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Special Alert

"CAT" Bites Grocers, Not Groceries Supreme Court Says It's Constitutional

by Gary M. Harden

Editor's note: This is the third in a series of articles by Mr. Harden on Ohio's Commercial Activity Tax. "Ohio's Commercial Activity Tax Bill (i.e. 'Bill the CAT')," August 2005, and "The CAT Goes on a Diet, Will it Starve? Ohio Appeals Court Agrees with Grocers, Tax is Unconstitutional," September 2008, are available on our web site.

On September 2, 2008, it looked like the Ohio Commercial Activity Tax or "CAT" would starve for lack of sufficient revenue when Ohio's 10th District Court of Appeals ruled the CAT unconstitutional as applied to gross receipts from certain food sales. About 20% of the tax relates to revenue from sales of food and of highway fuel, the latter of which is subject to a similar constitutional challenge. By the time of this decision, more than $350 million in refunds and a potential $188 million budgetary shortfall were pending. One year and 15 days later, the Ohio Supreme Court has just saved the CAT's kibble with this subtle but apparently sufficient distinction: the tax falls upon the "sellers of food" and not upon "the sale of food" (*Ohio Grocers Association v. Levin*). In so doing, the CAT takes a bite out of grocers but not the groceries.

Writing for the majority, Justice O'Connor relied upon the "strong presumption of constitutionality" and the grocers' burden to prove unconstitutionality "beyond a reasonable doubt," finding three approaches to support this distinction. First, the Court concluded the Constitution did

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not expressly prohibit the State from levying a tax on the privilege of doing business, and so it was permissible for gross receipts from the sale of food to be included in valuing that privilege. Second, the Court noted a long standing legal distinction between levying a tax upon a factor, and using that factor as a "measuring stick" for a tax. In a third but similar approach, the Court observed the privilege of doing business can be measured even by tax exempt factors, at least as compared to the corporate franchise tax, a tax which the CAT replaces.

Seemingly dissatisfied with its own justification, the majority strayed beyond the low standard that presumes constitutionality. Over the following 10 pages the Court took a swipe at the grocers' position as "*at best*, . . . competing plausible reading" of the Constitution, and the Tax Commissioner's position as "the correct reading of the provisions."

When finished, the Court had clearly made its demeanor, if not the veracity of its distinctions, well understood. This demeanor does not bode well for other constitutional challenges, including those pending. To support the Tax Commissioner's "correct reading of the provisions," the Court relied on several distinctions, including the way it operates. It relied upon the historic treatment of dissimilar taxes, like the Ohio franchise tax which includes gross receipts from food included in net income from combined business operations which could be affected by losses, loss carryovers, apportionment and other factors. Some of these distinctions actually could convince the reader that the CAT really does get the groceries, through the grocer.

The majority concluded the CAT operates like a tax on a privilege and not on the sale of food items because:

- the state legislature said it was a franchise tax on a privilege (cannot be much more superficial than that);
- it is imposed upon the person enjoying the privilege (upon the grocer who remits the tax, although the consumer will pay the tax passed on in the cost of goods sold, and with a sales tax the grocer also remits the tax to the state and is personally liable if this does not happen);
- the statutory language prevents the privilege holder from passing the tax on to the consumer by a separate charge (the CAT will be passed on to the consumer in the cost of good sold);
- it is imposed based upon the filing of an annual return (as opposed to being reported on the basis of some other period, for example, monthly, like a sales tax return);
- it is imposed based upon results of an entire year, and not on a transaction by transaction basis (the CAT is on *gross receipts*, undiminished by losses or the effect of any other material influence of a year's results, other than the additive effect of taxing each and every gross receipt); and finally
- "it is computed using a broad measure of market access that is rationally related to the enjoyment of the privilege of doing business." (All gross receipts, including those from the sale of food for human consumption. The Court somehow appeared persuaded by the fact that the tax rate was low, which of course can be changed.)

In a spirited but singular dissent, Justice Pfeifer was not persuaded by the substance of the majority's distinctions. Neither was he inclined to rely upon the presumption of constitutionality in the face of what otherwise appeared to him to be the specific intention of the Constitutional amendment that prohibited a tax on the sale of food, or on historic distinctions that were not germane to the instant tax. Quoting Holmes' law review article "The Path of the Law" (*Harvard Law Review*, 1897): "It is revolting to have no better reason for a rule of law than that it was laid down in the time of Henry IV. It is still more revolting if the grounds upon which it was laid down have vanished long since, and the rule simply persists from blind imitation of the past."

While the majority's approach may be questioned, the result appears clear. The state of Ohio's economy, potential refunds that could cripple state programs, budget deficits and the integrity of a tax system designed to improve collections, business and provide a more reliable source to fund education are important factors not to be discounted when weighing the substance of a constitutional challenge. The CAT became king of the urban tax jungle when it allowed the legislature to lower personal income tax rates, and to eliminate the state corporate franchise tax and personal property tax. Other constitutional challenges should expect scrutiny.

As a tax historian, one should question the will of the legislature. When tempted to raise additional revenue, will state law makers remain true to the new system of taxation, and adopt consistent adjustments to the CAT tax, or embark on a new adventure of "Bill the CAT" producing a changeling that fails to accomplish the worthy goals enacted? Will the legislature resurrect the franchise tax, personal property tax or perhaps increase the personal income tax rate to their former high levels? Such legislation already has been introduced into the State House (House Bill 284). Tax rates, especially income taxes, historically have been raised to their former levels directly, indirectly by broadening the base of tax or in combination. There are many examples. In the federal system the obvious example is the 1986 Federal Tax Code which lowered the top marginal rate to 28% and paid for it in a tax neutral act eliminating the investment tax credit (ITC) and broadening the tax base. The business incentive of lower rates was used to justify the elimination of ITC and broader tax base. The ITC still is gone, the tax base is broader than before and the top marginal rate has reached 39.6% with various claw back provisions that recoup for the Treasury the value of lower graduated marginal rates, the value of itemized deductions, alternative minimum tax on income that already has been spent on deductions not allowed for a different tax system and a host of similar provisions intent on increasing the effective rate by manipulating items other than the nominal rate. The current federal Congress is intent on more of the same. Do smoke and mirrors save face with the electorate?

One thing appears certain for now. The CAT, once appearing lean, is now free to nibble at its low rate on all the grocers' food.

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 Super Lawyers since its inception. He can be reached at our Toledo office (419-241-6000) should you wish to discuss this decision. 2021 Update: Mr. Harden is now employed by Harden Law, a firm with whom Eastman & Smith has a strategic alliance.