

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 13-14**

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

The sourcing of sales of tangible personal property for Tennessee franchise and excise tax apportionment purposes.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER] (the "Taxpayer") [REDACTED] will manufacture items of tangible personal property (the "Products") at [ITS] Tennessee manufacturing facility. The Taxpayer will store the Products in a warehouse that is owned and operated by the Taxpayer [REDACTED].

The Taxpayer will sell the Products to [AFFILIATED ENTITY] ("SalesCo") in an arm's length transaction. [REDACTED]. The structure of these sales transactions is set forth under the

following scenarios whereby SalesCo takes title to, but not possession of, the Products in Tennessee:

1) Drop Shipment Transaction. The Taxpayer receives an order from SalesCo for the purchase of Products. SalesCo directs the Taxpayer to ship the Products directly to a third-party customer. SalesCo's third-party customers are located inside and outside of Tennessee. Title to the Products passes from the Taxpayer to SalesCo when placed in the hands of a common carrier, and then from SalesCo to the Customer. The Taxpayer may arrange for the shipment of the Products to SalesCo's customer via common carrier. Alternatively, SalesCo may arrange for the shipment of the Products to its customer via common carrier.

2) Direct Sale Transaction. The Taxpayer receives an order from SalesCo for the purchase of Products, directing the Taxpayer to ship goods directly to a SalesCo warehouse outside of Tennessee. SalesCo does not take possession of the Products in Tennessee. The Taxpayer may arrange for the shipment of the Products to SalesCo via common carrier. Alternatively, SalesCo may arrange for the shipment of the Products via common carrier.

This letter ruling assumes that the Taxpayer will have activities in more than one state, such that it will be entitled to apportion its net earnings or loss and its net worth in accordance with TENN. CODE ANN. §§ 67-4-2010(a) and 2110(a) (2013).¹

RULINGS

1. In a Drop Shipment Transaction, is the Taxpayer required to include receipts from sales of Products shipped to SalesCo's out-of-state customers in the numerator of its apportionment formula, for purposes of determining its Tennessee franchise and excise tax apportionment ratio under TENN. CODE ANN. §§ 67-4-2012(a) (2013) and 67-4-2111(a) (2013)?

Ruling: No. For purposes of determining its Tennessee franchise and excise tax apportionment ratio under TENN. CODE ANN. §§ 67-4-2012(a) (2013) and 67-4-2111(a) (2013), the Taxpayer will exclude from the numerator of the apportionment ratio all receipts from sales of Products in a Drop Shipment Transaction that are shipped or delivered by the Taxpayer directly to an ultimate recipient outside Tennessee at the direction of SalesCo. It is irrelevant which party arranges for the shipment of the Products to SalesCo's customer via common carrier.

2. In a Drop Shipment Transaction, is the Taxpayer required to include receipts from sales of Products ultimately shipped to SalesCo's Tennessee customers in the numerator of its apportionment formula, for purposes of determining its Tennessee franchise and excise tax apportionment ratio under TENN. CODE ANN. §§ 67-4-2012(a) (2013) and 67-4-2111(a) (2013)?

¹ Note that the rulings contained herein are inapplicable if the Taxpayer does not have the right apportion under these provisions.

Ruling: Yes. For purposes of determining its Tennessee franchise and excise tax apportionment ratio under TENN. CODE ANN. §§ 67-4-2012(a) (2013) and 67-4-2111(a) (2013), the Taxpayer will include in the numerator of the apportionment formula only those receipts from sales of Products in a Drop Shipment Transaction that are shipped or delivered by the Taxpayer directly to an ultimate recipient in Tennessee at the direction of SalesCo. It is irrelevant which party arranges for the shipment of the Products to SalesCo's customer via common carrier.

3. In a Direct Sale Transaction, is the Taxpayer required to include receipts from sales of Products shipped to SalesCo's out-of-state warehouses in the numerator of its apportionment formula, for purposes of determining its Tennessee franchise and excise tax apportionment ratio under TENN. CODE ANN. §§ 67-4-2012(a) (2013) and 67-4-2111(a) (2013)?

Ruling: No. For purposes of determining its Tennessee franchise and excise tax apportionment ratio under TENN. CODE ANN. §§ 67-4-2012(a) (2013) and 67-4-2111(a) (2013), the Taxpayer will exclude from the numerator of the apportionment formula all receipts from sales of Products in a Direct Sale Transaction that are shipped or delivered by the Taxpayer to SalesCo's warehouse outside Tennessee. It is irrelevant which party arranges for the shipment of the Products to SalesCo's warehouse via common carrier.

