STATE OF TENNESSEE
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Opinion No. 11-52

Out-of-State Dealer's Nexus with Tennessee Due to Activities of In-State Distribution Center

QUESTIONS

1. Under what circumstances would an out-of-state dealer's use of an in-state distribution center to ship goods sold by the out-of-state dealer serve as sufficient nexus under the Commerce Clause of the United States Constitution to require the out-of-state dealer to collect Tennessee sales tax on its retail sales to Tennessee consumers?

2. If enacted, would the attached amendment[1] to Senate Bill 529/House Bill 136 of the 107th General Assembly be constitutionally defensible under the Due Process and Commerce Clauses of the United States Constitution?

3. If enacted, would the proposed amendment serve as sufficient underlying statutory authority to preclude, or otherwise invalidate, any future amendments to the sales and use tax rules that would exempt from Tennessee sales tax out-of-state dealers operating in-state through an in-state affiliated separate entity distribution network?

4. If enacted, would the proposed amendment serve as sufficient underlying statutory authority to preclude, or otherwise invalidate, any future amendments to Rule 96 that would exempt these in-state affiliated separate entity distribution networks from collecting Tennessee sales tax from these out-of-state dealers?

OPINIONS

1. An out-of-state dealer's use of an in-state distribution center will support a finding of nexus if the in-state distribution center's activities are significantly associated with the out-of-state dealer's ability to establish and maintain a market in this state for the sales.

2. Yes, the proposed amendment would be constitutionally defensible.

3. Yes, the proposed amendment, if enacted, would preclude any sales and use tax rules inconsistent with the statutory amendment.

[1] A copy of the proposed amendment is attached to this opinion. The Tennessee General Assembly's website indicates that the amendment has not yet been formally introduced.

4. Yes, the proposed amendment, if enacted, would preclude any future amendments to Rule 96 inconsistent with the statutory amendment.

ANALYSIS

1. Your request addresses Tennessee's constitutional and statutory authority to tax sales made to Tennessee residents by an out-of-state dealer that uses an in-state warehouse or distribution center to store and deliver goods sold by the out-of-state dealer. Under certain circumstances, the distribution center's physical presence in Tennessee would create sufficient nexus under the Due Process and Commerce Clauses to support Tennessee's imposition of sales taxes on the out-of-state dealer's sales to in-state customers. This opinion is intended to provide a discussion of attributional nexus factors in general terms only. It is the longstanding policy of this Office not to opine about the tax liabilities of particular taxpayers premised on detailed and individualized facts.

In 1992, the U.S. Supreme Court reaffirmed its bright-line rule that an out-of-state seller cannot be required to collect sales and use tax on goods purchased by in-state customers when the seller's only connection with the customers is by common carrier or mail. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 301-02 (1992). While the Court found that the Due Process Clause would allow a state to require a mail-order business with no in-state physical presence to collect sales and use tax, the Court held that physical presence is required under the Commerce Clause to establish a "substantial nexus" sufficient to tax such a mail-order business.

If an out-of-state seller owns an in-state warehouse or distribution center or has employees in the state, that would constitute a physical presence by the out-of-state seller sufficient to establish nexus. Ownership of property or presence of employees, however, is not the only means of establishing the physical presence necessary for nexus. Physical presence by an out-of-state seller can also arise from the actions of other parties. For example, nexus may be established by activities conducted within the taxing state by a taxpayer's affiliates or independent contractors. In *Tyler Pipe Industries, Inc. v. Washington Department of Revenue,* 483 U.S. 232, 107 S. Ct. 2810 (1987), and *Scripto, Inc. v. Carson,* 362 U.S. 207, 80 S. Ct. 619 (1960), the United States Supreme Court "expressly upheld the imposition of state sales and use tax obligations based on an out-of-state seller's use of non-employee representatives who are not regular agents to conduct business activities in the taxing state." *Arco Bldg. Systems, Inc. v. Chumley,* 209 S.W.3d 63, 74 (Tenn. Ct. App. 2006). These authorities reveal that such in-state activities will support a finding of nexus if they "are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *Tyler Pipe,* 483 U.S. at 250, 107 S. Ct. at 2821. For purposes of this analysis, it is immaterial that the activities are performed by third-party contractors or affiliates rather than the taxpayer's own employees. *See id.*; *Scripto,* 362 U.S. at 211, 80 S. Ct. at 621. The determinative issue is whether the in-state distribution center carries on substantial business activities in Tennessee on behalf of the out-of-state dealer. *See Arco Bldg. Systems,* 209 S.W.3d at 74.

