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Opinion No. 09-101

Nexus Created by In-State Resident Referrals to Out-of-State Vendors

QUESTION

Does the activity described in HB 1947, under which an in-state resident for a consideration solicits and refers business on behalf of out-of-state persons and entities, create nexus between the State of Tennessee and such out-of-state vendors sufficient to sustain the imposition of the sales tax against such persons and entities?

OPINION

It is the opinion of this Office that an agreement between an out-of-state vendor and an in-state resident as described in HB 1497 would create taxing nexus in Tennessee.

ANALYSIS

HB 1947 would amend the Retailers' Sales Tax Act, Tenn. Code Ann. §§ 67-6-101, *et seq*., to include a new section providing as follows:

> A person making sales of tangible personal property or services as described in § 67-6-201(12) and taxable under this chapter shall be presumed to be soliciting business through an independent contractor or other representative if such person enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet web site or otherwise, to such person, if the cumulative gross receipts from sales by such person to customers in the state who are referred to such person by all residents with this type of an agreement with such person is in excess of two thousand dollars ($2,000) during the preceding four (4) quarterly periods ending on the last day of February, May, August and November. This presumption may be rebutted by proof that the resident with whom such person has an agreement did not engage in any solicitation in the state on behalf of such person that would satisfy the nexus requirement of the United States constitution during the four (4) quarterly periods in question. Nothing in this subsection shall be construed to narrow the scope of the terms independent contractor or other representative for purposes of this chapter.

The question, then, is whether a vendor's agreement with a Tennessee resident under which the resident refers potential customers to that vendor in exchange for compensation creates a nexus between the State of Tennessee and out-of-state persons and entities sufficient to sustain the imposition of the sales tax against such vendors.

"[T]he Commerce Clause is more than an affirmative grant of power; it has a negative sweep as well. The Clause … 'by its own force' prohibits certain state actions that interfere with interstate commerce." *Quill Corp. v. North Dakota*, 504 U.S. 298, 309 (1992) (citations omitted). The United States Supreme Court first articulated its modern approach to effectuating the purpose of this negative or dormant aspect to the Commerce Clause in *Complete Auto Transit, Inc. v. Brady*:[1]

> In that case, . . . [t]he Court synthesized selected principles from its prior case law and announced that henceforth, state taxes would be upheld against challenges under the dormant Commerce Clause as long as: (1) the tax was applied to an activity that had a "substantial nexus" with the taxing state; (2) the tax was "fairly apportioned;" (3) the tax did not "discriminate against interstate commerce;" and (4) the tax was "fairly related" to the services provided by the taxing state. Following the *Complete Auto Transit* decision, the Court has consistently applied this four-part analysis to determine the constitutionality of a wide variety of state tax laws, including those involving sales or use taxes.

Arco Bldg. Sys. v. Chumley, 209 S.W.3d 63, 69 (Tenn. Ct. App. 2006) (internal citations omitted). The present inquiry focuses upon the first prong of the *Complete Auto* test.

It is important to acknowledge the distinction between this "substantial nexus" restriction imposed by the Commerce Clause and similar requirements imposed by due process. The United States Supreme Court notes that, although the requirements under these clauses "'are closely related,' the Clauses pose *distinct* limits on the taxing powers of the States." *Quill*, 504 U.S. at 305 (*quoting Nat'l Bellas Hess v. Dep't of Revenue*, 386 U.S. 753 (1967)).

"The Due Process Clause requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax, and that the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." *Quill*, 504 U.S. at 306 (internal quotations and citations omitted). "[I]f a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State." *Quill*, 504 U.S. at 307.

By contrast, the Commerce Clause's "substantial nexus" prong requires something more than the "slightest presence" in the taxing jurisdiction. *Quill*, 504 U.S. at 315 n.8. While the Court's post-*Complete Auto* "jurisprudence now favors more flexible balancing analyses," it "never intimated a desire to reject all established 'bright-line' tests." *Quill*, 504 U.S. at 314. In *Quill*, for instance, the Supreme Court declined to overrule the holding in *National Bellas Hess*, which had established a "safe harbor for vendors 'whose only connection with customers in the

[1] 430 U.S. 274 (1977).

[taxing] State is by common carrier or the United States mail.'" *Quill*, 504 U.S. at 315. "'[T]he crucial factor governing nexus is whether the activities performed in [the taxing] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the taxing] state for the sales.'" *Tyler Pipe Indus. v. Washington State Dep't of Revenue*, 483 U.S. 232, 250 (1987) (quoting lower court with approval).