ANALYSIS

Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of all persons, as defined under TENN. CODE ANN. § 67-4-2004(38) (2013), doing business within Tennessee.² Tennessee also imposes a franchise tax at the rate of \$0.25 per \$100, or major fraction thereof, on the net worth of a person doing business in Tennessee, pursuant to TENN. CODE ANN. §§ 67-4-2105(a) and 2106(a) (2013). Persons subject to the Tennessee franchise and excise taxes include, but are not limited to, corporations and limited liability companies.³

TENN. CODE ANN. § 67-4-2010(a) (2013) provides that a taxpayer that has business activities taxable both inside and outside the state of Tennessee shall allocate or apportion its net earnings or losses for Tennessee excise tax purposes. Similarly, TENN. CODE ANN. § 67-4-2110(a) (2013) provides that a taxpayer that has business activities taxable both inside and outside the state of Tennessee shall allocate or apportion its net worth for Tennessee franchise tax purposes. Unless it is a financial institution or a common carrier, a taxpayer must use the three-factor apportionment formula set forth under TENN. CODE ANN. §§ 67-4-2012(a) and 67-4-2111(a), which utilizes a property factor, a payroll factor, and a double-weighted receipts factor. The receipts factor "is a fraction, the numerator of which is the total receipts of the taxpayer in [Tennessee] during the tax period, and the denominator of which is the total receipts of the taxpayer everywhere during the tax period."⁴ Receipts are sourced to Tennessee based on whether such receipts derive from sales of tangible personal property or from sales other than sales of tangible personal property.

² TENN. CODE ANN. § 67-4-2007(a) (2013).

³ TENN. CODE ANN. § 67-4-2004(38) (2013).

⁴ TENN. CODE ANN. §§ 67-4-2012(g) and 67-4-2111(g)(1).

The Taxpayer has represented that it will have business activities both inside and outside the state of Tennessee. Because the Taxpayer is not a financial institution or a common carrier, it must use the three-factor apportionment formula, with a double-weighted receipts factor, set forth under TENN. CODE ANN. §§ 67-4-2012(a) and 67-4-2111(a).

The facts indicate that the Taxpayer makes sales of tangible personal property, which are sourced in accordance with TENN. CODE ANN. §§ 67-4-2012(h) and 67-4-2111(h). Generally, when the purchaser is not the United States government, such sales are sourced to Tennessee whenever the tangible personal property is “delivered or shipped” to a “purchaser . . . within this state” regardless of the other conditions of the sale.⁵ The destination of the taxpayer’s shipment or delivery is determinative for the sourcing of the taxpayer’s sales. Thus, when property is shipped by the taxpayer to a purchaser in Tennessee, the sale is sourced to this state even if the property is ordered from outside the state⁶ or the purchaser subsequently moves the property out of state.⁷

1-2. Drop Shipment Transactions

TENN. CODE ANN. §§ 67-4-2012(h)(1) and 67-4-2111(h)(1) provide that when the purchaser is not the United States government, such sales are sourced to Tennessee whenever the tangible personal property is “delivered or shipped” to a “purchaser . . . within this state” regardless of the other conditions of the sale.

TENN. COMP. R. & REGS. 1320-06-01-.33(1)(d) (1984) (“Rule 33(1)(d)”) addresses the type of transaction commonly described as a “drop shipment,” whereby the purchaser instructs the taxpayer to ship a product directly to a third party, without the purchaser taking possession of the product. Rule 33(1)(d) defines the phrase “purchaser within this state” for purposes of TENN. CODE ANN. § 67-4-2012(h) to include 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.”⁸ The fact that title was transferred to the out-of-state purchaser prior to the shipment is not determinative for purposes of sourcing the taxpayer’s sales. It is also irrelevant which party arranges for the shipment of the products to the ultimate recipient via common carrier.

Thus, a sale of tangible personal property will be sourced to Tennessee if the taxpayer delivers or has the products shipped directly to an ultimate recipient in Tennessee at the direction of a purchaser who does not take possession of the property, regardless of where the purchaser is located. The corollary to the drop shipment rule under Rule 33(1)(d) is that sales made to an in-state purchaser but shipped by the taxpayer directly to an out-of-state ultimate recipient are not

⁵ TENN. CODE ANN. §§ 67-4-2012(h)(1) and 67-4-2111(h)(1). *See also* TENN. COMP. R. & REGS. 1320-06-01-.33(1)(a) (1984).

⁶ TENN. COMP. R. & REGS. 1320-06-01-.33(1)(b).