Determinations as to nexus requirements are necessarily "fact specific and ultimately can only be adequately adjudicated as applied to specific situations and taxpayers." *In re Advisory Opinion,* 509 So. 2d 292, 312 (Fla. 1987); *see also* 2 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 19.02[2][c] (3rd ed. 2009) (observing that "[u]ltimately, the line between these types of activities of independent third parties that will and will not subject an out-of-state seller to use tax collection obligations must be worked out on a case-by-case basis"). According to one commentator, the factors significant to this analysis include

> (1) the precise nature of the relationship between the in-state actor and the out-of-state enterprise (*e.g.*, the degree of control of the former by the latter);
>
> (2) the particular activities that the in-state actor is performing "on behalf" of the out-of-state enterprise (*e.g.*, marketing the out-of-state enterprise's product as distinguished from contributing to the production of the product or providing some after-market service with respect to the product); and
>
> (3) whether, in light of the normal operations of the industry in question, the particular arrangement between the out-of-state enterprise and the in-state actor appears to be contrived to avoid tax liability.

Hellerstein, *State Taxation* ¶ 19.02[2][c].

A couple of notable decisions illustrate how courts apply these factors. In *Arco Building Systems, Inc. v. Chumley,* 209 S.W.3d 63, 74 (Tenn. Ct. App. 2006), the out-of-state dealer's in-state contractor prepared price quotes, drew up blueprints, fabricated products, arranged shipment to in-state customers, accepted final payments from in-state customers, and provided post-delivery consulting services and parts replacement. The Court of Appeals held that the in-state contractor's activities were sufficient to establish a substantial nexus despite the fact that the in-state contractor did not actually solicit sales from Tennessee residents. Distinguishing the out-of-state dealers described in *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904 (1992), and *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 87 S. Ct. 1389 (1967),[2] the court explained that "this case involves an out-of-state seller that has chosen to rely heavily on an in-state company to perform a wide range of services that are integral to the success of the seller's overall business operations in the taxing state."

[2]Both *Quill* and *Bellas Hess* involved an out-of-state mail-order house that had neither outlets nor sales representatives in the state and whose only connection with customers in the state was by common carrier or the U.S. mail. The Supreme Court held that these facts failed to establish the requisite minimum contacts with the state to permit the imposition of the sales and use tax. *Quill*, 504 U.S. at 301-02.

While not truly a nexus case, the decision in *Drugstore.com, Inc. v. Division of Taxation,* 23 N.J. Tax 624, 625-26 (N.J. Tax Ct. 2008), does deal with a distribution center. There, the plaintiff, a business headquartered in Washington State, created two wholly-owned subsidiaries, referred to as DSNP Sales and DS Distribution, to, respectively, sell and distribute merchandise available on the plaintiff's website to customers in New Jersey and elsewhere. Drugstore.com conceded that it had nexus with New Jersey because it had employees and property located at the New Jersey warehouse operated by DS Distribution. Nevertheless, drugstore.com contended that DSNP Sales was the actual seller of the merchandise, that DSNP Sales had no nexus with New Jersey, and, thus, that none of its sales of merchandise were subject to tax in the state. The evidence showed, however, that DSNP Sales was merely the nominal vendor of the merchandise because it had no physical presence anywhere, had no employees anywhere, and contracted all of its administrative and purchasing functions to drugstore.com. Drugstore.com's website appeared "seamless" to the customer and "gave no indication that an entity other than „drugstore.com' was the seller of the merchandise." *Id.* at 632. Based on these facts, the court disregarded the corporate structure set up by drugstore.com, finding that the reason for the formation of DSNP Sales was to bolster the claim that drugstore.com, which admittedly had nexus, was not involved in the sale of merchandise.

