GRADUATE SUPPLY HOUSE, INC. 1620 N. MILL STREET JACKSON, MS 39202-1535,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 05-751
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

THIRD PRELIMINARY ORDER

This case involves final assessments of State and local use and rental tax entered against the above Taxpayer. A hearing was conducted on December 6, 2005. An Opinion and Preliminary Order was entered on March 31, 2006. That Order generally discussed the nexus issue raised by the Taxpayer, and concluded that there was not sufficient evidence in the record to decide the issue.

The March 31, 2006 Order also directed the parties to attempt to agree to a stipulation of facts. The parties failed to do so, and a second hearing was conducted on January 24, 2007. The Taxpayer's representative submitted an affidavit from the Taxpayer's co-owner at the hearing that generally explained how the Taxpayer conducts business in Alabama. Although the affidavit is inadmissible as evidence, the Department nonetheless agreed to review the affidavit. The Department subsequently responded that the facts alleged in the affidavit, even if true, would not change its position.

The Taxpayer is based in Mississippi, and rented graduation caps and gowns in Alabama and elsewhere during the periods in issue. The threshold issue is whether the Taxpayer had nexus with Alabama, and was thus subject to Alabama's taxing jurisdiction during the assessment periods. The March 31, 2006 Order addressed the nexus issue as follows:

> For sales and use tax purposes, a taxpayer must have some "minimal business nexus" with Alabama to be subject to Alabama's taxing jurisdiction. *State of Alabama v. MacFadden-Bartell Corp.*, 194 So.2d 543, 546 (Ala. 1967). The U.S. Supreme Court has also held that to be subject to tax in a state, a taxpayer must have a "substantial nexus" with the state. *Complete Auto Transit, Inc. v. Brady*, 97 S.Ct. 1076 (1977). And for sales and use tax purposes, the Supreme Court has held that a taxpayer must have a physical presence in the state. *Quill Corporation v. North Dakota*, 112 S.Ct. 1912 (1992); *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 87 S.Ct. 1389 (1967).
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> The physical presence mandated by *Quill* does not require that actual employees of a taxpayer must be in the state. Rather, sufficient nexus is established if the taxpayer is conducting or engaging in business activities through independent contractors or agents acting on behalf of the taxpayer in the state. *Scripto, Inc. v. Carson*, 80 S.Ct. 619 (1960); *MacFadden-Bartell*, *supra*. "[T]he crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *Tyler Pipe Indus. V. Washington State Dept. of Revenue*, 107 S.Ct. 2810, 2821, quoting the Washington Supreme Court, 715 P.2d 123, 126 (1986). See also, *State of Louisiana v. Dell International, Inc., et al*, ____ So.2d ____ (2006).

Graduate Supply at 2.

The Taxpayer did not own property or have direct employees in Alabama during the periods in issue. It did, however, have a business relationship with at least four Alabama residents that assisted the Taxpayer in renting caps and gowns in Alabama. The issue is whether the Taxpayer-related activities performed by those individuals in Alabama were "performed in this state on behalf of the taxpayer, (and were those activities) significantly associated with the taxpayer's ability to establish and maintain a market in this state. . . ." *Tyler Pipe*, 107 S. Ct. at 2821. If so, the Taxpayer had nexus with and was subject to Alabama tax.

The Department determined that the four Alabama residents were agents of the Taxpayer in Alabama, and consequently that the Taxpayer had nexus with the State,

because the Taxpayer's bookkeeper indicated during the Department audit that the four Alabama residents, Rusty Parker, Ricky Phillips, Don Hodges, and Lee Daniel, were salesmen of the Taxpayer. The bookkeeper further stated on a nexus questionnaire completed at the beginning of the audit that the Taxpayer solicited business in Alabama through factory/manufacturers' representatives or agents.

The Taxpayer asserts that the above individuals are not associated with the Taxpayer, but rather are representatives of L. G. Balfour Company, which sells class rings, graduation invitations, and diplomas to students in Alabama and elsewhere. The Taxpayer's co-owner explained his company's relationship with the Balfour representatives in the above-referenced affidavit submitted at the January 24, 2007 hearing.

