

PUBLICATION

Spotlight on Tennessee: A Textbook Case of the Slippery Slope?

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In its 1992 decision in *Quill Corp. v. North Dakota*, the Supreme Court of the United States held that the "bright-line, physical presence requirement" should be re-affirmed "in the area of sales and use taxes." While states and taxpayers have argued frequently since *Quill* about whether the physical presence requirement applies to income taxes, it has been settled that the physical presence requirement applies to sales and use taxes. However, the Tennessee Court of Appeals in *Scholastic Book Clubs, Inc. v. Farr*, may have upset those settled expectations. The Court of Appeals viewed Tennessee school teachers as conferring nexus over an out-of-state mail order seller of children's books. Is *Scholastic Book Clubs* just another agency or attributional nexus case, or has the Court created a very real slippery slope?

Background

Under the Commerce Clause of the U.S. Constitution, the U.S. Supreme Court requires a state tax to satisfy four requirements so that the tax does not burden interstate commerce. One of those requirements is the "substantial nexus" requirement. As noted above, at least for sales and use taxes, the U.S. Supreme Court in *Quill* re-affirmed that a taxpayer must have a physical presence in a state to have substantial nexus.

In *Scholastic Book Clubs*, the taxpayer is an out-of-state direct marketer (or mail order seller) of children's books. Scholastic mailed catalogs to schools in Tennessee and other states, as well as to the homes of home-schooled children. Teachers and parents of home-schooled children decided, at their discretion and without any obligation to do so, whether to distribute the catalogs to students. If so distributed, students provided their book order forms and payment to the teachers who, in turn, forwarded the orders and payments to Scholastic Book Clubs by mail or telephone. Scholastic fulfilled the orders from its Missouri facility and delivered the books by common carrier to the schools or homes. The teachers or parents then distributed the books to students.

The Tennessee Department of Revenue (Department) imposed a tax collection obligation on Scholastic and assessed sales and use taxes, plus penalties and interest, on its sales of books to Tennessee students. Scholastic prevailed in Chancery Court, and the Department appealed.

Is *Quill* Only a Narrow Safe Harbor?

Courts in at least six other states have addressed the issue of whether school teachers are deemed representatives of out-of-state mail order book sellers for purposes of providing the requisite substantial nexus in a state for sales/use tax purposes. Courts in Arkansas, Connecticut, Michigan and Ohio have held for the book seller, while courts in California and Kansas have held for the state. All of these decisions, however, have centered on the issue of whether the school teachers were agents for the book seller under that state's agency law and, if so, whether that agency relationship was sufficient for substantial nexus under the U.S. Supreme Court precedents. The Tennessee Court of Appeals in *Scholastic Book Clubs* took a different approach.

The Department argued that Scholastic's "relationship with its customers in Tennessee is not merely by mail order." After rejecting Scholastic's argument that the auditor relied solely on an assertion that an implied

agency relationship existed, the Court never addressed agency again. Instead, the Court approached the nexus question differently, stating:

A safe harbor from a State's ability to assess sales and use taxes exists under the Commerce Clause "for vendors 'whose only connection with customers in the [taxing] State is by common carrier or the United States mail". Slip Op., at 9 (quoting *Quill*) (Underline provided).

Because Scholastic used Tennessee schools and teachers "to facilitate sales to school children in Tennessee," Scholastic's connections to Tennessee were not solely by common carrier or mail, according to the Court of Appeals. Ultimately, the Court of Appeals agreed "with the Commissioner that SBC's connections with its customers in Tennessee do not fall within the narrow safe harbor provisions affirmed in *Quill Corp.*" As a result, the Court of Appeals appears to view *Quill* as a narrow safe harbor for mail order sellers, as opposed to a precedent requiring any taxpayer to have a physical presence before it is required to collect or remit sales and use taxes. Thus, under this line of reasoning, any taxpayer whose connections with Tennessee are other than by mail or common carrier falls outside this safe harbor view of *Quill*.

Were the School Teachers "Significantly Associated with the Taxpayer's Ability to Establish and Maintain a Market" in Tennessee?

The Court of Appeals concluded that Scholastic "has created a *de facto* marketing and distribution mechanism within Tennessee's schools and utilizing Tennessee teachers to sell books to school children and their parents." Whether the teachers were Scholastic's agents under Tennessee law was apparently not dispositive in the Appeals Court's opinion. However, based on relevant U.S. Supreme Court guidance, what should have been dispositive was (a) whether the teachers were representatives of Scholastic, and (b) was that type of representation sufficient to establish physical presence or substantial nexus for Scholastic in Tennessee?

The Court of Appeals did not tackle the test established by the U.S. Supreme Court to determine if a representative establishes physical presence or substantial nexus for a taxpayer. In *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, the Court stated the "crucial factor" was whether the activities performed by a representative on behalf of an out-of-state taxpayer were "significantly associated with the taxpayer's ability to establish and maintain a market" in the taxing state. Thus, the question is not whether Scholastic used an already existing infrastructure in Tennessee (namely, this State's schools and teachers); rather, the question is whether the teachers made and maintained Scholastic's market in Tennessee. Scholastic had no control over the teachers; Scholastic did not compensate them; and the teachers were in all likelihood pursuing their primary independent objective to assist the students, not Scholastic.

How Slippery is This Slope?

Arguably, any mail order or remote seller uses a state's roads, police and fire protection and other public services and infrastructure as a part of a *de facto* marketing and distribution mechanism. After *Scholastic Book Clubs*, it appears that any taxpayer whose connections to Tennessee go beyond the U.S. mail or common carrier is at risk of nexus. *Scholastic Book Clubs* seems to go far beyond the Court of Appeals' prior decision in *Arco Building Systems, Inc. v. Chumley*. In *Arco Building Systems*, the Court of Appeals found that a Tennessee manufacturer attributed Tennessee physical presence to an out-of-state taxpayer based on *Tyler Pipe*. The Tennessee manufacturer designed products for the out-of-state taxpayer's Tennessee customers, fabricated and shipped the products to the customers, accepted final payments from the customers and provided post-delivery consulting services and shipment of replacement parts to the customers. The connections between the Tennessee manufacturer and out-of-state taxpayer in *Arco Building Systems* were of far greater significance than any connections between Scholastic and the school teachers.

It is not a fast descent down this slope to imagine that the rationale of *Scholastic Book Clubs* could be extended *ad infinitum*. Any company with connections to Tennessee, however subtle, that are other than by mail or common carrier could be at risk.

The *Scholastic Book Clubs* decision is of significant local and national import, as it is sure to attract the attention of other state departments of revenue. To discuss *Scholastic Book Clubs* in greater detail, please contact any attorney in the Firm's Tax Department.