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Chapter 14: Apportionment

Introduction to Tax Apportionment

When a business has operations in both Tennessee and other states, the portion of the business' income attributable to its activities in Tennessee must be determined so that the franchise and excise liability applies only to the portion of net worth and net earnings generated by Tennessee operations. Tennessee statutes and rules dictate the acceptable methods for apportioning business earnings for multi-state companies.[1] The state's guidance on apportionment stems largely from language found in the Uniform Division of Income for Tax Purposes Act ("UDITPA") and Multistate Tax Commission ("MTC") Regulations.[2]

The National Conference of Commissioners on Uniform State Laws drafted UDITPA as a model act and approved it in 1957. Its goal is to reduce diversity among states in the allocation and apportionment methods used to determine the several states' respective shares of a corporation's taxable income. Most states with an income tax have adopted UDITPA or UDITPA-like statutes. Tennessee has adopted *most* provisions of UDITPA; however, it did *not* adopt the "throwback provision," in which a sale is thrown back to the sales factor numerator of the state from which the goods were shipped, if the seller is not taxable in the destination state. Because states' apportionment methods differ, the sum of a business' aggregate apportionment ratios in each state in which it is subject to tax will rarely equal 100%.

1. Allocation (Nonbusiness Earnings) Versus Apportionment (Business Earnings)

The word "apportion" refers to *business earnings* and the word "allocation" refers to *nonbusiness earnings*. These two words are not interchangeable. *Business earnings* are earnings arising from transactions and activity in the regular course of the taxpayer's trade or business or earnings from tangible and intangible property, if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations.[3] *Nonbusiness earnings* are all earnings other than business earnings, and they are allocated and not apportioned.[4]

Tennessee taxes nonbusiness earnings allocated to Tennessee at the full 6.5% excise tax rate. Apportionment does not apply to nonbusiness earnings. Therefore, taxpayers should not report the gross receipts, payroll, and property associated with nonbusiness earnings on the standard apportionment schedule (Schedule N).[5] (See Chapter 8 – Business and Nonbusiness Earnings)

2. Right to Apportion

A taxpayer must apportion its net business earnings (losses) if it has business activities that are taxable both inside and outside Tennessee. A taxpayer is considered taxable in another state only when those same activities, if conducted in Tennessee, would constitute doing business in Tennessee and would subject the taxpayer to either the franchise or excise tax.[6] In other words, a Tennessee taxpayer purposefully engaged in an activity in another state with the object of gain, benefit, or advantage, and having substantial nexus (as defined by Tennessee law) in that state should apportion their net worth and net income for franchise and excise tax purposes.

⚠ **Note, the same "doing business"/ " substantial nexus" standard applies to both the determination of nexus and the right to apportion. See Chapter 3 - Nexus**

Taxpayers that do not meet the above criteria do *not* have the right to apportion.

- If an out-of-state entity files a minimum $100 franchise tax return simply because it is registered with the Tennessee Secretary of State, it would *not* be considered doing business in the state for the purpose of determining whether the taxpayer has the right to apportion. Therefore, if a Tennessee taxpayer were to file a similar return in another state simply because it was formed or organized in said state, this alone would *not* give the taxpayer the right to apportion.

⚠ **Auditors may request copies of state tax returns filed in other states. However, the fact that a taxpayer filed a tax return in another state, alone, does not necessarily mean that the taxpayer has the right to apportion.**

- If a Tennessee taxpayer's only connection with another state is a sale that does not exceed the substantial nexus bright-line test, the taxpayer does not have the right to apportion.

Taxpayers without the right to apportion should enter 100% on the apportionment ratio lines on the net worth and net earnings schedules (Schedules F1 and J, respectively). See Revenue Ruling 06-18 for an example of a taxpayer having substantial nexus in a state other than Tennessee and the taxpayer's right to apportion for franchise and excise tax purposes.

3. Public Law 86-272

Taxpayers claiming exemption from the excise tax under Public Law 86-272[7] may apportion their net worth subject to franchise tax. Also, a taxpayer that is subject only to franchise tax (or a similar tax in another state) has the right to apportion its net earnings subject to excise tax, even when the taxpayer is protected from paying an excise tax (or similar tax in that other state).

As previously stated, a taxpayer is considered taxable in another state only when conducting activities in that state that, if conducted in Tennessee, would constitute doing business in Tennessee and would subject the taxpayer to either the franchise or excise tax. Since Public Law 86-272 applies only to the excise tax, it does not affect franchise tax nexus or right to apportion. See the discussion in Chapter 3 – Nexus – on Public Law 86-272.

