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*Tennessee Appeals Court holds  
out-of-state book distributor had  
sufficient nexus, liable for sales  
and use taxes*

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The Tennessee Court of Appeals held that an out-of-state book distributor, with no physical location or employees in Tennessee, was subject to sales and use taxes. Specifically, the Court found that substantial nexus existed where local teachers and schools created a marketing and distribution mechanism within the State. [[\*Scholastic Book Clubs, Inc. v. Farr\*](#), No. M2011-01443-COA-R3-CV, 1/27/12].

## Background

Scholastic Book Clubs, Inc. ("Scholastic"), a Missouri corporation, markets and sells books and other products to teachers and students at schools and to home-schooled children and their parents across the United States, including in Tennessee. In general, during the school year Scholastic mails catalogs to teachers and to parents of home-schooled children on a monthly basis. The teachers and parents then decide whether they want to distribute the catalogs and, if orders are made, enter those orders on a master form and return the order to Scholastic for fulfillment.

During the audit period January 1, 2002, to May 31, 2008, Scholastic had Tennessee sales valued in excess of \$34 million. At all times, Scholastic did not own or lease real property in Tennessee nor did it have employees in Tennessee. In August 2008, the



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Tennessee Department of Revenue ("Department") assessed Scholastic unpaid sales and use taxes, plus penalties and interest, in excess of \$5.7 million.

After an informal conference, the Department advised Scholastic that it had determined "that an implied agency relationship existed" between Scholastic and the teachers and that consequently, Scholastic was liable for the assessed sales and use taxes.

Scholastic filed an action against the Department in trial court, asserting that its business was conducted exclusively by mail order and via the internet, and that no agency relationship existed between Scholastic and the teachers who participate in its program. Scholastic further asserted that the tax assessment was impermissible under the Due Process and Commerce Clause of the United States Constitution and under Article I, Section 8 of the Constitution of Tennessee. The trial court entered final judgment for Scholastic and the Department appealed.

### "Physical presence" is a "term of art."

On appeal, the Court framed the issue as "whether Scholastic has sufficient nexus with Tennessee to be subject to Tennessee's sales and use tax laws under the federal Commerce Clause." The Court noted that under *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), "an out-of-state vendor whose sales are by mail order must have some sort of presence in the taxing State for a sales and use tax to be permissible under the Commerce Clause."

In its argument, Scholastic focused on the lack of an agency relationship, asserting that Tennessee teachers are not agents of Scholastic, but rather act on behalf of the students to assist them with the ordering process. However, the Department countered, and the Court agreed, that the issue is not whether the teachers acted as Scholastic's agents, but whether Scholastic's connections with Tennessee teachers and schools establishes "substantial nexus" under the Commerce Clause.

Relying on its analysis in *Arco Building Systems, Inc. v. Chumley*, 209 S.W.3d 63 (Tenn.Ct.App.), the Court reiterated that "physical presence" as used in *Quill* was a term of art used to describe the connections found sufficient to support the imposition of nexus on out-of-state companies. The determinative issue is "whether substantial business activities have been carried on in the taxing state on the taxpayer's behalf."

In ruling against Scholastic, the Court found that Scholastic was not a vendor whose only connection with Tennessee customers was by common carrier or by mail. Rather, 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."

### PwC Observes

"Certainly a finding that a substantial nexus could be established through the in-state sales or marketing activities of a third party is not a novel concept," notes Kelly Smith, PwC Partner in Atlanta. "Indeed, as the Court pointed out, Tennessee is not the first state to examine the matter as it relates to Scholastic's relationship with the teachers. However, what is unique about the Court's decision is that it is based on a

finding that the activities of the teachers 'created a *de facto* marketing and distribution mechanism' within the state. This language differs somewhat from that used in other so-called 'attributional nexus' decisions, so it's unclear what the precise scope of the Court's decision will be. What is clear is that the Tennessee Court of Appeals, unlike a number of courts in other sister jurisdictions, concluded that a finding of substantial nexus was not dependent upon an agency relationship."

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