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Sales and Use Tax, Hard Times, and the Sticky Wicket of Nexus

Over the last few years as tax revenues have decreased and budgets have tightened, states across the country have aggressively pursued out-of-state retailers that may owe sales or use tax. From ticket sellers like StubHub, online retailers like Amazon, and mail-order companies like Scholastic Books, states are asserting that a wide variety of businesses once thought to be exempt have the substantial nexus necessary to require that they collect sales and use tax from their customers. Most recently, a Tennessee Court of Appeals at Nashville ruled that Scholastic Book Clubs, through its network of teachers, had sufficient nexus to require it to collect sales and use tax.

Nexus Background

Out-of-state retailers with substantial nexus – a constitutional measurement of whether a company is doing business within a state and thus subject to the state's tax laws – are required to collect sales and use tax on behalf of their customers. As a general rule, companies have sufficient nexus if they have a physical presence in a state, i.e., offices, employees, or more than a *de minimis* amount of personal property. However, the U.S. Supreme Court has provided a safe harbor for companies whose only connection with a taxing state is by common carrier or U.S. mail. While these rules appear straightforward, for Internet and mail-order companies, such as Scholastic Book Clubs, that have "somewhat related" affiliates in a state, the analysis can be much more complex.

The Scholastic Book Clubs Case

The Tennessee Court of Appeals case is the latest in a line of cases in which state taxing authorities asserted that Scholastic Book Clubs had substantial nexus. The facts of all of these cases are virtually identical: Scholastic Book Clubs, a corporation operating out of Missouri, mailed teachers catalogs of books, which the teachers could (but were not obligated to) pass out to students. Participating teachers then collected and placed their students' orders and distributed the purchased books once the order was received. At no time did Scholastic Book Clubs have employees or an office in Tennessee – seemingly its only contacts with Tennessee were its catalogs that were mailed into the state.

Ultimately, the court found that Scholastic Book Clubs had "created a *de facto* marketing and distribution mechanism within Tennessee's schools and utilized Tennessee teachers to sell books to school children and their parents." This was sufficient for the court to find that Scholastic Book Clubs' connections with Tennessee were greater than those allowed by the common carrier safe harbor, and, as such, constituted substantial nexus requiring that Scholastic Book Club collect sales and use tax on purchases made by Tennessee customers.

Tennessee is the third state to find that Scholastic Book Clubs had substantial nexus. California and Kansas, the previous two states, came to the same conclusion after determining that the teachers were agents of Scholastic Book Clubs. Courts in Michigan, Connecticut, Arkansas, and Ohio, however, have found just the opposite – focusing primarily on Scholastic Book Clubs' (and a similar company, Troll Book Clubs) lack of control over the teachers and the fact that the teachers were customers themselves.

The Importance of Tax Planning

This split in different states' opinions is a common occurrence as states apply the constitutional nexus guidelines to a variety of new factual situations, including situations involving the Internet. As states interpret the guidelines and leave an inconsistent and fragmented set of rules across the country, it has become imperative that companies conduct a state-by-state analysis of their state tax obligations in order to avoid the often substantial tax, penalties

and interest that may result if tax is not collected and remitted. All companies, and especially those with expanding interstate businesses, should plan carefully to avoid unintended tax obligations because even the most minor activity, done by the company itself or by an affiliate or agent, could result in a substantial nexus determination.

If you have any questions regarding this new development or would like to discuss any other tax concerns, please contact any of the attorneys listed below.

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