For example:

- Corporation X is based in Tennessee but has five full-time sales employees with tangible personal property (car, computer, inventory samples, and advertising materials) based in another state.
- The employees work out of their homes, and all of their activity in the other state falls within the exemption limits for sales solicitation under Public Law 86-272.
- Corporation X has the right to apportion in Tennessee regardless of whether a tax return was filed in the other state, because the level of physical presence in the other state would result in a franchise tax liability if the out-of-state activity was conducted in Tennessee.

Forms – Apportionment

Most taxpayers will use the standard apportionment formula on Schedule N to calculate their franchise and excise tax apportionment ratios. However, common carriers (e.g., railroads, motor carriers, pipelines, and barges), air carriers, and air express carriers calculate special apportionment ratios on Schedules O, P, and R, respectively.

Any taxpayer that is part of an affiliated group that has elected to compute their net worth on a consolidated basis will calculate its apportionment ratio on Schedule 170NC, 170SF or 170SC. (See Chapter 9 – Franchise Tax – for more information on consolidated net worth.) Taxpayers that are bound by a consolidated net worth election and that have 100% of their business operations within the state will complete one of these apportionment schedules but will not complete an apportionment schedule for excise tax purposes. However, multi-state taxpayers bound by a consolidated net worth election will use Schedules N, O, P, R, or S to apportion their net earnings subject to excise tax.

Manufacturers will use the standard apportionment Schedule N unless they have made the single sales factor election,[8] in which case they will use Schedule S to calculate their franchise and excise tax apportionment ratio.

Apportionment Ratio Calculation

1. Standard Apportionment – Schedule N

As stated previously, most apportioning taxpayers will use the standard apportionment schedule (Schedule N) to calculate the apportionment ratio used to apportion their net worth and net earnings. This schedule computes the ratio based on three factors (property, payroll, and sales) and uses a triple-weighted sales factor.[9] Mechanically, the computation is as follows:

	In Tennessee Dollar Value (a)	**Divided By**	**Everywhere Dollar Value (b)**	**Percentage (a) / (b)**
1	Property - *average of beginning and end of year values*	÷	Property - *average of beginning and end of year values*	__ %
2	Payroll	÷	Payroll	__ %
3	Sales	÷	Sales	__ %
4	Sales	÷	Sales	__ %
5	Sales	÷	Sales	__ %
Total of all ratios				**__ %**
Number of Everywhere Factors				**5**
Apportionment Ratio				**__ %**

Taxpayers sum the ratio for each factor (counting the sales factor three times) and then divide by five to arrive at the overall apportionment ratio. However, in some cases, the divisor may be less than five. If the denominator of a factor is zero, eliminate the factor and then computer the overall apportionment ratio from the remaining factor or factors.[10] For example:

- If a company has "0" in everywhere payroll, you will eliminate the payroll factor, and the total of all ratios will be divided by four rather than five.

2. Elective Apportionment for Certain Taxpayers

Manufacturers – Single Sales Factor

Manufacturers may elect to apportion their net worth and net earnings subject to Tennessee franchise and excise taxes, respectively, based on a single sales factor ("SSF").[11] Taxpayers electing the SSF apportionment method will apportion using a fraction:

- The **numerator** of which is the taxpayer's total gross receipts (sales) in Tennessee during the taxable year; and

- The **denominator** of which is the taxpayer's total gross receipts from all locations, within or outside Tennessee, during the taxable year.

Property and payroll are not considered.

This election is only for taxpayers whose principal business in Tennessee is manufacturing. A taxpayer is principally in the business of manufacturing if more than 50% of the taxpayer's revenue from its activities in this state, excluding passive income, is from fabricating or processing tangible personal property for resale and consumption off the premises. Passive income includes dividend income, interest income, income from the sale of securities, and income from the licensing or sale of patents and other intellectual property.

- The franchise and excise tax statutes do not define "manufacturer." However, the Department will generally apply the same logic, rulings, and judgment used for sales and use tax purposes in defining a manufacturer.[12]

- In addition, the same logic used to determine eligibility for the industrial machinery credit would apply in determining whether an entity is a manufacturer for the purpose of making the SSF election.

To make the SSF election, a manufacturer makes an election on Form FAE 170 for the taxable year to which the election first applies. Taxpayers must make the election on the original return; taxpayers may not file amended returns to make the election.[13] This election, once made, will remain in effect for a minimum of **five years**.[14] A taxpayer may revoke the election after five years and may only make a new election after five years have passed, beginning with the tax year for which the taxpayer revoked the previous election.