The co-owner concedes that the Taxpayer has "the privilege to work with Balfour representatives" in Alabama. He explained the various methods by which his company rents caps and gowns to Alabama customers. The primary method used 75 percent of the time is as follows: A Balfour representative measures the students at a school in Alabama to obtain the correct cap and gown sizes. The students pay the Balfour representative for the cap and gown rentals (and any Balfour items) at a price set by the representative. The representative then completes and sends the Taxpayer's cap and gown order forms to the Taxpayer. The Taxpayer fills the orders and bills the representative at a price less than the amount paid by the students to the Balfour representative. The Taxpayer claims that Balfour pays all applicable Alabama rental tax due on the transactions.[1]

[1] The Department disputes this claim because, according to the Department, Balfour is not registered with the Department to collect and remit Alabama rental tax.

A second method used 15 percent of the time involves a Balfour representative obtaining the cap and gown measurements from a school administrator. The representative completes the cap and gown order forms and submits them to the Taxpayer, which fills the order and bills the school at the Balfour representative's quoted price. The students pay the school, which in turn pays the Taxpayer. The Taxpayer then pays the Balfour representative a commission based on the difference between the Taxpayer's standard charge for the rentals and the higher amount quoted by the Balfour representative to the school. The co-owner did not explain if Alabama tax is paid on those transaction, or by which party.

A third method used 5 percent of the time involves a Balfour representative obtaining the correct sizes and then sending the completed measurement order forms to the Taxpayer. The school pays the Balfour representative an amount set by the representative. The Taxpayer fills the order and then bills the representative an amount less than the amount the representative is paid by the school. The co-owner again did not explain what, if any, Alabama tax is paid on those transactions, or by which party.

Finally, a fourth method also used 5 percent of the time does not involve a Balfour representative. Rather, the school contacts the Taxpayer directly, and the Taxpayer sends a measurement packet to the school. The school sends the completed measurement order forms to the Taxpayer, which fills the orders and bills the school, which has collected the money from the students. The co-owner did not explain if Alabama tax is paid on those transactions.

As discussed, nexus is established in a state if the activities of an independent contractor or agent acting on behalf of an out-of-state taxpayer in the state "are significantly

associated with the taxpayer's ability to establish and maintain a market in the state. . . ." *Tyler Pipe*, 107 S. Ct. at 2821.

The Taxpayer argues that the individuals that measure the students and then submit the completed order forms to the Taxpayer are Balfour representatives, and are not associated with or acting on behalf of the Taxpayer. I disagree.

A written agency agreement is not required in Alabama for an agency relationship to exist. Rather, an agency relationship may be expressed, implied, or apparent, and the existence of an agency relationship is a question of fact to be determined under the specifics of each case. *Lawler Mobile Homes, Inc. v. Tarver*, 492 So.2d 297 (Ala. 1986).

Although there is no written agency agreement between the Taxpayer and the Balfour representatives, the facts establish that the representatives are de facto or implied agents of the Taxpayer. They measure the students for the caps and gowns. They also provide the students (or the schools) with the Taxpayer's order forms. They collect the completed order forms and submit them to the Taxpayer. The representatives are clearly acting on behalf of the Taxpayer when performing those duties. The representatives' actions are also tacitly approved by the Taxpayer because approximately 95 percent of the Taxpayer's rentals in Alabama are through the Balfour representatives.

The representatives are also compensated for their activities or services on behalf of the Taxpayer. In the primary method employed, the students pay the Balfour representative for the cap and gown rentals. The representative in turn remits to the Taxpayer a lesser amount. The difference between the amount the students pay the representative and the lesser amount the representative pays the Taxpayer constitutes the representative's commission. Concerning the second method, the Taxpayer pays the

commission directly to the Balfour representative. The third method discussed is similar to the first in that the Balfour representative collects from the school, and then pays a lesser amount to the Taxpayer. Again, the difference is the representative's commission. The fourth method does not involve a Balfour representative.

