

TENNESSEE DEPARTMENT OF REVENUE  
REVENUE RULING # 24-06

**Revenue rulings are not binding on the Department. 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 receipts to ultimate end-users with respect to the receipts factor for the Tennessee franchise and excise taxes apportionment formula.

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 Company (the "Taxpayer") was formed and operates its principal place of business outside of Tennessee. The Taxpayer manufactures its products (the "Product") through an affiliated entity, which is also located outside of Tennessee. When the manufacturing process, which currently occurs outside of Tennessee, is complete, the Product is delivered to a third-party distribution facility (the "Facility") located in Tennessee. No further finishing, packaging, or alterations to the Product are necessary at that time. Upon arrival at the Facility, title transfers from the manufacturing entity to the Taxpayer. The Taxpayer then stores the Product at the Facility until it is sold.

The Taxpayer principally sells the Product to large wholesale distributors located within and outside of Tennessee (the "Wholesale Distributors"). The Taxpayer maintains title to the Product until it is delivered directly to the Wholesale Distributors. Some Product may then be distributed throughout the Wholesale Distributors' networks of regional distribution centers across the country before subsequently being sold to retail customers or end-users (together, the "Subsequent Buyers") inside and outside of Tennessee. The remaining Product will be sold by the Wholesale Distributors to Subsequent Buyers inside and outside of Tennessee without first passing through a regional distribution center.

The sale by the Taxpayer to the Wholesale Distributors is at the Wholesale Acquisition Cost (the "WAC"). Subsequent sales by the Wholesale Distributors are at the same WAC at which the Wholesale Distributors acquired the Product from the Taxpayer. The Wholesale Distributors earn revenue for what the Taxpayer characterizes as payment for distribution services.

The Wholesale Distributors do not alter the Product or packaging in any way. Furthermore, the lifespan of the Product is limited and can be maintained only under specified conditions. Thus, the

average time that the Taxpayer's Product remains at a Wholesale Distributor's distribution center is from fourteen to twenty-five days.

The Taxpayer receives regular reports listing the location of the Subsequent Buyers from the Wholesale Distributors. Furthermore, employees of the Taxpayer or its affiliates assist Subsequent Buyers with the purchase of the Product, and they provide assistance regarding payment, questions regarding the Product, and other customer service. As a result, the Taxpayer is often in direct contact with the Subsequent Buyers before and after title is transferred to the Wholesale Distributor. At the time the Product is sold from the Taxpayer to the Wholesale Distributor, there is no specific designation of a Product to a specific Subsequent Buyer, and the Taxpayer does not control the decision as to where the Product will be shipped after it sells the Product to the Wholesale Distributors.

### **RULING**

Is the Taxpayer entitled to source its receipts to the location of the Subsequent Buyers for its receipts factor ratio for the Tennessee franchise and excise taxes apportionment formula?

Ruling: No. The Taxpayer must source its sales to the location of the Wholesale Distributors to whom the Taxpayer sells the Product.

### **ANALYSIS**

Sales to Wholesale Distributors located in Tennessee must be sourced to Tennessee because (1) the sales of the Product to Wholesale Distributors located in Tennessee are sales made in Tennessee; (2) sourcing sales to the location of the Wholesale Distributors is part of a fair system of apportionment; (3) case law supporting sourcing sales to ultimate end-users does not apply to the facts of this ruling; and (4) Tennessee contemplates sourcing sales to the location of ultimate end-users in situations that are not applicable to the Taxpayer.

TENN. CODE ANN. § 67-4-2007 (2022) imposes an excise tax on the privilege of doing business in Tennessee based on 6.5% of a business's net earnings. TENN. CODE ANN. § 67-4-2106 (2022) imposes the franchise tax at a rate of twenty-five cents per \$100 of the business's net worth. In order to not violate the Commerce Clause of the United States Constitution, a state tax on a business's income must be, among other things, fairly apportioned.<sup>1</sup>

TENN. CODE ANN. § 67-4-2010(a) (2022) 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. A similar provision applies for apportioning a business's net worth for Tennessee franchise tax purposes under TENN. CODE ANN. § 67-4-2110(a) (2022). Because the Taxpayer has business activities both inside and outside Tennessee, it must apportion its net earnings and net worth for purposes of the Tennessee franchise and excise taxes.

