INCOME TAX

C is for Cookie - That's Good Enough for Ohio

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Introduction

Over the past few years, states have developed new and more aggressive theories of nexus, and it seems like new theories arise each week. We have come a long way from cases involving the taxability of intangible holding company structures.[1] In the business activity tax context, we have recently seen states attempt to assert nexus (successfully) over franchisor/franchisee relationships[2] and (unsuccessfully) over certain third party arrangements.[3]

In the sales and use tax context, there have been a number of concerning developments that further evidence the states' aggressive nexus theories. First, in a recent decision, the Texas Comptroller of Public Accounts concluded that software delivered electronically and licensed to Texas customers constituted physical presence in Texas for an out-of-state corporation. Relying on the data points of (a) electronically-delivered software and (b) sales into the state, the administrative law judge concluded that the taxpayer had "substantial nexus" under the Commerce Clause.[4] Second, in an op-ed published in the March/April issue of the *Journal of Multistate Taxation and Incentives*, the Connecticut Commissioner of Revenue Services argued that given Congress's apparent unwillingness to pass the Marketplace Fairness Act, the states should consider taking matters into their own hands by acting as if *Quill* is no longer good law. Third, and perhaps most notably, in his now well-discussed concurrence in *Direct Marketing Association*, Justice Anthony Kennedy called for the "legal system [to] find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*."[5] Fourth, this fall—influenced in large part by Justice Kennedy's language—the Alabama Department of Revenue promulgated a regulation that requires out-of-state sellers to collect use tax from Alabama customers if they have a "substantial economic presence" within the state.[6]

Finally and most recently, the Tax Commissioner of Ohio advanced one of the more creative (and concerning) nexus theories, arguing that internet cookies can, by themselves, create nexus for an out-of-state retailer. It is this theory that is the primary subject of this article.

Cookie Nexus

Ohio is one of many states that, for business activity purposes (*i.e.*, income and gross receipts tax purposes), has adopted quantitative statutory tests to determine whether an out-of-state corporation has substantial nexus solely as a result of its economic presence in the state ("factor presence nexus"). Specifically, substantial nexus exists for Ohio commercial activity tax purposes when the business "has bright-line presence in [the] state," which is satisfied when the taxpayer has Ohio-sourced gross receipts of at least $500,000 or 25% of its total gross receipts or it otherwise satisfies the state's bright-line tests for property or payroll within the state.

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1 *See, e.g., Geoffrey, Inc. v. South Carolina Tax Comm'n,* 437 S.E.2d 13 (S.C. 1993); *The Classics Chicago, Inc. v. Comptroller*, 189 Md. App. 695 (2010); *Lanco, Inc. v. Director, Div. of Taxation*, 908 A.2d 176 (N.J. 2006); *A&F Trademark, Inc. v. Tolson,* 605 S.E.2d 187 (N.C. Ct. App. 2004); *Geoffrey v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Ct. App. 2005).

2 *KFC Corp., v. Iowa Department of Revenue*, 792 N.W.2d 308 (Iowa 2010). Unlike the passive investment company cases, the out-of-state franchisor at issue had received royalty income from independently owned in-state franchisees.

3 *Scioto Insurance Co. v. Okla. Tax Comm'n*, 279 P.3d 782 (Okla. 2012). *Scioto* involved facts roughly similar to the facts of *KFC*; however, unlike KFC, where the licensor directly licensed intangibles to independent franchisees in Iowa, in *Scioto*, the entity holding the intangibles was a Vermont-based insurer that licensed intangibles to Wendy's International, which then entered into sub-licenses with independent Wendy's franchisees. *See also Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74 (W. Va. 2012) (holding, on Due Process grounds, that the Due Process Clause barred the state from asserting jurisdiction over a non-resident company that licensed intangibles to a related company which sold tangible personal property into West Virginia).

4 201409970H, SOAH DOCKET NO. 304-13-5657.26 (Tex. Comptr., Sept. 14, 2015).

5 *Direct Marketing Ass'n v. Brohl*, 135 S. Ct. 1124, 1135 (2015) (Kennedy, J. concurring).

6 Ala. Admin. Code 810-6-2-.90.03 (eff. Oct. 22, 2015).

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In connection with ongoing litigation in *Crutchfield, Inc. v. Testa*[7] (in which the taxpayers are challenging the constitutionality of that factor presence nexus standard), the Tax Commissioner of Ohio has asserted a theory of internet nexus that would create taxable presence essentially every time a retailer's website is accessed by a customer in the state.[8] If adopted by the Court—or even entertained—this theory would dramatically change the nexus landscape. Essentially, the theory is that Crutchfield owns tangible personal property in the form of browser "cookies" placed on consumers' computers and mobile apps placed on customers' cell phones. Because those cookie-containing computers and cell phones are located in Ohio, the Commissioner argues, the out-of-state businesses have themselves established physical presence nexus within the state's borders, despite the absence of any other traditional markers of physical presence (*e.g.*, employees, representatives, or tangible or real property). Ohio also argues that Crutchfield has physical presence in the form of "logos, images and even computer code [] left behind in the users' physical memory—'the cache'"—when Crutchfield's website was created.