See the third example at the end of this chapter for an example of apportionment when a manufacturer makes *both* the consolidated net worth and SSF elections.

Financial Asset Management Companies

Financial Asset Management Companies ("FAMC") may elect to apportion net earnings and net worth to Tennessee based on a single sales factor.[15] To be an FAMC, the entity must:

- Be treated as a partnership for federal income tax purposes;
- Be in the business of providing financial asset management services; and
- Either have a class of equity requiring it to file with the SEC or be owned by a publicly traded partnership[16] that owns at least 25% of the entity and such ownership constitutes more than 50% of the total assets of the publicly traded partnership.
    - A publicly traded partnership is an entity treated as a partnership for federal income tax purposes, files with the SEC, and its shares are traded on a registered national securities exchange or national securities exchange of a foreign country.[17]

An FAMC provides asset management services with respect to financial investments owned by others. FAMCs derive income on a fee or commission basis. Their services may include managing portfolio assets, rendering investment advice, including investment research and analysis, making determinations as to when investments are to be bought or sold, and making the purchase or sale. Financial investments include investments in stocks, options, bonds, and alternative asset classes (real estate, commodities, debt obligations, and more). A REIT is never an FAMC.

Certified Distribution Sales

Certain large taxpayers may elect to omit *certified distribution sales* from the numerator of their receipts factor for apportionment purposes and pay an alternative excise tax on such receipts.[18] A taxpayer may make this election if it:

- Has made sales in Tennessee of tangible personal property to distributors exceeding $1,000,000,000 during the tax period; and
- Has a receipts factor, as determined under Tenn. Code Ann. § 67-4-2012 without regard to this election, that exceeds 10%.

"Certified distribution sales" are sales of tangible personal property made in this state by the taxpayer to any distributor, whether the distributor is affiliated with the taxpayer, that are resold for ultimate use or consumption outside the state. The distributor must certify that the property has been resold for ultimate use or consumption outside this state.

Taxpayers pay the alternative excise tax annually based on the total amount of certified distribution sales excluded from the numerator of the taxpayer's receipts factor. Taxpayer's compute the amount of tax as follows:

- Exclusion of $2 billion or less of certified distribution sales for the tax period
  - Tax is 0.5% of the total amount of certified distribution sales
- Exclusion of $2,000,000,001 – $3,000,000,000 of certified distribution sales for the tax period
  - Tax is 0.375% of the total amount of certified distribution sales in excess of $2 billion, plus $10 million
- Exclusion of $3,000,000,001 – $4,000,000,000 of certified distribution sales for the tax period
  - Tax is 0.25% of certified distribution sales in excess of $3 billion, plus $13,750,000
- Exclusion of more than $4,000,000,000 of certified distribution sales for the tax period
  - Tax is 0.125% of certified distribution sales in excess of $4 billion, plus $16,250,000

Taxpayers file the Certified Distribution Sales Election form on or before the due date of the tax return for the period for which the election is to take effect. The election remains in effect until revoked by the taxpayer or until the taxpayer no longer qualifies for the election. A taxpayer may revoke the election by notifying the Department, in writing, on or before the due date of the tax return for the period for which the revocation is to take effect.

Taxpayers should attach the Distributor Certification Statements to the election form prior to mailing. Taxpayers should *not* file the Certified Distribution Sales Election form annually, but electing taxpayers *should* maintain Distributor Certification Statements for each year during which the election is in effect. The statement should read as follows:

- "[Distributor's name] certifies that tangible personal property was purchased from [taxpayer] in this state and it was resold for ultimate use or consumption outside the state."

> ⚠ **Auditors will request Distributor Certification Statements from taxpayers for each year that a Certified Distribution Sales Election is in effect.**

3. Consolidated Net Worth Apportionment

Please refer to Chapter 9 – Franchise Tax – for a more in-depth discussion on apportioning consolidated net worth between affiliated group members. The standard apportionment schedule (Schedule N) and the consolidated net worth apportionment schedules (170NC, 170SF, 174NC, 174SC) are similar but have the following notable differences:

- Schedule N is prepared based on tax basis books and records, whereas the consolidated net worth apportionment schedules are based on GAAP basis books and records.

- Taxpayers should eliminate intercompany transactions and holdings between affiliated group members and holdings in non-domestic persons[19] when calculating the consolidated net worth apportionment factors but such transactions and holdings are ***not*** eliminated from the non-consolidated apportionment factors reported on Schedule N. For example:

    - The most common consolidated net worth elimination is intercompany sales; these sale must *not* be reported in the consolidated net worth sales factor.