Scripto, Inc. v. Carson, 362 U.S. 207 (1960), presents a scenario similar to that contemplated by HB 1947. There, Florida sought to impose use tax on "certain mechanical writing instruments" sold and shipped from a taxpayer's place of business in Atlanta to Florida residents for use in that State. *Scripto*, 362 U.S. at 207. The taxpayer did not have any employees or brick-and-mortar facilities in Florida. *Scripto*, 362 U.S. at 209. The Court described Scripto's contractual arrangement as follows:

> Orders for its products are solicited by advertising specialty brokers or, as the Supreme Court of Florida called them, wholesalers or jobbers, who are residents of Florida. At the time of suit, there were 10 such brokers -- each having a written contract and a specific territory. The somewhat detailed contract provides, *inter alia*, that all compensation is to be on a commission basis on the sales made, provided they are accepted by appellant; . . . . The contract specifically provides that it is the intention of the parties 'to create the relationship . . . of independent contractor.'"

Id. The Supreme Court held that "nexus is present here" in part because the taxpayer "ha[d] 10 wholesalers, jobbers, or 'salesmen' conducting continuous local solicitation in Florida and forwarding the resulting orders from that State to Atlanta for shipment of the ordered goods." *Scripto*, 362 U.S. at 211.

Like *National Bellas Hess*, *Scripto* was decided under both the Due Process Clause and the Commerce Clause. While *Scripto* may have mingled the two analyses in the sort of manner for which the *Quill* Court later expressed regret, it retains its vitality for Commerce Clause nexus analysis. After *Complete Auto*, the Supreme Court in *Tyler Pipe* cited *Scripto* for the proposition that the "showing of a sufficient nexus could not be defeated by the argument that the taxpayer's representative was properly characterized as an independent contractor instead of as an agent." *Tyler Pipe*, 483 U.S. at 250. Tyler sold a variety of pipe and drainage products in Washington, but the Court noted that "all of those products are manufactured in other States. Tyler maintains no office, owns no property, and has no employees residing in the State of Washington. Its solicitation of business in Washington is directed by executives who maintain their offices out-of-state and by an independent contractor located in Seattle." *Tyler Pipe*, 483 U.S. at 249. The state court held that Tyler's in-state sales representatives "have helped Tyler Pipe and have a special relationship to that corporation. The activities of Tyler Pipe's agents in Washington have been substantial." The Supreme Court agreed "that the activities of Tyler's sales representatives adequately support the State's jurisdiction to impose its wholesale tax on Tyler." *Tyler Pipe*, 483 U.S. at 250-51.

Arco is a recent, thorough discussion of nexus principles by our Court of Appeals in a setting with similarities to *Scripto* and *Tyler Pipe*. Arco was a seller of metal buildings that "contracted with four manufacturers in Georgia, Louisiana, Tennessee, and Texas to construct the buildings based on its customers' specifications." *Arco*, 209 S.W.3d at 64. Like the taxpayers in *Scripto* and *Tyler Pipe*, Arco maintained no employees or brick-and-mortar presence in Tennessee. *Arco*, 209 S.W.3d at 73. However, it "specifically authorized an in-state company to accept and deposit final payments from its customers. The in-state company [was] involved in Arco's Tennessee operations from beginning to end in the preparation of price quotes to drawing up blueprints to fabricating the product to arranging for shipment of the product to accepting final payment from the customer." *Arco*, 209 S.W.3d at 74. The Court of Appeals held that "use of non-employee representatives who are not regular agents to conduct business activities in the taxing state" can support the imposition of sales tax[2] and that "'a substantial nexus may be established by activities carried on within the state *by affiliates and independent contractors*.'" *Id*. (quoting *America Online, Inc. v. Johnson*, 2002 Tenn. App. LEXIS 555, at *3) (emphasis in original).

Finally, New York presently has a statute nearly identical to HB 1497. It provides that

> a person making sales of tangible personal property or services taxable under this article ("seller") shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller, if the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods ending on the last day of February, May, August, and November. This presumption may be rebutted by proof that the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the United States constitution during the four quarterly periods in question..

