



The “CAT” Goes on a Diet, Will It Starve?

Ohio Appeals Court Agrees with Grocers, Tax is Unconstitutional

by Gary M. Harden

On September 2, 2008, Ohio’s 10th District Court of Appeals ruled in favor of the Ohio Grocers Association that Ohio’s Commercial Activity Tax (CAT) is unconstitutional as applied to gross receipts from certain food sales (*Ohio Grocers Assn. v. Wilkins*).

The Grocers Association opposed the CAT from its conception on the grounds that the CAT is a disguised sales tax or other excise tax in violation of the Ohio Constitution. Certain June 8, 1976, amendments to the Constitution, in particular, Article XII, Sections 3 and 13, preclude any excise or other sales tax on food for human consumption off the premises where sold. Section 13 extends the prohibition up and down the food chain to wholesale sales of food and ingredients; sales and purchases of food and ingredients by manufacturers, processors, packagers, distributors and resellers; as well as to the packaging that contains the food and ingredients. On these grounds, the appellate court reversed a 2006 decision in favor of the Tax Commissioner, and entered judgment in favor of the Grocers Association. The case was remanded to the Franklin County Court of Common Pleas for further proceedings consistent with this opinion.

What does this mean?

First, some background. The CAT made law as part of Ohio’s 2005 biennial budget bill, worded as an “excise tax on the privilege of doing business in Ohio.” Its approach is simple and direct: gross receipts multiplied by a small percentage, applied to all business sales and service revenue generated within Ohio. Traditional income taxes, franchise taxes, personal property and sales taxes involve exclusions, deductions, credits, incentives, deferrals, graduated rates and other complexity driven by economic, political and in some instances, social engineering goals. The CAT is much less sensitive, aloof from motivations other than revenue. It’s indifferent to taxpayers’



margin, bottom line and other pedigree. The Ohio Legislature expected the CAT to make Ohio competitive with its neighbors, promoting tax simplification and fairness, and saving the state considerable administrative and enforcement expense. It was also supposed to stabilize Ohio's tax base, making it less dependent upon employers' reinvestment in depreciable equipment and less dependent on a net income base which could be reduced or eliminated when the local economy suffers.

Differing from the traditional taxes which it diminishes or eliminates over time, the CAT nibbles at the first fruits of gross receipts in very small bites. The first \$150,000 of taxable receipts are exempt. There is a \$150 tax on receipts up to \$1 million, and beyond that there's a flat rate on the balance phased in over five years, currently at 0.208% and capped at 0.26% next April. It applies to every sale, every resale. When added to the cost of goods sold each step of the way, it adds successive layers to the price in the process so that each bite is progressively larger. Its flat rate on gross receipts, adding layer upon layer until the final sale to a consumer, has a known regressive effect on consumers purchasing groceries, and upon grocers who operate on profit margins as thin as 1% – 2% of gross. As the food industry struggles to pass on to consumers some of the largest increases in costs experienced during the last 20 years, the CAT bite hurts even more. From conception to this delivery, a CAT fight has been brewing.

Since July 1, 2005, the CAT nibbled on every sale up and down the food chain. Repeal of the tax as applied to gross receipts from food sales would result in a crash diet and a state refund obligation of hundreds of millions of dollars to businesses that operate in Ohio. It could starve state government, as several other taxes have already been reduced or eliminated. From food retailers and wholesalers, Ohio collected \$273.4 million in fiscal 2006 and \$594.9 million in fiscal 2007, of which \$416.4 million went to schools. Estimates of just the retail food industry's deposit in the CAT revenue box are represented at a more modest \$188 million. Fiscal 2008 revenue was budgeted to be even larger as the CAT rate tops out at 0.26% this year.

The CAT simply may not survive this and other challenges. Allowed only to dine out at restaurants (no carry out, please), the door has been opened to yet another challenge. It may not be able to drive; it will have to walk. The appellate court's decision is based upon a legal conclusion that a tax on gross receipts is by its nature an excise tax, and such an excise tax is constitutionally prohibited regardless of any additional label assigned by the Ohio legislature such as that it is "on the business for the privilege of doing business in Ohio" and not "on the transaction of a sale to a consumer."

A different CAT fight is already underway with Ohio's fuel industry, as the CAT takes its bite out of gross receipts from the sale of motor vehicle fuels as well. Another constitutional provision, Article XII Section 5a, requires that excise taxes on fuel must be spent solely on highways, bridges, traffic law enforcement and hospitalization costs of indigent victims of motor vehicle accidents. The CAT tax is ear marked for schools and local government. So, if the latest appellate decision in *Ohio Grocers Assn. v. Wilkins* is upheld on grounds that the CAT is an excise tax, it would follow that CAT revenue from fuel sales must be redirected to highways and away from schools retroactive to the first dollar collected in 2005.

The September 3, 2008, *Gongwer News Service Ohio Report* estimates that weaning the CAT from food and fuel would eliminate 20% of total CAT revenue. So, it would appear that the Ohio Tax Commissioner must win his appeal to the Ohio Supreme Court on the specific grounds that a CAT on gross receipts is not a prohibited excise tax, asking the court to interpret the Ohio Constitutional amendments adopted in 1976 (food) and in 1947 (fuel) to exclude this kind of an excise tax, a distinction that does not appear in those sections of Constitution.

Such a distinction may instead require a constitutional amendment, taking far more time and being equally unpredictable. The Tax Commissioner losing, or even winning on any other grounds, could leave the CAT \$139 million short, roadkill along the highway after chasing cars.

We have every reason to believe that the Tax Commissioner will appeal the Ohio Grocers Association decision to the Ohio Supreme Court, and in the meantime, he will continue to collect the CAT until the tax is either sustained or these rulings on unconstitutionality become final. Reason would compel us to expect the Ohio legislature to explore backing another breed of CAT on a contingency plan.

For now, we are advising clients in the food industry that they will need to file and pay the CAT tax on all food related sales until the appellate decision becomes final or the law is changed. In order to support possible future amended tax returns, businesses should track and segregate these gross receipts from other sources, if this is not part of their regular tax accounting. As the tax first became effective July 1, 2005, businesses and their return preparers should watch applicable statutes of limitations. If appeals drag on too long, protective refund claims can and should be filed before expiration of these statutes of limitations in order to protect refund rights. Announcements from the Ohio Department of Taxation may be issued with an official position on these and other issues as the court's decision is evaluated.

We will continue to monitor the situation and you should feel free to contact me directly if you have any questions.



Mr. Harden, a member of the Firm, focuses his practice on federal taxation, benefits and general business law. He is peer reviewed AV by Martindale Hubbell, has been listed each year since 1995 in The Best Lawyers in America, and each year in Ohio SuperLawyers since its inception.

2021 Update: Mr. Harden is now employed by Harden Law, a firm with whom Eastman & Smith has a strategic alliance.

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