The United States Supreme Court cases dealing with this issue have involved actual solicitation activities by the in-state affiliate or contractor, thus leaving room for the argument that actual solicitation is required to establish attributional nexus. This Office has argued that solicitation activities are not essential to a finding of nexus. *See, e.g., Arco Building Systems, Inc. v. Chumley,* 209 S.W.3d 63, 74 (Tenn. Ct. App. 2006) (wherein in-state contractor's activities on behalf of out-of-state dealer did not include solicitation); *see also Borders Online, LLC v. State Bd. of Equalization,* 29 Cal. Rptr. 3d 176, 189 (Cal. Ct. App. 2005) (rejecting argument that state had no authority to impose tax collection duty on out-of-state retailer unless its in-state representative was actually making sales transactions); *Gear Research, Inc. v. Department of Treasury,* No. 207207, 1999 WL 33441136, at *5 (Mich. Ct. App. June 18, 1999) (rejecting notion that "sales activities in the form of sales solicitations [are] necessary" to establish nexus). We also recognize that tenable arguments can be made that actual solicitation activities are necessary to support a finding of nexus. *See Amazon.com, LLC v. Department of Taxation & Finance,* 913 N.Y.S.2d 129, 143 (N.Y. App. Div. 2010) (remanding as-applied Commerce Clause claim to trial court for development of factual record on whether dealer's in-state representatives engaged in activities that constituted solicitation). Any more specific guidance as to the nexus required to apply Tennessee's sales and use tax statute is difficult to discern; as the U.S. Supreme Court has noted, "our law in this area is something of a „quagmire' and the „application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensible power of taxation.'" *Quill Corp.*, 504 U.S. at 315-16 (quoting *Northwestern State Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)).

2. For purposes of imposing sales and use tax liability, section 1 of the proposed amendment to Senate Bill 529/House Bill 136 defines a "dealer" as, *inter alia,* every person who "[m]aintains, uses, owns or operates within this state, directly or by a subsidiary, agent or affiliate as defined in § 67-4-2004, any facility, office, distributing house, sales room or house,

warehouse, or other place of business." Section 2 of the amendment declares it to be the legislative intent that every person, whether or not he has a place of business in Tennessee, is exercising a taxable privilege if the person

> uses any agent, facility, office, distributing house, sales room or house, warehouse, or other place of business in this state for delivering or shipping tangible personal property or providing related services to a consumer in this state if the delivery, shipment or related services are provided pursuant to a retail sale by the person to the consumer, whether or not the place of business is owned, operated or maintained by the person's subsidiary, agent or affiliate as defined in § 67-4-2004.

Relative to the issue of nexus, section 3 of the proposed amendment provides that

> substantial nexus to any such person who does not have a place of business in this state is established through the person's maintenance, use, ownership, or operation of any place of business, directly or by a subsidiary, agent or affiliate as defined in § 67-4-2004, having a presence in this state *for the purpose of conducting activities in this state that substantially contribute to the person's ability to establish and maintain a market in this state*. (emphasis added)

Section 4 of the proposed amendment shifts the liability for the sales tax from the out-of-state dealer to the in-state distribution center under certain circumstances. That section provides that

> [s]ales of tangible personal property by a dealer to a retailer who directs that the dealer deliver or ship tangible personal property or provide related services to the retailer's customer in this state, who is a user or consumer, shall be subject to the tax imposed by this chapter, unless the retailer is registered as a Tennessee dealer and the retailer has presented a valid Tennessee certificate of resale to the dealer.

If enacted, the proposed amendment to Senate Bill 529/House Bill 136 would be constitutionally defensible under the Due Process and Commerce Clauses of the United States Constitution. As currently drafted, the amendment incorporates the constitutional standard set forth by the United States Supreme Court in *Tyler Pipe.* By its language, section 3 of the amendment recognizes the establishment of a substantial nexus only in those situations where the in-state affiliate or agent conducts "activities in this state that substantially contribute to the person's ability to establish and maintain a market in this state." The amendment is designed to reach out-of-state dealers within the constitutional limits set forth in *Tyler Pipe* and, thus, is constitutionally defensible.