In summary, the Balfour representatives and the Taxpayer have at least a tacit agreement or understanding whereby the representatives perform various activities on behalf of the Taxpayer in Alabama. They in turn receive a commission for their activities. The representatives are acting as agents of the Taxpayer, and their actions on behalf of the Taxpayer in Alabama allow the Taxpayer to establish and maintain its business of renting caps and gowns in Alabama. Stated differently, the activities of the Balfour representatives are "significantly associated with the [T]axpayer's ability to establish and maintain a market in (Alabama). . . ." *Tyler Pipe*, 107 S.Ct. at 2821. The Taxpayer thus has nexus with Alabama under the rationale of *Tyler Pipe* and *Scripto*.

Other states have addressed the agency nexus issue in cases involving in-state teachers that assisted an out-of-state retailer in selling goods to the teachers' students. See, *Scholastic Book Clubs, Inc. v. State, Dept. of Treasury, Revenue Div.*, 567 N.W.2d 692 (Mich. App. 1997); *In the Matter of the Appeal of Scholastic Book Clubs*, 920 P.2d 947 (Kan. 1996); *Freedom Industries v. Roger W. Tracy, Tax Commissioner of Ohio*, 1994 Ohio Tax LEXIS 2025 (12/12/1994); *Troll Book Clubs, Inc. v. Roger W. Tracy, Tax Commissioner of Ohio*, 1994 Ohio Tax LEXIS 1374 (8/19/1994); *James Pledger, Director v. Troll Books Clubs, Inc.*, 871 S.W.2d 389 (Ark. 1994); and *Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal. App. 3d 734 (1989).

The above cases all involved substantially similar facts. The out-of-state retailer mailed its catalogs to teachers in the state. The teachers distributed the catalogs to their students. The students submitted completed order forms to the teachers, who forwarded the orders to the out-of-state retailer with payment. The retailer delivered the goods to the teachers, who distributed the goods to the students. The retailer did not compensate the teachers, although some awarded "bonus points" that could be used to purchase additional goods from the retailer.

In the California and Kansas *Scholastic Book Clubs* cases, the courts held that the teachers' activities on behalf of Scholastic constituted an implied agency relationship that established nexus.

> First, we note that an implied agency may exist if it appears from a party's words, conduct, or other circumstances that the principal intended to give the agent authority to act. Second, that agency relationship may exist notwithstanding a denial by the alleged principal or whether the parties understood it to be an agency. We conclude that Kansas teachers are acting under Scholastic's authority once they undertake to sell the books to the students. By Scholastic's accepting orders and payments and shipping merchandise to teachers for distribution to the student purchasers, the Kansas teachers are the implied agents of Scholastic.

Scholastic, 920 P.2d at 955, 956.

In the Michigan *Scholastic Book Clubs* case and the other cases cited above, the courts found that an agency relationship was not established, and consequently, that the out-of-state sellers did not have nexus. "The teachers are not a sales force that works for (the out-of-state seller). Rather, they are analogous to parents who order an item from a mail-order catalog for their children; no one would seriously argue that such parents are a 'sales force' for mail-order vendors." *Scholastic Book Clubs*, 576 N.W.2d at 696.

In deciding this case, it is not necessary to decide the "teacher nexus" issue presented in the above cases because the facts in this case are materially different than in those cases. First, the teachers were not compensated by the out-of-state retailers for their activities on behalf of the retailers.[2] In this case, however, the Taxpayer pays (either directly or indirectly) the Balfour representatives a commission for their activities on behalf of the Taxpayer in Alabama.

Second, the rationale used by some of the courts that decided against nexus was that the teachers' actions in distributing the catalogs and taking orders were simply an extension of their teaching duties. That is, the teachers' actions were primarily to further their students' education, not to sell goods for the out-of-state retailers. "First, and most importantly, teachers are not in the business of selling Troll's books, they are in the vocation of educating the children entrusted to their charge." *Freedom Industries*, 1994 Ohio Tax Lexis 2025 at 16, quoting *Troll Book Clubs*, 1994 Ohio Tax Lexis 1374 at 17. "The school teachers, PTA leaders, and mom's groups are only doing what they would do anyway – take care of the children in their care." *Freedom Industries*, 1994 Ohio Tax Lexus at 17.

