

State and Local Tax Practice Group

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Connecticut Supreme Court Nexus Decision Expands Definition of Retailers Required to Collect Sales and Use Tax

On March 19, 2012, the Connecticut Supreme Court issued a significant sales tax decision that will greatly expand the State's ability to require out-of-state retailers to collect and remit sales tax on their sales to Connecticut customers. In its decision, *Scholastic Book Clubs, Inc. v. Commissioner of Revenue Services*, SC 18425 (Conn. Mar. 27, 2012), the Court held that Scholastic Book Clubs, Inc. ("Scholastic") had sufficient contacts within Connecticut for Connecticut to require it to collect Connecticut sales tax. By ruling that Scholastic's relationship with over 14,000 Connecticut teachers created physical presence in Connecticut and thereby obligated Scholastic to collect and remit sales tax on its Connecticut sales, the Connecticut Supreme Court arguably expanded the ability of Connecticut's Department of Revenue Services to require out-of-state retailers to pay tax on their sales into Connecticut.

The Facts

Scholastic is a Missouri-based retailer of books and related items, which invites school teachers in Connecticut (and other states) to share Scholastic sales materials with their students. Teachers who participate are responsible for distributing Scholastic catalogs to students, receiving orders and money, submitting a single order and payment to Scholastic, receiving and distributing merchandise, and handling any customer service issues that arise due to missing, incorrect or damaged items. Scholastic does not directly compensate teachers for participating, but does allow teachers to earn items for their school. This arrangement is Scholastic's only contact with Connecticut. Scholastic also sends materials into the state by mail and common carrier, but this activity does not constitute engaging in business in Connecticut under existing law. Scholastic has no office or employees in Connecticut, nor does it have any independent contractor or agency relationship with persons or companies located in Connecticut.

The Court's Analysis of State Law

The Court first ruled that the teachers who voluntarily, and without direct compensation, coordinated Scholastic's sales to students, were Scholastic's "representatives" and that under Connecticut law, that relationship was sufficient to obligate Scholastic to collect Connecticut sales tax. The Court noted that Connecticut General Statutes section 12-



407(a)(15)(A) provides that an out-of-state retailer is “engaged in business” in Connecticut, and therefore obligated to collect Connecticut sales tax, if it has a “representative, agent, salesman, canvasser, or solicitor operating in the state for the purpose of selling, delivering or taking orders.” Scholastic argued that the teachers were not its “representatives” because the teachers were not Scholastic’s agents, did not agree to act for Scholastic’s benefit and received no direct compensation. Instead, Scholastic argued that the teachers acted in their own interests and *in loco parentis* for their students. Although the Court agreed that the teachers were not agents of Scholastic, the Court noted that Section 12-407(a)(15)(A) provides that an out-of-state retailer is engaged in business if it has *either* a representative or agent in Connecticut, and accordingly, the legislature intended for the statute to apply to a broad range of relationships, not just established agency relationships. The Court further found that Scholastic was able to sell its products in Connecticut only through the teachers who participate in its program. The Court held that this relationship was the type of representative affiliation that the Legislature intended to constitute engaging in business in Connecticut, thereby imposing a responsibility to collect sales tax.

The Court’s Analysis of the Commerce Clause

Regardless of the state law analysis, Connecticut’s tax laws must comply with federal constitutional limitations designed to protect businesses operating in interstate commerce. Under general constitutional law principles, a state taxing statute can be ruled invalid if it violates the Commerce Clause of the United States Constitution. In the most basic terms, the Commerce Clause bars states from enacting laws that burden interstate commerce. A statute will survive a Commerce Clause challenge only if the “tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.” *Complete Auto Transit v. Brady*, 430 U.S. 274, 279 (1977). The United States Supreme Court has ruled that in order for a state to impose its sales tax on an out-of-state retailer, the retailer must have a physical presence in the taxing state. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and *Bellas Hess Inc. v. Dept. of Revenue*, 386 U.S. 753 (1967).

In *Scholastic*, the Court ruled that the teachers’ activities related to Scholastic’s Connecticut sales were sufficient to establish physical presence and to satisfy the “substantial nexus” requirement, even though the relationship fell short of an agency relationship. In reaching this conclusion, the Court stated that the activities of the teachers were similar enough to the activities undertaken by independent salespeople in *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), a case in which the United States Supreme Court ruled that the requirements of the Commerce Clause were satisfied by the visits of independent sales representatives, and that it did not matter that the teachers were not Scholastic’s agents.



Decision in Context

The *Scholastic* fact pattern has been addressed by several courts around the country. With this decision, Connecticut becomes the fifth state to rule in a case involving whether a book club that contacts teachers by mail and common carrier and relies on teachers to coordinate sales to their students, but has no other contacts within a state, has substantial nexus with a state for purposes of sales tax collection obligations. Previously, courts in two states (California and Kansas) have ruled that similar facts gave rise to sufficient nexus, and courts in two other states have ruled to the contrary (Michigan and Arkansas). The Connecticut Supreme Court distinguished this case from those decided in Michigan and Arkansas because the sales tax statutes of those two states require an agency relationship, whereas Connecticut also considers a representative (non-agency) relationship with the retailer to be sufficient to create nexus. Because of the varying views of the different state courts, it is possible that the United States Supreme Court may have an interest in taking the case on appeal, should Scholastic choose to file a *writ of certiorari*.

Implications of the Decision

The Supreme Court's interpretation opens the door for the Connecticut Department of Revenue Services to impose Connecticut sales tax collection requirements on out-of-state retailers based on a wider variety of relationships than previously considered. While Scholastic sought out the relationships at issue in this case, the Department of Revenue Services could rely on the Court's expansive definition of "representative" to attempt to impose a sales tax collection obligation on an out-of-state retailer whose Connecticut sales or distribution efforts were aided by the efforts of a person or entity acting independently in a way that benefited the out-of-state retailer.

In light of this decision, any out-of-state retailer which has been selling to Connecticut customers and has not been collecting sales tax (based on its view that its activities in Connecticut did not create physical presence in Connecticut) is encouraged to contact one of the members of our Practice Group for guidance as to whether this decision might have a material impact on its tax position.

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