# Ohio Tax Talk: Ohio's Bite of Apple Turns Out To Be Sour

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With a market cap of $2.4 trillion and revenue of $275 billion in 2020, Apple, Inc. ("Apple") is unquestionably one of the world's most valuable and sophisticated companies. As most people know, Apple generated its fortune selling tangible technological devices like the iPhone, iPad, Mac, and Apple TV and related software and third-party digital content and applications, such as eBooks, Apple Music, and movies.

Apple's wealth makes it an extremely attractive target for taxing authorities worldwide, including the Ohio Department of Taxation (the "Department"). In a recent audit of Apple's operations, the Ohio Tax Commissioner (the "Tax Commissioner") concluded that Apple had underpaid its Commercial Activity Tax (CAT) obligations to the state for tax years 2011-2016, leading to an assessment of approximately $4 million, including interest and penalties.

Apple filed its Notice of Appeal on August 6, 2021, contesting the Tax Commissioner's final determination ("Final Determination"). Apple argued that the Commissioner erred in disallowing Apple's use of two important exemptions to the CAT: the Qualified Distribution Center Exemption and the Agency Exclusion. Ultimately, the case was settled on appeal.

This case serves as a good reminder to Ohio taxpayers that the Department and its auditors are rigid in their audits and will be seeking supporting documentation for positions asserted by taxpayers. Unlike Apple, many Ohio taxpayers lack the resources (both financial and connections) to contest a final determination from the Tax Commissioner. While the settlement remains confidential, Ohio taxpayers would be wise to educate themselves on the Qualified Distribution Center Exemption and the Agency Exemption and what documentation is needed to avail oneself of these exemptions from the CAT if the Tax Commissioner comes knocking.

**The CAT**


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The CAT is Ohio's take on a privilege of doing business tax that imposes a 0.26 percent flat rate tax on all gross receipts situsued to the state.[1] The CAT is levied on the entirety of a taxpayer's gross receipt without deductions. The lack of a deduction for things such as costs of goods sold and other expenses mainly separates the CAT from an income tax and makes the CAT a more complicated tax for out-of-state taxpayers to comprehend and contest. Included in the definition of "gross receipts" are receipts from the sale, exchange, or disposition of property, receipts realized from the performance of services, and receipts realized from another's use or possession of a taxpayer's property (*e.g.*, lease payments).[2]

Although the CAT has a broad reach, it does exclude certain transaction structures from its claws. Two prominent exemptions include the Qualified Distribution Center Exemption and the Agency Exemption.

**The Qualified Distribution Center Exemption**

The Ohio Revised Code explicitly exempts "qualifying distribution center receipts" from the CAT.[3] To properly analyze whether a taxpayer's receipts are eligible for this exclusion, it is vital to understand a few definitions.

"Qualifying distribution center receipts" are defined by the Ohio Revised Code to be receipts from "qualified property that is delivered to a qualified distribution center, multiplied by a quantity that equals one minus the Ohio delivery percentage."[4]

A "Qualified Distribution Center" is a warehouse or warehouse-like facility that holds a qualifying certificate issued by the Tax Commissioner.[5]

"Qualified property," in turn, is a property that is sent to a Qualified Distribution Center for *further shipping* to another location in or out of state.[6] Further shipping includes, importantly, "storing and repackaging property into smaller or larger bundles, so long as the property is not subject to further manufacturing or processing."[7] In other words, the Qualified Distribution Center can do more than simply load and unload trucks and other vehicles.


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Finally, the "Ohio delivery percentage" is defined as "the proportion of the total property delivered to a destination inside Ohio from the qualified distribution center during the qualifying period compared with total deliveries from such distribution center everywhere during the qualifying period."[8] It is crucial to understand that the Ohio delivery percentage is determined by the Qualified Distribution Center's cumulative deliveries across all suppliers. This percentage is applicable to each individual supplier that utilizes the Qualified Distribution Center regardless of the percentage of the individual supplier's actual property that will be shipped outside the state.[9]

If a taxpayer fails to provide appropriate documents proving that each of these requirements is satisfied, the Department will not hesitate to tax the entirety of the gross receipts. Some examples of the types of evidence that could be useful in supporting a claim for the Qualified Distribution Center exemption include a qualifying certificate from the Qualified Distribution Center, a written contract outlining the scope of services a Qualified Distribution Center provides, and documents tracking the ultimate destination of the products shipped through the Qualified Distribution Center.

