ohio), based on the location of the credit card account holders. Specifically, they argue that it is the services provided by Fujitsu that permit the processing of credit card authorizations, customer payments, etc., which benefit the credit card account holders, which therefor benefits Comenity. Hearings for these cases are scheduled for April 6, 2023. *See ADS Alliance Data Systems, Inc. v. McClain* (BTA Case No. 2022-2), *Comenity Servicing, LLC v. McClain* (BTA Case No. 2022-2).

5. Construction Contracts/Business Fixtures: In *PCM, Inc. v. McClain*, the Commissioner assessed PCM for purchases of "taxable business fixtures" such as specialty electrical systems for a data center, exterior signage, raised flooring for business use, carpeting, and other similar items. The BTA upheld the assessment, and PCM appealed to the Ohio Supreme Court arguing that these items incorporated into real property are materials, not business fixtures, and therefore not subject to use tax. PCM also argues that all taxes on taxable materials were already paid by the construction contractor (Daimler Group). Finally, PCM argues that the BTA improperly denied its request for a hearing at the BTA because the request was made by a non-attorney officer of the corporation. On October 7, 2021, the Ohio Supreme Court referred the case to mediation.

   On November 9, 2021, the Tax Commissioner issued an opinion finding that video board and message displays are business fixtures for purposes of Ohio sales and use tax. The video display systems at issue were installed in sports stadiums and arenas as digital billboards on the facade of buildings, as signs by entrances to businesses, and on the interior of buildings.

   In the opinion, the Commissioner recognized that the video display systems could not be removed, transported, and installed at a subsequent site without significant damage. Additionally, the Commissioner distinguished these taxable fixtures from a "structure", which the Commissioner recognized as something that obtains its character as a result of being constructed on real property. The Commissioner explained that items classified as "fabrications or constructions"—structures—are not tangible personal property that is merely attached to the land, but rather are constructed upon the realty in which they are situated and have no existence until they are constructed on site. The Commissioner recognized that video display systems are composed of separate pieces of tangible personal property, which exist and have utility prior to being affixed and are therefore taxable business fixtures, not structures. Tax Comm'r Opinion, Opinion No. 21-0001 (Nov. 9, 2021).

6. Telecom Litigation: A number of cases filed at the BTA raised the issue of whether taxpayers' purchases of integrated voice response systems are

exempt telecommunications purchases under O.R.C. § 5739.02(B)(34). Specifically, the taxpayers purchased equipment that records customer data so that the taxpayers can bill their customers for network use. O.R.C. § 5739.02(B)(34) notes that sales of TPP "used directly and primarily in transmitting, receiving, switching, or recording any interactive . . . communication, including voice, image, data, and information, through the use of any medium, including . . . poles, wires, cables, switching equipment, and record storage devices" are exempt from tax.

In a series of cases before the BTA, several taxpayers have argued that their purchases of the integrated voice response systems are not taxable because those purchases record customer data. As a result, the taxpayers have asserted that they use the systems "directly and primarily in recording communications." By contrast, the Commissioner found that the integrated voice response systems do not record "communications," but instead track accounting information concerning the taxpayers' customers' usage of their telecommunications' networks.

The BTA remanded one of the cases (*Alltel Communications LLC v. Testa*) to the Tax Commissioner for further proceedings. *See Alltel Comm'n LLC v. Testa,* Case Nos. 2016-26-27 (BTA 2016); *see also New Par LP v. Testa,* Case Nos. 2016-30-31 (BTA 2016); *Cellco Partnership v. Testa,* Case Nos. 2016-28-29 (BTA 2016).

7. Resale Exemption: In *Cincinnati Reds, LLC v. Testa,* Docket No. 2017-0854, the Ohio Supreme Court held that promotional items, like bobblehead dolls, that were distributed by a professional baseball team to fans at a game qualified for the resale exemption. *See* 155 Ohio St. 3d 512 (2018).

The Department conducted an audit of the Reds' purchases, which ultimately resulted in an assessment. The Reds specifically protested the Department's assessment of use tax on its purchases of promotional items, which the Reds argued were resold as part of the price of an admission ticket to a game.

The BTA agreed with the Department and concluded that the Reds' intent was to give away promotional items for free, which the board said was further bolstered by the fact that not every fan received a bobblehead during games for which they were advertised.

The Supreme Court, however, found that the BTA's conclusion was contradicted by the testimony given by the Reds CFO at the BTA. Judge Fischer wrote that the CFO "specifically testified that the costs of promotional items are included in ticket prices when they are set before the start of a season" and that the promotional items are usually distributed at less desirable games that are not expected to sell out the stadium.

The majority further agreed that promotional items were offered instead of discounted ticket prices, saying that "one portion of the ticket price accounts for the right to attend the less desirable game and a separate portion of the ticket price accounts for the right to receive the promotional item."

