



# State and Local Tax Alert

## Tennessee Edition



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## Tennessee Court of Appeals Holds That Scholastic Book Clubs Has Nexus in Tennessee

By Brett R. Carter and Patricia Head Moskal

The Tennessee Court of Appeals ruled on January 27, 2012 that Scholastic Book Clubs' ("Scholastic") use of schools and teachers to facilitate book sales and deliveries in Tennessee establishes a sufficient presence in Tennessee requiring Scholastic to collect sales and use tax on its sales. *Scholastic Book Clubs, Inc. v. Farr*, Dkt. No. M2011-01443-COA-R3-CV, slip op. at 9 (Jan. 27, 2012).

Scholastic markets and sells books and other publications and products to teachers and students at nursery, primary, and secondary schools across the United States. During the period under audit by the Tennessee Department of Revenue, over 8,000 Tennessee schools participated in Scholastic's program, generating sales in excess of \$34 million. Scholastic did not collect or remit Tennessee sales and use tax on the book sales and, following audit, the Department of Revenue issued a \$6 million sales tax assessment.

The activities of Scholastic in Tennessee were undisputed on the parties' cross-motions for summary judgment at the trial court. Specifically, the parties agreed that Scholastic maintained no property, employees, agents, bank accounts, data, or telephone listings in the state. The trial court concluded that Scholastic "lacked a 'substantial nexus' in the State of Tennessee" and was not required to collect Tennessee sales and use tax.

The issue on appeal was whether the activities of Tennessee schools performed by school employees on behalf of Scholastic created a sufficient presence in Tennessee under the Commerce Clause to support an assessment of Tennessee sales and use tax.

Scholastic argued that its only connection to customers in Tennessee is through mail order catalogs. The teachers distribute the catalogs to their students and, in some instances, assist students with the purchase of books. Book orders are submitted to the teachers, together with payment, and the teachers forward the orders and payment to Scholastic at its Missouri headquarters. The orders are filled and sent via common carrier to the teachers to be distributed to the students in Tennessee. Based on these facts, Scholastic maintained that it did not have a physical presence in Tennessee and that the teachers were not agents of Scholastic.

The Court of Appeals reasoned that the issue was not whether the teachers were "agents" of Scholastic but whether Scholastic's connections with Tennessee schools and teachers established a "substantial nexus" to sustain the assessment on Commerce Clause grounds. This issue has a long history of being litigated across the country, and the Court acknowledged a split in other jurisdictions such as California, Kansas, Michigan, and most recently in Connecticut.

The Tennessee Court of Appeals relied on its most recent nexus decision, *Arco Building Systems, Inc. v. Chumley*, 209 S.W.3d 63 (Tenn. Ct. App. 2006), to conclude that Scholastic had created "a *de facto* marketing and distribution mechanism within Tennessee's schools ... utilizing Tennessee teachers to sell books to school children and their parents." Accordingly, the Court held that Scholastic's connections with customers in Tennessee did not fall within the "safe harbor" of the Commerce Clause established by *Quill Corp. v. North Dakota*, 504 U.S.

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### AUTHORS



**Brett R. Carter**

615.252.2383

[bcarter@babbc.com](mailto:bcarter@babbc.com)



**Patricia Head Moskal**

615.252.2369

[pmoskal@babbc.com](mailto:pmoskal@babbc.com)

298 (Tenn. Ct. App. 1992). Moreover, the Court rejected Scholastic's assertion that it used no public services in Tennessee, because "this State's school facilities and teachers are, in large part, funded by taxpayer dollars."

The Court of Appeals has remanded the case to the trial court for further proceedings consistent with the ruling. In addition to raising a Commerce Clause challenge, Scholastic also raised Due Process and Tennessee Constitutional challenges that were not decided on the parties' cross-motions for summary judgment. Scholastic has sixty (60) days within which to file an application with the Tennessee Supreme Court for discretionary review.

**Practice Pointer:** *This decision continues a troubling trend in Tennessee for multistate businesses that have typically focused on compensated employees and contractors when determining what states in which they must collect and remit use tax. In Arco, the activity that satisfied the nexus standard was the use of an in-state manufacturer. Here, the Court of Appeals ignores the fact that the teachers were uncompensated for their participation in the Scholastic program, focusing instead on the fact that the teachers' activities are performed on behalf of Scholastic regardless of monetary compensation. The broader standard that has evolved will require out-of-state companies to reconsider current filing positions in Tennessee based on activities performed on their behalf by various third parties.*

## Tennessee Court Rules That Navy Captain Must Pay Use Tax on Personal Aircraft upon Reassignment to Navy Base in Tennessee

By Brett R. Carter

A Tennessee trial court issued a ruling on January 26, 2012, concluding that a Captain in the United States Navy was required to pay Tennessee use tax on his personal aircraft when he was reassigned to a naval base in Tennessee. *McIntyre v. Farr*, Dkt. No. 09-2145-III (Jan. 26, 2012).

The taxpayer, Capt. Ian McIntyre, purchased a single-engine airplane in Texas in 2007 for \$156,000. He did not pay sales tax in Texas because the transaction was exempt under Texas law. In May 2008, Capt. McIntyre was transferred by the Navy from his duty station in Texas to a naval base in Tennessee. Upon arrival in Millington, the taxpayer leased a hangar for the airplane at the local airport, and in June 2009, the Department of Revenue issued a use tax assessment in the amount of \$8,393 against Capt. McIntyre on the purchase price of the airplane. Notably, Tennessee law provides no exemption from use tax for military personnel relocated to the state on military orders.

The parties filed cross-motions for summary judgment at the trial court with the taxpayer raising various statutory and constitutional challenges to the Department of Revenue's assessment. In addition, Capt. McIntyre argued that Tennessee's taxation of his use of the airplane violated the Servicemembers' Civil Relief Act, 50 U.S.C.A. App. § § 501 et. seq. ("SCRA").

The Court rejected the taxpayer's challenges, concluding that Tennessee had both a statutory basis and constitutional right to impose a use tax on Capt. McIntyre's airplane "use" in Tennessee. With respect to the SCRA argument, the taxpayer maintained that the SCRA prohibited taxation of servicemembers if taxation was based on the servicemember "being absent or present in any tax jurisdiction of the United States solely in compliance with military orders." Relying on *Sullivan v. United States*, 395 U.S. 169, 176 (1969), the Court concluded that the SCRA did not apply to sales and use taxes and applied, instead, only to annually recurring ad valorem taxes on personal property.

Pending a ruling on the state's statutory attorney's fee claim, the taxpayer will have 30 days to decide whether to appeal the trial court's ruling to the Tennessee Court of Appeals.

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