    - Taxpayers that are members of a consolidated net worth affiliated group should eliminate intercompany rental expense from the property factor and the corresponding intercompany rental income from the sales factor for consolidated net worth apportionment purposes.

- On Schedule N, dividend income is *included* in the sales factor if it is received from a less-than-80% owned corporation; dividend income from 80%-or-more owned corporations is *excluded* from both the numerator and denominator of the sales factor; in other words, such dividend income is "thrown out."[20] For consolidated net worth apportionment purposes, however, *all* intercompany dividend transactions between affiliates (even if received from a less-than-80% owned affiliate) are eliminated and not included in the sales factor.

Pass-through Entity Ownership

When a taxpayer has an ownership interest (either direct or indirect) in a pass-through entity (such as a limited partnership, S corporation, or limited liability company) that is *not* doing business in Tennessee and is *not* subject to the excise tax, the taxpayer's distributive share of the property, payroll, and sales attributes of the pass-through entity should be included in the taxpayer's apportionment factors on Schedule N.[21] Conversely, the taxpayer's distributive share of a pass-through entity's property, payroll, and sales attributes should be *omitted* from the taxpayer's apportionment factors when the pass-through entity *is* doing business in Tennessee and filing a franchise and excise return.

In addition, a franchise and excise taxpayer that is a general partner in a general partnership must reflect its pro rata ownership share of the general partnership's activity on its franchise and excise tax return. This includes the taxpayer's ownership share of a general partnership's income and expenses in the excise tax base; property and rental expense in the franchise tax base; and property, payroll, and sales in the apportionment formula, if the taxpayer is apportioning.[22] General partnerships are not subject to the franchise and excise tax at the entity level, but their activity is taxed at the owner level if the owner is a type of entity that offers limited liability protection (corporation, LLC, LP, etc.).

A taxpayer that has an ownership interest in a pass-through entity receives a federal Schedule K-1 from the pass-through entity that reports the taxpayer's share of income (loss) from the pass-through entity. The taxpayer will include the Schedule K-1 income (loss) in its federal income tax return. Because the Tennessee excise tax return begins with federal taxable income (loss), the taxpayer's Tennessee excise tax return includes the taxpayer's distributive share of income (loss) from the pass-through entity. However, if the pass-through entity itself is subject to the excise tax and filing an excise tax return, the taxpayer will reverse its distributive share of all income, gains, expenses, and losses received from the pass-through entity (via Schedule K-1) out of the taxpayer's excise tax base on Schedule J.[23] Whenever a pass-through entity's income (loss) is reversed out on Schedule J by the taxpayer, this signifies that the pass-through entity's apportionment attributes will be *omitted* from the taxpayer's apportionment factors on Schedule N. However, if the pass-through entity's income (loss) is *not* reversed out, its property, payroll, and sales attributes will be *included* in the taxpayer's apportionment factors on Schedule N to determine the taxpayer's apportionment ratio.

On the following page is a schedule that summarizes the relationship between Schedule J reversals of pass-through items and the corresponding inclusion or exclusion in the apportionment factors on Schedule N. Note, because general partnerships are not subject to franchise and excise tax at the entity level, their net earnings (loss) will *not* be reversed out of the taxpayer's excise tax base on Schedule J, and the taxpayer's distributive share of the general partnership's Tennessee and everywhere apportionment attributes will be included in the taxpayer's apportionment factors on Schedule N.

Taxpayer is a Partner/Shareholder of:	**Income/Gain Expense/Loss is *Reversed* on Taxpayer's Excise Tax Return**	**Property, Payroll, & Sales Attributes of the Pass-through Entity are *Included* in the Taxpayer's Apportionment Factors on Schedule N**
General Partnership	**No**	**Yes**
LP, S corporation, LLC, *or other entity treated as a partnership* that is subject to excise tax and filing a return	**Yes**	**No**
LP, S corporation, LLC, *or other entity treated as a partnership* that is **not** subject to excise tax and **not** filing a return	**No**	**Yes**

⚠ **Audit Tip:**
Auditors will request copies of all Schedule K-1s received by the taxpayer. An initial step in auditing apportionment is identifying the taxpayer's direct and indirect ownership interests in pass-through entities. The property, payroll, and sales factors will include attributes from pass-through entities that are not doing business in Tennessee, and thus, are not subject to the franchise or excise tax.