The majority concluded its decision by saying that the "transfer of promotional items to fans thus constitutes a 'sale'" and the "promotional items are subject to the sale-for-resale exemption."

On December 7, 2018, in *Pi In The Sky, LLC v. Testa*, Docket No. 2017-0236, the Ohio Supreme Court affirmed an assessment of use tax against an LLC that purchased an aircraft and subsequently leased the aircraft to its sole member. The LLC, Pi In The Sky LLC ("PITS"), was a single member LLC formed for the purpose of purchasing and leasing an aircraft to its sole member, Mitchell's Salon and Day Spa, Inc. ("Mitchell's"). Mitchell's owns and operates several hair salons and spas in the greater Cincinnati area. Mitchell's president is a licensed pilot. PITS purchased the aircraft from an Indiana-based vendor and did not pay sales or use tax at the time of purchase. The Department audited PITS and assessed use tax.

PITS appealed the assessment, arguing that the subsequent lease of the aircraft to Mitchell's qualified the initial purchase of the aircraft as an exempt purchase for resale. The Department argued that the sales-for-resale exemption did not apply because PITS was not "engaged in business" as required by the resale exemption. Under Ohio law, the resale exemption in O.R.C. § 5739.01(E) applies when the purpose of a purchase is to resell the purchased item in the same form in which it was acquired, while that purchaser is engaging in business. According to the Department, PITS was not engaging in the business of leasing because:

- PITS had not reported a business location apart from the personal residence of Mitchell's president;
- There was no evidence that leasing activity took place at the aircraft's hangar;
- The aircraft was never used by a third-party lessee;
- There was no evidence that PITS ever marketed the aircraft for lease;
- Many of the flights were to or from a lake house owned by Mitchell's' president;
- The aircraft was purchased using personal funds of Mitchell's' president; and

- The lease agreement between PITS and Mitchell's lacked economic substance, such as arm's-length rental rates.

The Tax Commissioner and the BTA upheld the Department's assessment and the Ohio Supreme Court affirmed. The Ohio Supreme Court found that PITS had not carried its burden to show that it satisfied the requirements of the state's sale-for-resale exemption. Because the Court determined that the aircraft did not qualify for the state's resale exemption, it declined to address whether PITS engaged in a sham transaction.

8. Manufacturing Exemption: In *Lafarge North America, Inc. v. Testa*, Case No. 2018-2047, the Ohio Supreme Court held in favor of taxpayer Lafarge regarding where their manufacturing process began. The case involved slag, which is a by-product that separates from molten ore during steelmaking. Lafarge argued that its manufacturing process begins at a slag mountain, where slag is broken up and transported to a screening plant. The Department argued that the breaking up and transporting of slag precedes Lafarge's manufacturing operation.

The Ohio Supreme Court's analysis relied on O.R.C. § 5739.02(B)(42)(g), which states that Ohio's use tax does not apply to the purchase of an item intended for use "primarily in a manufacturing operation to product tangible personal property for sale." In the end, the court held that Lafarge's manufacturing process began at a slag mountain, and not at the screening plant, because Lafarge would break the slag into marketable pieces at the mountain. Once the broken down slag reached the screening plant, it did not undergo any type of material change, conversion or transformation. Therefore, the court determined that Lafarge's manufacturing process began at the mountain where Lafarge cut slag from the mountain and then proceeded to Lafarge's use of a bulldozer to crush the slag. The court also held that the fuel and repair parts that Lafarge purchased for the equipment used to cut and crush the slag were exempt from tax because they were primarily used in Lafarge's slag manufacturing process.

In *E. Mfg. Corp. v. Testa*, Docket No. 2017-0666, the Ohio Supreme Court ruled against a taxpayer who was claiming a use tax exemption for total environmental regulation of a "special and limited area" of their facility. In order to qualify for an exemption under this rule, the taxpayer must satisfy a three prong test: "(1) the tangible personal property must be used to totally regulate the environment, (2) the regulation must be in a special and limited area of the manufacturing facility, and (3) the regulation must be essential for production to occur." The taxpayer must satisfy all three prongs of the test to qualify for the exemption. In this case, the court ruled against the taxpayer because it failed to satisfy the "special and limited area" prong of the test. The taxpayer sought an exemption for its entire manufacturing space, approximately 92% of the facility. The court concluded that the

taxpayer could not seek an exemption for its purchases of gas that was used to regulate the environment of virtually the entire manufacturing facility.

9. Mining Exemption: In *Stingray Pressure Pumping LLC v. McClain*, the BTA considered whether an exemption applies to certain pieces of equipment purchased and used by Stingray in the production of crude oil and natural gas by hydraulic fracturing. In a prior decision, the BTA had upheld the Commissioner's determination that the exemption did not apply. Since that time, the statutory exemption was amended to specify whether the exemption applied for certain kinds of property used in the production of crude oil and natural gas. The Ohio Court of Appeals held that the new statutory language did apply to the current appeal, and remanded the case back to the BTA. On February 25, 2022, on remand, the BTA held that the following items did not qualify for the oil and gas exemption: (1) data van, (2) sand king/sand silo, (3) T-belt, (4) hydration unit, (5) chemical unit, and (6) blender. On March 23, 2022, Stingray appealed to the Ohio Supreme Court. Case No. 2022-0304.