The state's theory of "cookie nexus" is flawed and misguided. First, the Commissioner misapplies precedent by basing its argument on *Andrew Jergens Co. v. Wilkins*,[9] a decision in which the court held that "canned application software is tangible personal property for *personal property tax* purposes." Much like in the sales and use tax context, the states have latitude in defining the tax base as a statutory matter, and states often statutorily define "property" in such a way to capture software. However, states cannot construct or "interpret" their laws in a manner that runs afoul of the Commerce Clause for nexus purposes, as tax base considerations are completely different from nexus considerations.

Second, and more significantly, Ohio also fails to appreciate the essential points of *Quill* if it believes that simply defining/treating software as tangible personal property is sufficient to create "physical presence" under *Quill.* When the U.S. Supreme Court decided *Quill*, it established a bright-line physical presence standard, concluding that a business must have at least "a small sales force, plant, or office" to be subject to tax.[10] Is it reasonable to think that the Supreme Court did not actually mean physical presence in that concrete sense, but rather intended physical presence to be a moving target or a fungible creature of statute capable of being defined and redefined upon legislative or judicial whim? Consider the ramifications: if the Ohio Tax Commissioner's theory were correct, then during the nearly 50 years since *National Bellas Hess* was decided any state, at any time, could have circumvented the "physical presence" rule of *National Bellas Hess* and *Quill* by defining any form of intangible property (*e.g.*, radio signals, television signals, facsimile transmissions, trademarks, *etc*.) as "tangible property" and subjected any company to nexus on that basis. While one could argue that Ohio's position is slightly more nuanced,[11] the contours of its position are largely window dressing.

Indeed, Justice White's dissent in *Quill* makes clear that the Supreme Court was not talking about "virtual" presence when it established the bright-line physical presence standard. Computer-based transactions did not constitute physical presence then and they should not now simply because the technology has changed slightly:

> …in today's economy, physical presence frequently has very little to do with a transaction a State might seek to tax. Wire transfers of money involving billions of dollars occur every day; purchasers place orders with sellers by fax, phone, and computer linkup; sellers ship goods by air, road, and sea through sundry delivery services without leaving their place of business.[12]

Moreover, if the state's theory is true it would mean that states have wasted years asserting economic nexus: talk about a loophole! Is it reasonable to think some of the brightest legal minds just "missed" this gaping hole and were simply leaving the door open for the states to re-define fax communications (as one example) as tangible personal property to work around the physical presence standard?

Interestingly, Ohio is not acting on an island. In fact, Matt Chafin, chief counsel for the Ohio Department of Taxation, told *State Tax Notes* that he believes several other states

7 No. 2015-0386 (Ohio) (filed March 6, 2015).

8 This theory is in addition to Ohio's primary argument in the case, which is that Ohio's factor-presence nexus standard passes constitutional muster under *Complete Auto* and its progeny (which, in Ohio's view, do not require physical presence outside of the sales/use tax context).

9 848 N.E.2d 499 (Ohio 2006).

10 *Quill*, 504 U.S. 298, 315 (1992).

11 Ohio attempts to support its theory by reference to two reports prepared by two separate expert witnesses.

12 *Quill*, 504 U.S. at 328 (White, J., dissenting).

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are also considering the “internet nexus theory.”[13] Perhaps we should not be surprised. In BBNA’s latest annual survey of state tax administrators, 24 jurisdictions would conclude that nexus exists where data is stored on an in-state leased server, regardless of how long such data is stored.[14] This is essentially the same position. What makes *Crutchfield* different, however, is that instead of being an informal “position” that taxpayers can weigh in light of existing precedent, the Ohio Supreme Court will set new parameters—contrary to existing U.S. Supreme Court precedent—if it accepts the Commissioner’s position on this issue. This is dangerous for all taxpayers, and not just those in Ohio.

It is hard to say whether the Commissioner is simply arguing in the alternative or really intends to press this theory forward, but the fact that it is being argued at all is nonetheless concerning. It used to be the case that when we heard “C is for cookie,” all that came to mind was an image of a happy-go-lucky blue monster with a slight cookie dependency problem. Now, unfortunately, for those of us involved in state tax, we are left to ponder whether cookies mean something entirely different for taxpayers. Assuming the Ohio Supreme Court rules correctly, we can go back to our prior state of bliss—until then, C is for cookie . . . nexus.

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[13] Brian Bardwell, “Ohio Officially Endorses ‘Internet Nexus,’” 2015 STT 204-1 (Oct. 22, 2015).

[14] Bloomberg BNA, 2015 Survey of State Tax Departments, at S-23.