TENN. CODE ANN. § 67-4-2012(a)(3) (Supp. 2023) provides that net earnings are apportioned to Tennessee by multiplying the earnings by a fraction, the numerator of which is the property factor

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<sup>1</sup> See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) (finding that a state tax on a business's income (1) must be applied to an activity with a substantial nexus with the taxing state; (2) must be fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state).

plus the payroll factor plus five times the receipts factor, and the denominator of the fraction is seven.<sup>2</sup> The same apportionment formula applies for apportionment of net worth for Tennessee franchise tax purposes.<sup>3</sup>

The factor relevant to this ruling is the receipts factor. The receipts factor is a fraction, the numerator of which is the total receipts of the taxpayer in this state during the tax period, and the denominator of which is the total receipts of the taxpayer everywhere during the tax period.<sup>4</sup>

1. *The shipment of the Product to Wholesale Distributors located in Tennessee are sales in Tennessee.*

Pursuant to TENN. CODE ANN. § 67-4-2012(h), sales of tangible personal property are in Tennessee if the property is delivered or shipped 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. Similarly, TENN. COMP. R. & REGS. 1320-06-01-.33(1)(a) (2016) provides that sales of tangible personal property are in this state if the property is shipped to a purchaser within this state regardless of the F.O.B. point or other conditions of sales. TENN. COMP. R. & REGS. 1320-06-01-.33(1)(c) further provides that:

[p]roperty is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.

Example: The taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of taxpayer's products shipped to the purchaser's warehouse in this state are property "delivered or shipped to a purchaser within this state".

Here, the Taxpayer sells and delivers the Product to Wholesale Distributors, some of whom are located in Tennessee. In accordance with TENN. CODE ANN. § 67-4-2012(h) and the clarifying regulations mentioned above, the deliveries of the Product to Wholesale Distributors located in Tennessee are unambiguously sales in Tennessee.

The sales of the Product by the Taxpayer to the Wholesale Distributors are made in the ordinary course of the Taxpayer's business. Fundamentally, the subsequent sales from the Wholesale Distributors to the Subsequent Buyers are separate transactions which are not attributable to the Taxpayer. Accordingly, the Taxpayer's sales to Wholesale Distributors located in Tennessee should be sourced to Tennessee.

The Taxpayer has suggested that since its Product remains in the warehouses of the Wholesale Distributors located in Tennessee from fourteen to twenty-five days that a *de minimis* principle, or

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<sup>2</sup> This formula is for tax years ending on or after Dec. 31, 2023, but before Dec. 31, 2024. Financial institutions, common carriers, and manufacturers that have elected to use a single sales factor formula are not required to use the three-factor apportionment formula.

<sup>3</sup> See TENN. CODE ANN. § 67-4-2111(a)(2) (Supp. 2023).

<sup>4</sup> TENN. CODE ANN. §§ 67-4-2012(g) (Supp. 2023), 67-4-2111(g).

deviation from the standard, should apply because of the duration the Product spends in Tennessee.<sup>5</sup> While the Tennessee Department of Revenue has applied the *de minimis* principle to taxpayers in Tennessee who sought immunity from a state tax under a federal statute,<sup>6</sup> absent a statutory provision providing for a *de minimis* standard in a state taxing scheme, Tennessee courts have rejected taxpayers' *de minimis* presence arguments.<sup>7</sup> Accordingly, the sales to the Wholesale Distributors located in Tennessee are properly apportioned sales to Tennessee.

It should also be noted that according to the facts of this ruling, the Taxpayer provides customer service for Subsequent Buyers and receives reports of their locations. These facts do not alter the transactions between the Taxpayer and the Wholesale Distributor, and it is those transactions that are being sourced to Tennessee.

2. *Sourcing sales to the location of the Wholesale Distributors is part of a fair system of apportionment.*

"Tennessee's excise tax on corporate earnings is based on the Uniform Division of Income for Tax Purposes Act (UDIPTA)." *Blue Bell Creameries, LP v. Roberts*, 333 S.W. 3d 59, 65 (Tenn. 2011) (citations omitted). "[T]o further its goal of assuring fair apportionment among states and taxation of neither more nor less than 100% of the net income of multistate corporations, UDIPTA uses an apportionment formula." *Vodafone Americas Holdings, Inc. & Subs. V. Roberts*, 486 S.W. 3d 496 at 516 (Tenn. 2016).

