

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 04-12**

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Sourcing of “drop shipment” sales for purposes of franchise, excise tax apportionment formula receipts factors.

SCOPE

Revenue rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue rulings are advisory in nature and are not binding on the Department.

FACTS

The Taxpayer is a manufacturer located in Tennessee. The Taxpayer has contracted with several affiliated entities (hereinafter referred to collectively as the “Marketing Entities”) to market and sell its products to unrelated customers. The third party customer negotiates directly with the Marketing Entities for the purchase of the product. Upon the consummation of a sale with the customer, the Marketing Entities purchase the product from Taxpayer at arms-length. The product is shipped directly from Taxpayer’s manufacturing facility in Tennessee to the out-of-state customers via common carrier.

The three party sales between Taxpayer, the Marketing Entities and the ultimate customer are structured as a “flash title” transfer between Taxpayer and the Marketing Entities. Specifically, title for the product is transferred to the Marketing Entities at the Taxpayer’s dock at the time of shipment of the product to the Market Entity’s customer. The Marketing Entities will contract separately with the third party common carrier to transport the product to the Marketing Entities customer. Shipping terms for the transport of product to third party customers may vary. Although the Marketing Entities never actually take physical possession of products in Tennessee, title to the products will transfer momentarily to the Market Entities at the Taxpayer’s Tennessee location.

For purposes of this Revenue Ruling, it is assumed that the Taxpayer is doing business in a state other than Tennessee and is properly entitled to apportion its net worth and net earnings for franchise, excise tax purposes.

QUESTIONS PRESENTED

1. Is the Taxpayer required to include sales of product ultimately shipped to the Marketing Entities' out-of-state customers in the receipts factor numerator of its Tennessee corporate franchise, excise tax apportionment formula?
2. Is the Taxpayer required to include sales of product shipped to the Marketing Entities' Tennessee customer in the receipts factor numerator of its Tennessee corporation franchise, excise tax apportionment formula?

RULING

1. No.
2. Yes.

ANALYSIS

APPLICABLE TENNESSEE LAW AND FRANCHISE, EXCISE TAX RULES

Tenn. Code Ann. §§ 67-4-2012(a) and 67-4-2111(a) provide that a business entity that is doing business both within and without Tennessee may apportion its Tennessee net worth and net earnings for franchise, excise tax purposes by multiplying them by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the receipts factor and the denominator of which is four (4).

For purposes of the receipts factors, Tenn. Code Ann. § 67-4-2012(h)(1) provides that sales of tangible personal property for excise tax purposes are included in the numerators of such factors if:

The property is shipped or delivered to a purchaser, other than the United States government, inside this state regardless of the F.O.B. point or other conditions of the sale[.]

Tenn. Code Ann. § 67-4-2111(h)(1) makes similar provisions for franchise tax purposes.

Tenn. Comp. R. & Regs. 1320-6-1-.33(d) states that a "purchaser within this state" (the excise tax statute now uses the term "purchaser . . . inside this state") includes:

. . . the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state.

The following example is given with regard to Tenn. Comp. R. & Regs. 1320-6-1-.33(d):

Example: A taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in this state pursuant to purchaser's instructions. The sale by the taxpayer is "in this state".

Tennessee has no "throw-back" rule that requires sales of tangible personal property shipped or delivered to a purchaser in a state where the seller has no tax nexus to be included in the numerator of the origin state's receipts factors.

The language in Tenn. Code Ann. §§ 67-4-2012(h)(1) and 67-4-2111(h)(1) is very similar to § 16(a) of the Uniform Division of Income for Tax Purposes Act (UDITPA). Tenn. Comp. R. & Regs. 1320-6-1-.33(d) and its example contain language similar to Multistate Tax Compact (MTC) Regulations. UDITPA in a model act drafted by the National Conference of Commissioners on Uniform State Laws and approved at their 66th Annual Conference in July, 1957. It was intended to reduce diversity among states in allocation and apportionment methods used to determine their respective shares of a business entity's taxable income.

Currently, UDITPA or UDITPA like statutes have been adopted by the majority of the states that levy an income tax on business entities. The Multistate Tax Compact created the Multistate Tax Commission in the interest of uniform income taxation of business entities. Member states may subscribe to the Compact and its joint audit program. The Compact adopts UDITPA as an optional method of apportionment by member states. About half the states have adopted some of the MTC regulations or similar provisions.

Tennessee is not a member of the Multistate Tax Compact, but is an associate member and has adopted apportionment provisions similar to the Compact's UDITPA rules. Tenn. Code Ann. § 67-4-2004(1) expresses the legislative intent to implement and clarify the distinctions between business and non-business income earnings, as found in the Uniform Division of Income for Tax Purposes Act, as generally interpreted by states adopting the act.

RECEIPTS FROM THE SALE OF TANGIBLE PERSONAL PROPERTY ARE ATTRIBUTED TO TENNESSEE USING THE "DESTINATION TEST"

Tenn. Code Ann. §§ 67-4-2012(h)(1) and 67-4-2111(h)(1) and Tenn. Comp. R. & Regs. 1320-6-1-.33(d) provide that, for purposes of the receipts factors of the apportionment formula, sales of tangible personal property are Tennessee sales if the property is delivered or shipped to a purchaser within Tennessee. The F.O. B. point or other conditions of the sale are not determinative in this regard.

There are no Tennessee court decisions under current law concerning attribution of sales for purposes of the franchise, excise tax apportionment formula receipts factors. However, there is one unpublished Tennessee Supreme Court decision under prior law that gives some insight with regard to the questions presented. It should be noted that

the old statutory terms “. . . customers within Tennessee . . .” are similar to the present statutory terms “. . . purchaser . . . inside this state . . .” and “. . . purchaser . . . in this state . . .” found in Tenn. Code Ann. §§ 67-4-2012(h)(1) and 67-4-2111(h)(1).