In this case, the Balfour representatives are salesmen. They are directly employed by Balfour, but, as discussed, they also solicit rentals for the Taxpayer. Their activities for the Taxpayer substantially contribute to and are essential to the Taxpayer's rental activities

[2] The California court found in *Scholastic Book Clubs* that the "bonus points" awarded to the teachers were "similar to the Florida jobbers' commissions in *Scripto*. . . ." *Scholastic Books*, 207 Cal. App. at 740. But providing teachers with a credit toward the purchase of merchandise is materially different from paying a salesman a substantial monetary commission.

in Alabama. They are also performing their normal business activities when they provide those services on behalf of the Taxpayer.

But even if the Balfour representatives are not deemed to be de facto or implied agents of the Taxpayer, the Taxpayer still had nexus with Alabama because it owned the hundreds if not thousands of caps and gowns that were being rented in Alabama during the subject periods.

In *Dial Bank v. State of Alabama*, Inc. 95-289 (Admin. Law Div. O.P.O. 8/10/1998), an out-of-state taxpayer otherwise without contacts with Alabama leased two MRI machines in the State. The Administrative Law Division held that the taxpayer's ownership of those tangible machines in Alabama established Commerce Clause nexus.

> The Taxpayer in this case had a physical presence in Alabama because it owned the two tangible MRI machines in Alabama. The machines cost over $3.3 million, and the Taxpayer derived substantial income from the machines. The physical presence of those machines in Alabama established substantial nexus for Commerce Clause purposes.

Dial Bank at 8.

The same rationale applies in this case. The Taxpayer owned the caps and gowns while they were being rented in Alabama, and it derived substantial income from the presence of the caps and gowns in Alabama. The physical presence of the Taxpayer's income-producing property in Alabama established substantial nexus for Commerce Clause purposes.[3] The Taxpayer was thus doing business in and subject to Alabama's taxing

[3] The Taxpayer clearly had due process nexus with Alabama because it regularly and purposefully availed itself of Alabama's economic market when it regularly solicited (through the Balfour representatives) and then rented the caps and gowns to Alabama customers. See generally, *Quill Corporation v. North Dakota*, 112 S. Ct. 1904, 1910 (1992).

jurisdiction during the periods in issue.[4]

The Taxpayer's representative also raised various issues concerning the Department's audit in addition to the nexus issue. Specifically, he objects that while the Department randomly selected four test months to determine a margin of error to be applied over the entire audit period, it threw out the one month that the Taxpayer had overpaid and only used the three months that showed a deficiency. If the omitted month is also considered, the Taxpayer would have had a net overpayment for the four sample months. The representative also explained at the December 6, 2005 hearing that the Department examiners improperly failed to apply the correct error rate. The representative's explanation is found on pages 21 – 35 of the December 6, 2005 hearing transcript. The representative also touched on various other problems he had with the audit, see T. at 35 – 53.

To ensure that all of the Taxpayer's objections to the audit are addressed, the Taxpayer's representative should submit a list of his various objections to the audit, with a

[4] A different conclusion was reached in *Union Tank Car v. State of Alabama*, Corp. 04-247 (Admin. Law Div. 1/11/2005). In that case, Union Tank Car rented railroad cars outside of Alabama that the lessees sometimes used in Alabama. It otherwise had no property, employees, or agents in Alabama. The Administrative Law Division held that the company was not doing business in Alabama, and thus was not subject to Alabama income tax. Union Tank Car's alternative nexus argument was pretermitted by the above finding. The Administrative Law Division was affirmed by the Alabama Court of Civil Appeals in *State Dep't of Revenue v. Union Tank Car*, 2007 Ala. Civ. App. LEXIS 246, April 13, 2007

In this case, however, the Taxpayer had agents soliciting business on its behalf in Alabama, the lessees entered into the lease agreements in Alabama, and the lessees used the rented caps and gowns exclusively in Alabama. The Taxpayer was thus in the business of renting property in Alabama and, as discussed, had nexus with the State.

detailed explanation of each. The list and explanations should be submitted to the Administrative Law Division by December 14, 2007. It will be submitted to the Department for review and response, with a copy of the December 6, 2005 hearing transcript. Appropriate action will then be taken. To assist the Taxpayer's representative, a copy of the hearing transcript is also enclosed with his copy of this Preliminary Order.

Entered November 20, 2007.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Margaret Johnson McNeill, Esq. (w/transcript)
Ashley H. Stafford, CPA (w/transcript)
Joe Cowen
Mike Emfinger