⁷ TENN. COMP. R. & REGS. 1320-06-01-.33(1)(c).

⁸ TENN. COMP. R. & REGS. 1320-06-01-.33(1)(d).

sourced to Tennessee.⁹ Thus, a sale of tangible personal property will not be sourced to Tennessee if the taxpayer delivers or has the property shipped directly to an ultimate recipient outside Tennessee at the direction of a purchaser who does not take possession of the property, regardless of where the purchaser is located.

Here, the Taxpayer is located in Tennessee. When SalesCo submits an order for a Product, SalesCo directs the Taxpayer to ship the Products directly to a third-party customer. Title to the Products passes from the Taxpayer to SalesCo when placed in the hands of a common carrier, and then from SalesCo to the customer. SalesCo never takes possession or delivery of the Products. The ultimate recipient may be in Tennessee or may be outside of Tennessee. In accordance with Rule 33(1)(d), a sale of Products will be sourced to Tennessee if the Taxpayer delivers or has the products shipped directly to an ultimate recipient in Tennessee at the direction of SalesCo. Conversely, a sale of Products will not be sourced to Tennessee if the Taxpayer delivers or has the products shipped directly to an ultimate recipient outside Tennessee at the direction of SalesCo.

For purposes of determining its Tennessee franchise and excise tax apportionment ratio under TENN. CODE ANN. §§ 67-4-2012(a) and 67-4-2111(a), the Taxpayer will therefore include in the numerator of the apportionment formula only those receipts from sales of Products in a Drop Shipment Transaction that are shipped or delivered by the Taxpayer directly to an ultimate recipient in Tennessee at the direction of SalesCo. The Taxpayer will exclude from the numerator of the apportionment ratio all receipts from sales of Products in a Drop Shipment Transaction that are shipped or delivered by the Taxpayer directly to an ultimate recipient outside Tennessee at the direction of SalesCo.

3. Direct Sale Transaction

TENN. CODE ANN. §§ 67-4-2012(h)(1) and 67-4-2111(h)(1) provide that when the purchaser is not the United States government, sales of tangible personal property are sourced to Tennessee whenever the tangible personal property is “delivered or shipped” to a “purchaser . . . within this state” regardless of the other conditions of the sale.

TENN. COMP. R. & REGS. 1320-06-01-.33(1)(c) (1984) (“Rule 33(1)(c)”) addresses sales transactions in which property is delivered or shipped to a purchaser within Tennessee, where the property is subsequently transferred by the purchaser to another state for resale. Rule 33(1)(c) provides as an example a taxpayer that makes a sale to a purchaser who maintains a central warehouse in Tennessee, where all merchandise purchases are received. In the example, the purchaser then reships the goods to its branch stores in other states for sale. Rule 33(1)(c) states that all of taxpayer’s products shipped to the purchaser’s warehouse in Tennessee are considered property “delivered or shipped to a purchaser within this state.” It is irrelevant which party arranges for the shipment of the products via common carrier.

⁹ See, e.g., Revenue Ruling 04-12 (April 26, 2004) (ruling that receipts from sales of products shipped by a manufacturer directly to an in-state affiliate’s out-of-state customers are excluded from the numerator of the manufacturer’s Tennessee apportionment formula).

Thus, in accordance with Rule 33(1)(c), a sale of tangible personal property will be sourced to Tennessee if the taxpayer delivers or has the products shipped to a purchaser in Tennessee, even if the products are subsequently transferred by the purchaser to another state for resale. The corollary to the rule under Rule 33(1)(c) is that a sale of tangible personal property will not be sourced to Tennessee if the taxpayer delivers or has the products shipped to a purchaser outside Tennessee.

Here, the Taxpayer is located in Tennessee. Upon submitting an order for Products, SalesCo directs the Taxpayer to ship or deliver the Products to SalesCo's warehouse outside Tennessee. SalesCo never takes possession of the Products in Tennessee. In accordance with Rule 33(1)(c), such sales of Products will not be sourced to Tennessee. For purposes of determining its Tennessee franchise and excise tax apportionment ratio under TENN. CODE ANN. §§ 67-4-2012(a) and 67-4-2111(a), the Taxpayer will therefore exclude from the numerator of the apportionment formula all receipts from sales of Products in a Direct Sale Transaction that are shipped or delivered by the Taxpayer to SalesCo's warehouse outside Tennessee.

Kristin Husat
General Counsel

APPROVED: Richard H. Roberts
Commissioner

DATE: October 11, 2013