Tennessee's sales factor statute for sales of tangible personal property, TENN. CODE ANN. 67-4-2012(h)(1), embodies the "destination rule," in which a state attributes receipts from sales to "[t]he state to which the goods are sold are shipped to the customer (sales destination rule)." Waller Hellerstein, *State Taxation* ¶ 8.06[3][a] (3d ed. 2022). The destination rule "is now in use, in one way or another, in every one of the forty-four states (and the District of Columbia) that employs a sales or receipts factor in the apportionment formula of their corporate income taxes."<sup>8</sup> The widespread use of the destination rule for apportioning sales means that deviations from the rule will result in less than full apportionment.

If sales of goods are sourced to the location of subsequent purchasers after a secondary transaction, and the subsequent purchasers are in states imposing taxes measured by income, the sales from the seller to the wholesale distributor would be removed from the Tennessee sales factor but would not be added to the numerator of the state in which the subsequent purchaser is located. For the seller of goods, this would create "nowhere income"—income that is not taxed by any state. Sellers of goods, where the goods ultimately reach subsequent purchasers in Tennessee through a network of distributors, may not necessarily have any connection or nexus to Tennessee (the distributor would be connected through its sales to customers in Tennessee). Effectively, sales to wholesale distributors would only move in one direction—away from Tennessee. In the absence of a comprehensive rule between the states that allows for sourcing sales to wholesale distributors of goods that are then

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<sup>5</sup> See *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*, 506 U.S. 214 (1992) (recognizing that a *de minimis* exception exists within 15 U.S.C. § 381(a));

<sup>6</sup> See Tenn. Dept. Rev. Ltr. Rul. 97-16 (June 2, 1997) and Tenn. Dept. Rev. Ltr. Rul. 95-22 (June 2, 1995) (applying the *de minimis* principle to taxpayers whose activities fall under the immunity granted by 15 U.S.C. § 381).

<sup>7</sup> *McCurry Expeditions, LLC v. Roberts*, 461 S.W. 3d 912, 920 (Tenn. Ct. App. Nov. 14, 2014) (citing *Cole Bros. Circus, Inc. v. Huddleston*, No. 01-A-01-9301-CH00004, 1993 WL 190914, at \*4 (Tenn. Ct. App. June 4, 1993), stating that "[t]here is no statutory exception for a '*de minimis*' presence in Tennessee.").

<sup>8</sup> *Id.* at ¶ 9.18[1].

resold out-of-state, it is crucial that the sales from the Taxpayer to Wholesale Distributors be sourced to the location of the Wholesale Distributors.

3. Cases supporting sourcing sales to ultimate end-users are not applicable to the facts of this ruling because they do not involve sourcing sales to Subsequent Buyers.

The Taxpayer suggests that the use of “ultimate destination” rhetoric in a collection of nationwide cases supports sourcing the Taxpayer’s sales to the Subsequent Buyers. However, these cases involve the location of the purchaser or “dock sale” issues, and they do not involve the sourcing of sales to a subsequent, separate transaction.<sup>9</sup> In fact, several of these cases support the conclusion that the Wholesale Distributors are the Taxpayer’s customers. Relevant to this ruling, these cases contemplate where to source sales to wholesale distributors. These cases do not contemplate the states having to source the secondary sales to subsequent customers by function of the wholesale distribution chain.

For example, in the unpublished Tennessee Supreme Court case of *Woods v. Jack Daniel Distillery*, the taxpayer was engaged in manufacturing, bottling, and selling whiskey to wholesale distributors, its principal customers.<sup>10</sup> Some out-of-state wholesale distributors arranged to have their own trucks pick up the goods from the taxpayer’s warehouse in Tennessee and carry them to the wholesale distributor’s place of business outside Tennessee.<sup>11</sup> The state argued that the customer pickup sales should be sourced to Tennessee.<sup>12</sup> The Court held that the location of the customer (the wholesale distributor) determines whether the sale is to an out-of-state customer and is thus excluded from the numerator of the receipts factor.<sup>13</sup> Notably, the Court did not contemplate allocating sales based on the location of the wholesale distributors’ customers. While the Court’s decision is not controlling with respect to current statutory language, the Court’s reasoning in *Woods v. Jack Daniel Distillery* supports that the Wholesale Distributors are the purchasers of Product to whom the Taxpayer’s sales should be sourced.

4. Tennessee contemplates excluding sales to ultimate consumers from the receipts factor but not in situations pertaining to the Taxpayer’s facts.