3, 4. Moreover, if enacted, the proposed amendment would preclude the amendment or promulgation of any applicable sales and use tax rules, including Rule 96,[3] to exempt sales to Tennessee residents by out-of-state dealers that use in-state distribution centers to ship their products, where such activities fall within the "substantially contribute" standard set forth in *Tyler Pipe*. "The Commissioner of Revenue only has the power to make and publish rules and regulations for the enforcement of the sales tax provisions which are consistent with the statute." *Tidwell v. RCA Corp.,* 528 S.W.2d 179, 181 (Tenn. 1975). Any administrative rule that conflicts with the controlling statute is void. *See id.* As drafted, the amendment imposes sales tax liability against out-of-state dealers that use in-state distribution centers to ship their products to Tennessee customers, where such activities fall within the "substantially contribute" standard set forth in *Tyler Pipe*. Also, as Rule 96 currently does, the amendment imposes sales tax liability against the in-state distribution centers under certain circumstances. Thus, any attempt to amend or promulgate sales and use tax rules in a manner inconsistent with the proposed amendment, once properly enacted, would be ineffective to prevail over the statute's express language.

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[3] Tenn. Comp. R. & Regs. 1320-5-1-.96.

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Amendment No._____

FILED
Date _____
Time _____
Clerk _____
Comm. Amdt. _____

_____
Signature of Sponsor

AMEND Senate Bill No. 529 House Bill No. 136*

by deleting all language after the enacting clause and by substituting instead the following:

SECTION 1. Tennessee Code Annotated, Section 67-6-102(25), is amended by deleting subdivision (G) in its entirety and by substituting instead the following:

(G) Maintains, uses, owns or operates within this state, directly or by a subsidiary, agent or affiliate as defined in § 67-4-2004, any facility, office, distributing house, sales room or house, warehouse, or other place of business;

SECTION 2. Tennessee Code Annotated, Section 67-6-201(a), is amended by adding the following as a new subdivision (13):

(13) Whether or not the person has a place of business in this state, uses any agent, facility, office, distributing house, sales room or house, warehouse, or other place of business in this state for delivering or shipping tangible personal property or providing related services to a consumer in this state if the delivery, shipment or related services are provided pursuant to a retail sale by the person to the consumer, whether or not the place of business is owned, operated or maintained by the person's subsidiary, agent or affiliate as defined in § 67-4-2004;

SECTION 3. Tennessee Code Annotated, Section 67-6-211, is amended by designating the present language as subsection (a) and by adding the following language immediately after the language "mass of property in this state":

, and substantial nexus to any such person who does not have a place of business in this state is established through the person's maintenance, use, ownership, or operation of any place of business, directly or by a subsidiary, agent or affiliate as defined in § 67-4-2004, having a presence in this state for the

purpose of conducting activities in this state that substantially contribute to the person's ability to establish and maintain a market in this state. The processing of orders electronically, including facsimile, telephone, the Internet, or other electronic ordering process, does not relieve the person of the obligation to collect the tax imposed by this chapter.

SECTION 4. Tennessee Code Annotated, Section 67-6-211, is further amended by adding the following as a new subsection (b):

(b) Sales of tangible personal property by a dealer to a retailer who directs that the dealer deliver or ship tangible personal property or provide related services to the retailer's customer in this state, who is a user or consumer, shall be subject to the tax imposed by this chapter, unless the retailer is registered as a Tennessee dealer and the retailer has presented a valid Tennessee certificate of resale to the dealer.

SECTION 5. If any provision of this act or the application thereof to any person or circumstance is held invalid, such invalidity shall not affect other provisions or applications of the act which can be given effect without the invalid provision or application, and to that end the provisions of this act are declared to be severable.

SECTION 6. This act shall take effect upon becoming a law, the public welfare requiring it.