N.Y. Tax Law § 1101(b)(8)(vi). Amazon.com LLC has challenged the application of this "Commission-Agreement Provision." *Amazon.com LLC v. New York State Dep't of Taxation & Fin*., 2009 N.Y. Misc. LEXIS 28 (N.Y. Sup. Ct. 2009). Amazon operates an "Associates Program" "which allows participants ('Associates') to maintain links to Amazon.com on their own websites and compensates them by paying 'a percentage of the proceeds of the sale.'" *Amazon*, 2009 N.Y. Misc. LEXIS 28 at **3. The relationship is governed by an "Operating Agreement" that specifies that the Associates are "independent contractors." The trial court found that "Amazon contracts with thousands of Associates that provided it with a New York address" and that "Amazon chooses to benefit from New York Associates that are free to target New Yorkers and encourage Amazon sales, all the while earning money for Amazon in return for which Amazon pays them commissions. Amazon does not discourage its Associates from reaching out to customers or contributors and pressing Amazon sales." *Amazon*, 2009 N.Y. Misc. LEXIS 28 at **14. Concluding that "Amazon should not be permitted to escape tax

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[2] For this proposition it cites *Tyler Pipe* and *Scripto*.

collection indirectly, through use of an incentivized New York sales force to generate revenue, when it would not be able to achieve tax avoidance directly through use of New York employees engaged in the very same activities," the trial court found no Commerce Clause violation. *Amazon*, 2009 N.Y. Misc. LEXIS 28 at **15.

The *Amazon* Court's analysis is sound. The principal difference between New York's Commission-Agreement Provision and HB 1497 is that New York's statute sets a threshold of $10,000 during the four previous quarterly periods, whereas HB 1497 requires only $2,000. HB 1497 would therefore bring in out-of-state vendors with a lesser volume of sales than is required in New York or than was present in *Amazon*. The parties and the court in *Amazon* seem to treat the threshold requirement for taxability as being for a period of one year (i.e., the total span of "four quarterly periods ending on the last day of February, May, August, and November") and requiring sales of more than $10,000 during this period as a whole. *See, e.g., Amazon*, 2009 N.Y. Misc. LEXIS 28 at **4, **14-15. In the opinion of this Office, however, the language in both the New York statute and HB 1497 is better read as requiring sales of the threshold amount ($2,000 in Tennessee) for each quarter – otherwise the specification of particular quarterly periods introduces needless complication to the statutory language.[3] Regardless, this ambiguity could perhaps be clarified by amendment as HB 1497 proceeds through the Legislature.

In the view of this Office, based upon the foregoing authority, taxpayers falling within the ambit of the activity described by HB 1497 have nexus with Tennessee sufficient to sustain the imposition of sales tax. While the Supreme Court analyses of substantial nexus in *Scripto* and *Tyler Pipe* are in different contexts than those that would be presented under HB 1497, those cases provide the guidelines under which the validity of the bill must be tested. The similarities to *Scripto* are striking. Just as is contemplated by HB 1947, *Scripto* involved an agreement between the vendor and the in-state resident (the broker/jobber) for the solicitation of orders. As in the present bill, that agreement provided for a commission to be paid to the broker for sales filled by the vendor. In the *Scripto* agreement, the in-state resident was specifically designated an "independent contractor" and HB 1947 specifically contemplates that the in-state residents might bear the same designation.[4] Moreover, if – as in *Tyler Pipe* – the activities of these in-state residents were "performed in [Tennessee] on behalf of the" vendor and were "significantly associated with the taxpayer's ability to establish and maintain a market in [the taxing] state for the sales,'" then the "crucial factor" for determining substantial nexus would be present. *Tyler Pipe*, 483 U.S. at 250.

It is the physical presence in the taxing State of individuals soliciting business on behalf of vendors that establishes the state's taxing nexus over the vendors. However, it is possible that

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[3] Additionally, for out-of-state dealers who have sufficient nexus with Tennessee to collect and remit sales tax under current statutes, the Department of Revenue has promulgated a rule under which "[d]ealers having average monthly gross sales of $400.00 or less and taxable services of $100.00 or less may in the discretion of the Commissioner be required to pay tax to their suppliers on purchases in lieu of registering for sales and use tax purposes since the Department's cost of administering the account would exceed the taxes reported." This would work out to a threshold of $4,800 in sales per year, far more than $2,000 per year, buttressing the conclusion that the $2,000 figure is meant to represent each of the four quarters.

[4] The *Scripto* Court noted that this "independent" status "neither results in changing his local function of solicitation nor bears upon its effectiveness in securing a substantial flow of goods into Florida." *Scripto*, 362 U.S. at 211.

a court reviewing HB 1497 might conclude that the threshold amount is low enough to bring into question whether the nexus created by the activity is truly substantial. This is especially so if such a court were to read HB 1497 to require $2,000 in sales volume per *year* (as in *Amazon*) rather than per *quarter* (as this Office believes is the best reading of HB 1497). Nevertheless, it is the opinion of this Office that the proposed legislation is consistent with Tennessee's constitutional reach under *Scripto, Tyler Pipe, Arco,* and related cases.

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