Prior law stated that the sales factor of the manufacturer’s apportionment formula would consist of “The ratio of the gross sales to customers within Tennessee to total gross sales from all sources.” (See T.C.A. § 67-2707 under prior law). In *Woods v. Jack Daniel Distillery*, slip op. S. Ct. (Tenn. April 16, 1977), the Tennessee Supreme Court upheld the Chancellor’s ruling that sales destined to purchasers located outside Tennessee should be excluded from the sales factor numerator because earnings from such sales are derived from markets outside Tennessee. The Chancellor had reasoned that it made no difference whether the products sold were transported out of Tennessee by common carrier or by the customer himself. In upholding the Chancellor’s decision, the Tennessee Supreme Court said that the word “within” contained in the statute modifies “customers”, not “sales”, and therefore, the location of the customer determines whether the sale is to an out-of-state customer and is thus excluded from the sales factor numerator.

Today, most states employ UDITPA’s “destination test” in determining the attribution of receipts from sales of tangible personal property. J. Healy and M. Schadewald, *Multistate Corporate Tax Guide*, I 594 (2004). Under the destination test, sales delivered to a purchaser in the taxing state are included in the numerator(s) of the state’s apportionment formula receipts factor(s). Sales delivered to a purchaser outside the taxing state are excluded from the numerator(s) of the state’s apportionment formula receipts factor(s).

The “destination” or “place of market” theory correctly recognizes the contribution of the consumer state to the realization of corporate income. In addition, the “destination test,” as opposed to the “transfer of physical possession” theory, is easy to apply and is not so subject to manipulation by taxpayers. *Strickland v. Patcraft Mills, Inc.*, 302 S.E.2d 544 (Ga. 1983).

A taxpayer may be able to structure a delivery or transfer of physical possession in the state that affords the greatest tax savings, but the purchaser’s business location is not likely to be changed solely for the benefit of the seller. *Olympia Brewing*, 326 N.W.2d 642 (Minn. 1982). If physical possession or passage of title were the controlling factor, an out-of-state taxpayer could structure sales transactions with Tennessee customers so that transfer of title or physical possession always occurs outside Tennessee. If this were the case, an out-of-state seller could have Tennessee nexus for franchise, excise tax purposes, and have sales to customers in Tennessee, but still have no Tennessee sales to include in the numerator of its apportionment formula sales factor.

As discussed in the above paragraphs, Tennessee franchise, excise tax statutes and Tenn. Comp. R. & Regs. clearly adopt the UDITPA “destination” or “market theory” for the purpose of sourcing sales receipts for apportionment purposes.

RECEIPTS FROM THE SALE OF MERCHANDISE THAT IS “DROP SHIPPED” BY
THE SELLER TO THE PURCHASER’S CUSTOMER ARE SOURCED TO THE STATE
IN WHICH THE PURCHASER’S CUSTOMER IS LOCATED

The facts presented describe a typical “drop-shipment” sales transaction in which the purchaser directs his supplier to ship merchandise ordered directly to the purchaser’s customer. In such a case, Tennessee law and Tenn. Comp. R. & Regs. require that the receipts resulting from such a sale be sourced to the state in which the purchaser’s customer is located. This is consistent with the UDITPA “destination” or “market” theory.

Tenn. Code Ann. §§ 67-4-2012(h)(1) and 67-4-2111(h)(1) state that the F.O.B. point and other conditions of a sale are to be ignored when sourcing its receipts for purposes of franchise, excise apportionment formula receipts factors. The sales receipts are to be sourced to the Tennessee numerator if “The property is shipped or delivered to a purchaser . . . in this state . . .”. It is axiomatic that sales receipts are not included in the Tennessee numerator if the property is shipped or delivered to a purchaser outside this state.

Tenn. Comp. R. & Regs. 1320-6-1-.33(d) and its accompanying example confirm this. The text of the rule states that sales receipts are sourced to Tennessee if, at the designation of the purchaser, the seller delivers to, or has the property shipped to, the purchaser’s customer who is the ultimate recipient in Tennessee.

The example to Tenn. Comp. R. & Regs. 1320-6-1-.33(d) describes a classic drop shipment situation in which a seller located in Tennessee sells merchandise to a purchaser in another state. At the request of the purchaser, the seller directs its supplier in another state to ship the merchandise to the purchaser’s customer in Tennessee. Receipts from the sale are sourced to Tennessee and included in the numerators of the seller’s receipts factors.

Again, it is axiomatic that sales receipts are not sourced to Tennessee and included in the numerators of the seller’s receipts factors if, at the request of the purchaser, the seller ships the merchandise to the purchaser’s customer in another state.

The controlling factor in sourcing drop shipment sales for purposes of the seller’s apportionment formula receipts factors is where the seller, at the direction of the purchaser, delivers or ships the merchandise to the purchaser’s customer.

CONCLUSION

In the facts presented, the Tennessee Taxpayer sells merchandise to its Marketing Entity purchasers. At the request of such purchasers, the Taxpayer ships the merchandise to the purchasers’ customers who are the ultimate recipients of the merchandise. Some of the purchasers’ customers are located in Tennessee and some are located in other states.

Accordingly, the Taxpayer should source these drop shipment sales receipts to Tennessee if the ultimate recipient, who is the purchaser's customer to whom the merchandise is shipped at the purchaser's request, is in Tennessee. If the purchaser's customer to whom the merchandise is shipped is located in another state, the sale should not be included in the numerators of the Taxpayer's apportionment formula receipts factors.

Of course, all of the Taxpayer's sales receipts should be included in the denominators of its apportionment formula receipts factors.

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APPROVED: Loren L. Chumley, Commissioner

DATE: 4/26/04