**The Agency Exemption**

The Ohio Revised Code also exempts "[p]roperty, money, and other amounts received or acquired by an agent on behalf of another in excess of the agent's commission, fee, or other remuneration" from the CAT.[10] Ohio Administrative Code § 5703-29-13 elaborates that "[i]n certain circumstances, portions of the amounts received by a person defined as an agent are excluded from the definition of gross receipt . . . The agent is only required to report as a gross receipt the portion of the amount received that it retains as a commission or fee rather than the entire amount."[11]

The Supreme Court of Ohio has consistently held that an agency relationship exists where "one party exercises the right of control over the actions of another, and those actions are directed toward the attainment of an objective which the former seeks."[12] To prove the existence of an agency relationship, the taxpayer is expected to provide the Tax Commissioner a contract that explicitly establishes


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the agency relationship; otherwise, the Tax Commissioner will presume that no agency relationship exists and the taxpayer will have to include the total amount received in its gross receipts.[13]

To support a claim for the agency exemption, taxpayers should prepare to present evidence such as a contract that explicitly establishes an agency relationship and outlines the scope of the services to be provided by the agent as well as a compensation structure. Partially redacted documents showing the taxpayer's transfer of amounts received in excess of commissions owed to the principal would also be useful evidence to provide the Department during an audit.

**The Sour Apple**

Apple's distribution channels for its tangible products include Apple retail stores (both brick and mortar and online) and other third-party channels such as third-party wholesalers, retailers, and resellers. In Ohio, Apple uses sales partners such as Best Buy (among others) as warehouse/distribution facilities to ship Apple products to Apple's third-party retailers and wholesalers. In other words, Apple ships its products to the Ohio sales partners who then ship the products to Apple's third-party distribution partners. Some products ultimately end up outside Ohio. Citing ORC § 5751.40 and § 5751.40(A)(2), Apple argued that it relied in good faith on its Ohio sales partners' Qualified Distribution Center certificates and only shipped these products to the Ohio sales partners for further shipping. Therefore, according to Apple, the Tax Commissioner erred in prohibiting Apple from excluding these gross receipts from its CAT liability. Apple's presentation of a qualifying certificate from the Qualified Distribution Center was likely a vital piece of evidence presented.

Apple's distribution channels for its intangible digital products like audiobooks, movie rentals, Apple Music, eBooks, and Apps are structured in two different models, depending on the digital product. For digital products sold through Apple's App Store or Apple's other digital content stores (*e.g.*, audiobooks, arcade games, movie rentals, New+ service, Apple Music, and music downloads), Apple uses a "buy and resale model." Approximately 50% of Apple's


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gross receipts attributable to the App Store are derived from the buy and resale model, but this model was not at issue in the current audit.

The other 50% of Apple's gross App Store receipts are derived through Apple's second model, called the "agency model." This model is used to sell eBooks and apps owned by third-parties but sold through the App Store. For these products, Apple has no control of the product before it is transferred to the customer; Apple merely serves as the marketing and delivery platform through which the product is purchased. As required by the O.A.C. § 5703-29-13(C)(2), Apple provided the Tax Commissioner with relevant provisions of its agency model contracts. These provisions explicitly established that Apple was an agent commissionaire on behalf of the third-party content creator/owner regarding eBooks and apps sold on the App Store. The arrangement's compensation structure established a commission equal to 30% of the price paid by end-users for the digital products for Apple.

In its appeal of the Final Determination, Apple argued that the Tax Commissioner failed to consider Apple's agent status with respect to the sales of the eBooks and Apps. Citing the agency exemption in ORC § 5751.01(F)(2)(l), Apple insisted that its agency model contract created an agency relationship between Apple and the relevant third-party. Therefore, the only gross receipts subject to the CAT are Apple's 30% commission, not the entirety of the payment received by Apple from the end-user.

**Conclusion**

Ultimately, Apple's appeal to the Board of Tax Appeals was dismissed because of a confidential settlement between the parties. Nevertheless, Ohio taxpayers utilizing Qualified Distribution Centers for distribution of tangible products and taxpayers deriving receipts through an agency model would be wise to familiarize themselves with what the Department was searching for in its audit of Apple.

Taxpayers should review the statutory authority and guidance on these two important CAT exemptions and reach out to their tax


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advisors to ensure that all necessary paperwork is in place to avail themselves of these exemptions.

For more information, contact Edward I. Rivin or any attorney with Frost Brown Todd's Tax practice group.

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[1] *See* Ohio Revised Code ("ORC") § 5751.02(A).
[2] *See* ORC § 5751.01(F)(1).
[3] ORC § 5751.01(F)(2)(z).
[4] ORC § 5751.40(A)(1) (emphasis added).
[5] *See* ORC § 5751.40(A)(3), (6).
[6] *See* ORC § 5751.40(A)(2).
[7] *Id.*
[8] *See* ORC § 5751.40(A)(7).
[9] *See* Ohio Department of Taxation Informational Release CAT 2006-07.
[10] ORC § 5751.01(F)(2)(I) (emphasis added).
[11] O.A.C. § 5703-29-13(A) (internal quotations omitted).
[12] *See e.g.*, *Hanson v. Kynast* (1986), 24 Ohio St.3d 171, 173; *see also* O.A.C. § 5703-29-13(B). The term "agent" is defined in ORC § 5751.01(P)(2).
[13] *See* O.A.C. § 5703-29-13(C)(2).

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