Standard Apportionment Factors - Property, Payroll, and Sales

The "In Tennessee" and "Total Everywhere" values for the three apportionment factors reported on Schedule N should be supported by the taxpayer's tax basis books and records. However, these factors, on their own, are not as important as the overall apportionment ratio that is used to calculate the franchise and excise tax bases. For example,

- "In Tennessee" and "Total Everywhere" numbers were reported as $100 and $1,000, respectively, but should have been reported as $1,000 and $10,000.

- The apportionment ratio as computed from the original numbers would be the same as the apportionment ratio based on the corrected numbers—10%. So, there would be no change to the computed tax liability in this case.

1. Property Factor

The property factor includes all owned or rented real and tangible property used during the tax period in the taxpayer's trade or business.[24] This includes property actually in use or available for use and property capable of being used. For example:

- A temporarily idle plant, a closed manufacturing facility held for sale, and raw material reserves not currently being processed should all be included in the property factor.

- Partial utilization of "construction in progress" property may result in a pro rata factor inclusion based on a percentage of the amount utilized, as discussed below.

- The types of property included in the apportionment factor are the same types as those included for franchise tax purposes, (including land, buildings, machinery, equipment, prepaid supplies, partnership property, inventory, and rents).

- **Computer software is considered an intangible for franchise and excise tax purposes, and it is not included in the property factor.**

Generally, real and tangible property is sourced based on where the property is located. Mobile property, like construction equipment, trucks, and leased electronic equipment, is sourced based on the percentage of *time* spent in the state. However, the value of a vehicle assigned to a traveling employee will be considered located in Tennessee if the employee's compensation is assigned to Tennessee under the payroll factor or if the vehicle is licensed in Tennessee.

Property in transit between various locations will be considered at the destination location for sourcing purposes. Property in transit between a buyer and seller that is included in the taxpayer's balance sheet will be sourced to the state of destination.[25]

Owned Tangible Property

The standard apportionment values for real and tangible property are reported at their non-depreciated tax (cost) basis.[26] Most taxpayers will have detailed depreciation schedules prepared for both GAAP financial statement and tax reporting purposes. The cost values used for standard apportionment purposes should agree to the tax depreciation schedule.

The following are examples of property valuation for the property factor:

- The taxpayer acquired a factory building in this state at a cost of $500,000, and 18 months later expended $100,000 for a major remodeling of the building. The taxpayer files its return for the current tax year on a calendar-year basis. The taxpayer claims a depreciation deduction of $22,000 for the building on its current year tax return. The value of the building that is includable in the numerator and denominator of the property factor is $600,000. The depreciation deduction is not considered in determining the value of the building for property factor apportionment purposes.

- During the current taxable year, X Corporation merges into Y Corporation in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, X Corporation owns a factory that X built five years earlier at a cost of $1,000,000. X has been depreciating the factory at the rate of two percent per year, and the basis of the factory in X's hands at the time of the merger is $900,000. Since the property is acquired by Y in a tax-free transaction, the property's basis in Y's hands is the same as it is in X's hands. Y includes the property in Y's property factor at X's original cost basis (i.e., $1,000,000), without adjustment for depreciation.

⚠ **Audit Tip: Auditors will request tax basis depreciation schedules in support of the property values reported on Schedule N.**

Property – Like-Kind Exchanges

Replacement property acquired in a like-kind exchange is valued at the original tax-basis cost of the relinquished property given up in the exchange. Please see Chapter 11 for more information on like-kind exchanges.

Rented Property

Rental values are quantified at eight times the annual rent amounts, regardless of the type of property rented.[27] This differs from the treatment of rents in determining the franchise tax property base, where assets reported on Schedule G are grouped by asset types with rental multiples of one, two, three, and eight.

In many cases, sub-rent receipts will constitute business earnings, and no sub-rent offset or deduction will be allowed for the standard apportionment property factor. Sub-rents are only allowed to offset rent expense if the sub-rent-receipts are non-business earnings. In contrast, sub-rents are not deducted when the sub-rents constitute business earnings (i.e., the property which produces the sub-rents is used in the regular course of the trade or business of the taxpayer when it is producing such earnings).[28] Note, sub-rentals are treated differently when determining the franchise tax property base on Schedule G.[29]

Rent expense deducted on the corresponding federal income tax return in excess of "reasonable rent"[30] for real property owned by an affiliate is added back in arriving at the excise tax base. Because the expense is excluded from the tax base, it is also excluded from the related property apportionment factor.