Tennessee allows a taxpayer, who meets a gross sales threshold and a receipts factor threshold, to elect to exclude “certified distribution sales” from the numerator of its receipts factor.<sup>14</sup> Under TENN. CODE ANN. § 67-4-2023 (Supp. 2023), “certified distribution sales” means “sales of tangible personal property made in this state by the taxpayer to any distributor, whether or not affiliated with the taxpayer, that is resold for ultimate use or consumption outside the state; provided that, the distributor has certified that such property has been resold for ultimate use or consumption outside

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<sup>9</sup> See *Lone Star Steel v. Dolan*, 668 P.2d 916 (Colo. 1983); *Dept. of Revenue v. Parker Banana Co.*, 391 So. 2d 762 (Fla. App. 1980); *Olympia Brewing Co. v. Commissioner of Revenue*, 326 N.W. 2d 642 (Minn. 1982); *Rev. Cabinet v. Rohm and Haas Kentucky, Inc.*, 929 S.W. 2d 741 (Ky. App. 1996); *McDonnell Douglas Corp. v. Franchise Tax Bd.*, 26 Cal. App. 4th 1789 (Ca. App. 1994); *Paccar, Inc., v. Al. Dept. of Revenue*, 2006 WL 370805 (Dept. Rev. Admin. Law Div., Jan. 11, 2006); *Powerex Corp. v. Dept. of Revenue*, 346 P.3d 476 (Or. 2015).

<sup>10</sup> 1977 WL 558045 \*1 (Tenn. April 18, 1977).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at \*2.

<sup>14</sup> The threshold for gross sales made in this state is one billion dollars, and the threshold for the receipts factor is 10%. TENN. CODE ANN. §§ 67-4-2023(b)(1) and (2) (Supp. 2023).

this state.” A taxpayer that makes the election to exclude its certified distribution sales from the numerator of its receipts factor must pay an excise tax on the total amount of the certified distribution sales that were excluded from the numerator.<sup>15</sup>

TENN. CODE ANN. § 67-4-2023 shows that the Tennessee legislature contemplated what to do with sales of products made to distributors in Tennessee, where the products are resold and ultimately used or consumed outside of Tennessee. In such transactions, the legislature has provided an alternative taxing scheme to account for those sales when certain thresholds are met, and an election is made. As such, TENN. CODE ANN. § 67-4-2023 supports the premise that the Tennessee legislature intended for sales of products to distributors located in Tennessee be sourced to Tennessee even if those products are subsequently sold to users in other states.

Tennessee also allows sourcing to an “ultimate recipient” in a drop shipment transaction in which the purchaser directs its supplier to ship merchandise ordered directly to the purchaser’s customer.<sup>16</sup> TENN. COMP. R. & REGS. 1320-06-01.33(d) states:

[t]he term “purchaser within this state” shall 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.

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”.

The corollary to that rule would be that a sale to an ultimate recipient outside of Tennessee would not be a sale to a purchaser within this state. This rule is not applicable in the Taxpayer’s situation because the Taxpayer in this ruling is not engaged in a drop shipment transaction. A drop shipment transaction to which this rule applies involves a taxpayer, a purchaser, and a designated ultimate recipient. The rule requires that the taxpayer deliver the product to the ultimate recipient at the direction of the purchaser.

According to the facts in this ruling, the Wholesale Distributors are the purchasers, but they are not directing the Taxpayer to ship the Product to the end-user or ultimate recipient. Instead, at the time the Wholesale Distributors purchase the Product, there is no designated end-user or ultimate recipient. Even if there was a designated end-user at the time of the purchase, this rule would not apply because the Taxpayer is not shipping the Product to the end-user, the purchaser is. TENN. COMP. R. & REGS. 1320-06-01.33(d) supports the premise that in order to source a sale to an ultimate end-user, that end-user must be designated at the time of the transaction.

## Conclusion

In light of the above analysis, the Taxpayer’s sales may not be sourced to the location of the Subsequent Buyers. Sales of the Product to Wholesale Distributors, where the Product is delivered to

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<sup>15</sup> TENN. CODE ANN. § 67-4-2023(b)(2).

<sup>16</sup> See, e.g., Tenn. Dept. Rev. Rev. Rul. 04-12 (April 26, 2004) and Tenn. Dept. Rev. Ltr. Rul. 13-14 (Oct. 11, 2013).

Wholesale Distributors located in Tennessee, constitute a sale in Tennessee and are included in the numerator of the Taxpayer's receipts factor for calculating franchise and excise taxes. Sales of the Product, where the Product is delivered to Wholesale Distributors located outside of Tennessee, do not constitute a sale in Tennessee and are not included in the numerator of the Taxpayer's receipts factor for calculating franchise and excise taxes.

Approved: David Gerregano

Date: July 31, 2024