III. ADDITIONAL ITEMS

A. Financial Institutions Tax

Constitutionality of Regressive Rate Structure: FIT taxpayers may be entitled to a refund because the regressive rate structure of the FIT discriminates against interstate commerce in violation of the Commerce Clause. The FIT is imposed on Ohio equity capital, as reported by the taxpayer to bank regulators.[1] The tax rates are regressive: 0.8% of Ohio equity capital up to $200 million, 0.4% of Ohio equity capital between $200 million and $1.3 billion, and 0.25% of Ohio equity capital in excess of $1.3 billion.[2] This is problematic because lower rates apply by reference to a greater amount of "*Ohio* equity capital."[3] *Ohio* equity capital is the portion of a bank's total equity capital that is apportioned to Ohio.[4] So the more a bank concentrates its business in Ohio, the greater its total equity capital is *Ohio* equity capital, and thus the greater the portion of its total equity capital is taxed at lower rates. To remedy this discrimination, taxpayers should be permitted to first determine its FIT liability using its total equity capital and then apportion this liability.

B. Municipal Income Tax

Pennsylvania Resident Not Subject to Cleveland Municipal Income Tax on Wages earned for work performed outside of Ohio. *Morsy v. Dumas* involved an individual that lived and worked in Pennsylvania for her employer in Cleveland during Ohio's COVID Stay at Home order beginning in March 2020. In March 2020, the Ohio General Assembly passed H.B. 197, which provided that services performed by an employee at his or her home are deemed to be performed at the employee's principal place of work. As a result, the taxpayer's employer continued to withhold municipal income tax, and the taxpayer sought a refund from the City of Cleveland, which was denied. The taxpayer argued that the tax violated the fair apportionment requirement of the Commerce Clause under *Complete Auto*, because she was required to pay tax on 100% of her salary to both Cleveland and her town of residence in Pennsylvania. The Cuyahoga County Court of Common Pleas found that the Ohio General Assembly cannot create jurisdiction to levy a tax on the income of persons who are not residents of Ohio, and that was earned for work performed outside Ohio.

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1 O.R.C. § 5726.04(A)(2) ("The tax levied on a financial institution . . . shall be . . . (2) The product of total Ohio equity capital multiplied by" a series of regressive tax rates.).

2 O.R.C. § 5726.04(A)(2).

3 O.R.C. § 5726.04(A) (Equity is multiplied by "eight mills for each dollar of the first two hundred million dollars of total Ohio equity capital, by four mills for each dollar of total Ohio equity capital greater than two hundred million . . . .") (emphasis added).

4 O.R.C. § 5726.04(C) ("'total Ohio equity capital' means the product of the total equity capital of a financial institution … multiplied by the Ohio apportionment ratio . . . .").

As a result, the court ordered a refund and enjoined the City from collection of such municipal income taxes. *Morsy v. Dumas, Finance Director of the City of Cleveland*, Cuyahoga Court of Common Pleas, Case No. CV 21 946057 (September 26, 2022).

IV. BIOGRAPHIES

A. Kyle O. Sollie

Kyle and his colleagues in Reed Smith's offices throughout the country use the right tools at the right time to help their clients pay no more state tax than legally due. Kyle's practice includes state tax return positions, audits, appeals, and litigation, focusing on Pennsylvania, New Jersey, Delaware, and California.

B. Paul E. Melniczak

Paul joined Reed Smith in 2010 and is a partner in the State Tax Group. Paul assists clients with income, sales, and gross receipts tax issues around the country, including Pennsylvania, Ohio, and New Jersey.

Paul is a leader in Reed Smith's Ohio Tax Practice, which represents numerous taxpayers on a wide-range of Ohio CAT, FIT, and sales tax issues at audit and through the Board of Tax Appeals and Ohio Supreme Court. Paul is a member of the Ohio Bar and is active in the Ohio Chamber of Commerce Tax Committee, as well as the Ohio Tax Conference planning committee.

C. Autumn D. Homza

Autumn joined Reed Smith in 2017 as an associate in the State Tax Group. Autumn assists clients in various industries with a broad range of multistate tax matters involving income, sales, and gross receipts tax issues. Autumn also focuses on advising clients through unclaimed property audit defense, voluntary disclosure, and compliance matters.

D. Jacqueline T. Noyes

Jackie is an associate in Reed Smith's State Tax Group. Jackie focuses her practice on state and local tax issues, including sales and use tax, corporate income, and franchise tax. Jackie has worked with and advised clients in jurisdictions across the country.