Rents included in the property factor are annualized on returns covering a period of less than 12 months (this is the same requirement for determining the franchise tax base). However, rents covering a period that is less than the period covered by the short-period return are *not* annualized.[31]

See Chapters 9 and 10 of this manual for topics that apply to both the franchise tax property base and the property factor of the apportionment ratio:

- License vs. lease
- Rents that include a service
- Finance and operating leases
- In lieu of rent payments

Inventory

The standard apportionment schedule (Schedule N) computes an apportionment ratio for both franchise and excise taxes. The only difference between the franchise tax apportionment and excise tax apportionment computation is the treatment of exempt finished goods inventory.[32] For franchise tax apportionment, the property factor excludes the amount of exempt finished goods inventory from the numerator/"In Tennessee" and the denominator/"Total Everywhere" values.[33]

The franchise tax apportionment ratio is less, relatively speaking, when there is exempt finished goods inventory. In contrast, the excise tax property factor does not exclude exempt finished goods inventory from the computation.[34] The property factor ratio for excise tax does not take into account any exempt inventory numbers reported on Schedule N. As a result, the excise tax property factor ratio will not change as the result of exempt inventory.

The tax basis value of inventory is used in the property factor. The amount reported as part of the property factor should generally include the amount reported on federal Form 1125-A – Cost of Goods Sold.[35] In most cases, the beginning and ending inventory balances reported on federal Form 1125-A will match the amounts reported on the balance sheet; however, if there is a difference, the tax basis balances should be used.

See Chapters 9 and 10 for a discussion on the treatment of exempt inventory in the franchise tax base (Schedule G) and for consolidated net worth apportionment (Schedule 170NC).

Construction in Progress

Taxpayers should exclude property or equipment under construction during the tax period (except inventorial goods in process) from the property factor until the taxpayer actually uses such property to produce business earnings. If the taxpayer partially uses the property to produce business earnings while under construction, the value of the property, to the extent used, should be included in the property factor.[36]

Property Averaging

Taxpayers must use the average value of owned property in determining the standard apportionment ratio. This is done by averaging the property values as of the beginning and the end of the tax period.

In limited situations, taxpayers may compute the property factor using *monthly averages*.[37] Taxpayers should only use this alternative method if there have been substantial fluctuations in the values of owned property during the tax year and the average of the beginning and ending values for the tax year does not produce a fair result.

Averaging, with respect to rented property, is achieved automatically when the standard apportionment methodology is used. Therefore, monthly averaging would not be applicable to rents.

Taxpayers should not confuse this averaging with the franchise tax base monthly averaging that is required to be utilized by a taxpayer in *final return status*.[38]

Comparison of standard apportionment values (Schedule N) to franchise tax base values (Schedule G)

Item	Franchise Tax Base (Schedule G)	Standard Apportionment for Franchise and Excise Taxes (Schedule N)
Property owned is valued at - Tax basis cost	No	Yes
Property owned is valued at - GAAP book value (BV)	Yes	No
Operating lease vs. finance lease	Could be the same or different. Schedule G is GAAP basis and Schedule N is tax basis.	
Rental factor – 1, 2 or 3 multiple	Yes	No *all rental property uses multiple 8*
Deduction for Certified Pollution Control Equipment (BV)	Yes	No
Deduction for Exempt Required Capital Investment (BV)	Yes	No
Sub-rents (where sublessee has same rights as TP) are netted against rents	Yes	No
Exempt Finished Goods Inventory is Deducted	Yes	Yes – Franchise portion of schedule No – Excise tax portion of schedule
Pass-through entity attributes are included if entity is not filing a return	Yes	Yes

Audit Procedures – Property Factor

A taxpayer may expect an auditor to request some, or all, of the following documents or information and to perform some, or all, of the following activities in their audit of the franchise and excise tax standard apportionment ratio reported on Schedule N:

- Identify the business entities whose property should be included in the property factor, including:

- Pass-through entities not filing a franchise and excise tax return.
- Disregarded entities.

- Determine the taxpayer's methodology to source property/rents/inventory to Tennessee. For example, general ledger account numbers indicate activity by location, depreciation software retains asset location information, and lease files track the location of the leased property.

    - Ask that the taxpayer include state-sourcing information, when available, in addition to everywhere information when requesting documents/workpapers.
    - Tie information provided to the federal income tax return.

- Identify all tangible property owned or leased/rented by the taxpayer.

    - Request the tax basis general ledger and trial balance.
    - Request tax basis depreciation schedules.
    - Determine the year-end inventory value from tax basis books.
        - If exempt finished goods inventory is claimed, determine the value of inventory by type and location (finished goods, raw material, etc.).

    - Identify finance and operating type leases by reviewing the tax basis books.
        - Determine that all leases are reported correctly on the schedule as either owned or leased property.

- Obtain taxpayer workpapers that show where the amounts reported on the tax return came from.

    - Determine that the workpapers are complete and accurate by tying information to source documents provided by the taxpayer.

- Based on your audit procedures, determine whether the "In Tennessee" and "Total Everywhere" values for the property factor were correctly reported, and explain any differences.

2. Payroll Factor

The payroll factor numerator is the total amount of compensation paid in this state during the tax period and the denominator is the total compensation paid everywhere during the tax period.[39] Compensation[40] means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. A person is generally considered an "employee" if reported by the taxpayer as an employee for payroll taxes imposed by the Federal Insurance Contributions Act ("FICA"). However, there are circumstances under the common law where *an individual for whom FICA is paid may not be considered an employee of that entity*.[41]

In addition to traditional payroll, where an entity hires and utilizes workers for which it incurs payroll expenses, there are labor arrangements where determining who is the employer requires a detailed analysis of the labor arrangement. Below are discussions on determining the employer, sourcing payroll to Tennessee, and other topics related to the payroll factor.

Key terms used in this section:

- Affiliated Group - Companies with common management or ownership.
- Administrative Service Organization ("ASO") - Provides human resource and payroll reporting services to its clients. W-2s and other reports remain in the client's name.
- Common Law Employer - The entity that controls the workers. If control is unclear, it is the entity best classified as the employer based on other common law factors.
- Common Paymaster or Payroll Agent - Issues payroll checks for others.
- Contract Labor - The employee works on a contract basis and is not under the supervision or control of the business that has contracted for the service.
- Direct Payroll – W-2s are issued in the company's name where the employees work.
- Employee or Staff Leasing Company - Provides workers on a temporary or project specific basis for a fee. The leasing company issues W-2s in its own name.
- Indirect Payroll – W-2s are not issued in the company's name where the employees work.
- Partial Utilization - An employee provides services to more than one entity.

- Professional Employer Organization ("PEO") - May act as a co-employer based on a contractual obligation to share employer responsibilities. Both the PEO and taxpayer will have indications of an employer for *some* purposes, but neither party will be the employer for *all* purposes. The W-2 may or may not be in the PEO's name, depending on the agreement. Utilization and control will generally determine which taxpayer will be considered the employer.

- Service Recipient - The location where the laborers actually work.

- Service Provider - The entity furnishing laborers to a separate business entity.

- Third-Party Service Provider - The company providing workers to be utilized by a business not under common control or management.

Determining the Employer

Common Law Employment Rules

TENN. COMP. R. & REGS. 1320-06-01-.30 ("Rule 30") provides the authority to use "the usual common law rules" in determining the employer-employee relationship and in identifying the common law employer.[42] Under these rules, a person is generally considered an "employee" if the taxpayer includes the person as an employee for payroll taxes imposed by FICA. *However, there are circumstances under the common law where an employee for whom FICA is paid may not be considered an employee of that entity.* The following common law concepts may be considered when determining which entity is the employer for the purpose of the payroll factor. Auditors will consider the particular facts of each case and use their best judgment in weighing the following factors to decide:

- The *degree of control* exercised over the way the work is performed. This involves the laborer working exclusively for the entity in question and the entity controlling all aspects of the laborer's work duties and responsibilities. This is normally readily apparent in the structure of the labor arrangement and the activities of the workers. **This is the most important factor in the analysis.**

- If after considering the above, it remains unclear as to which entity has ultimate control over the employee, the following factors are then considered:

- The right to hire and terminate the employee;
- The right to reassign the employee to another client while the employee is performing services for the service recipient;
- The entity bears the cost of employee benefits;
- The entity issues the W-2 and files employment taxes in the entity's name; and
- Whether the work performed is part of the principal's regular business.

Utilization/Control

The taxpayer's level of control and involvement with a worker, such as *full utilization*, *partial utilization*, and *no utilization*, is a significant factor in determining payroll. *Exclusive utilization* of a worker where significant managerial control is exercised likely satisfies the *common law* definition of an employee and is thus included in the payroll factor. Although a taxpayer's employees may work on-site providing services at the location of a customer, this does not necessarily mean they are the customer's employees. For example:

- Janitorial and security service contracts require the taxpayer's employees to perform services at the customer's location. These individuals are still the taxpayer's employees since the taxpayer maintains control and all other aspects of the employer-employee relationship.

Utilization and control is a key consideration in determining the payroll factor in the following discussions:

- *Never Split One Employee's Wages between Entities* – When computing the payroll factor, an employee's compensation is never split up between various entities. An employee has only one employer for payroll factor purposes. The partial utilization of an employee in an affiliated group, or a temporary worker provided by an agency, would not cause the employee's payroll to be divided between entities. Partial utilization of a worker would exist when an employee, such as a computer technician, provides services to several affiliated members or is provided temporarily by an agency. In this case, the employee would be included in the payroll factor of only one company since an employee's salary is not split in computing the payroll factor. In that case, the employee's payroll would be assigned to the company that exercised the ultimate control of that employee's activities. *Note, an employee's wages may be split between states.* For example, an employee that worked the first half of the year in Tennessee and the second half in Kentucky would have their wages split between these states for payroll factor purposes.

- *Independent contractors* provide contract labor for their customers based on an agreement. *They are not under the supervision or control of the business, which has contracted for their service,* and they do not meet the common law rules for an employer-employee relationship. Expenses for independent contractors or any other labor not properly classified as an employee are excluded from the payroll factor.

- A taxpayer may contract for on-site services, such as consulting, security, landscaping, janitorial, or food services. In such a circumstance, the service provider uses labor to provide the service to the taxpayer, but the taxpayer has no control over the laborer's schedule, assignments, performance, or hiring and firing under the normal common law employee criteria. In this case, services provided to the taxpayer with the independent contractor's own labor is not reported in the taxpayer's payroll factor.

- The revenue received by independent contractors from the companies they contract with is not wages. The independent contractors generally receive a federal Form 1099-MISC with box 7 – Nonemployee Compensation – completed that shows the total payments they received during the tax year from the service recipient. Payroll taxes are not withheld from contract labor earnings.

- *Administrative Service Organizations (ASO)* are third-parties that provide human resource and *payroll reporting services* for their clients, such as completing payroll forms, tax returns, and other employment paperwork. *The tax returns, W-2s, and other reports remain in the taxpayer's name.* The employees work exclusively for and under the direction of the taxpayer. The use of an ASO has no bearing on the employer-employee relationship.

- *Third-Party Service Provider, Co-Employer and Staff Leasing* – Contractual agreements with third-party service providers, which include the payment of payroll and related taxes, can vary greatly. The contracting agency may be described as a labor or service provider, Professional Employer Organization ("PEO"), co-employer, or staff leasing company. These agreements may involve full-time, temporary and/or part-time labor provided by the third-party provider, but the main factor in determining the common law employer will be who has primary control over the workers.

⚠ **Audit Tip: Auditors may request contractual agreements with third-party service providers in order to determine the employer-employee relationship.**

Auditors may review labor agreements with third-party providers in order to evaluate them for any employer-employee relationship. The auditor may inquire as to:

- Who utilizes the worker's services;
- Who instructs the workers on how to do their work;
- Who is named as the employer on the payroll tax returns;
- Who interviews and hires the workers;
- Monetary remuneration between the companies; and
- Who provides employee benefits, like health insurance?

The entity meeting the common law rule of an employer would include those costs in the payroll factor of its apportionment formula, but any mark-up paid to a third-party provider/staff leasing company is *not* included in the factor. A primary example of this arrangement is a third-party provider that provides labor to a taxpayer who completely controls the laborers' activities as an employer but uses the third-party provider for administrative convenience since they also handle the payroll paperwork.

In some circumstances, the third-party provider may retain control over the workers for purposes of assigning them to the taxpayer, hiring and firing, providing the direct pay and benefits, and filing all tax returns. This is typical when a third party provides temporary, seasonal or part-time labor. In such a case, if the Department cannot establish that the taxpayer has overall control of the labor, the labor expense will be included in the third-party provider's payroll factor, not the taxpayers.

- *Affiliated Group* – Traditional or direct payroll occurs when an entity hires and utilizes workers for which it incurs payroll expenses. Indirect payroll is when the payroll reports and W-2s are issued in the name of a company where the workers are not utilized and controlled. For example, a group of affiliated companies may designate one affiliate to perform the payroll function for all the affiliates. The operating affiliates reimburse the common paymaster for the payroll costs incurred on their behalf with an inter-company charge. These inter-company charges may be classified as management fees, administrative fees, overhead fees, or labor expenses, and would be considered indirect payroll if the operating company exerts control over the employees. The common paymaster affiliate issues the W-2s but does not utilize and control the workers and should not include them in their payroll factor. The affiliate reimbursing the common paymaster has indirect payroll and should report the labor in their payroll factor.

⚠ **Audit Tip**
Indirect payroll should be included in the payroll factor of the common law employer, even though the direct payroll and payroll taxes are paid by the common paymaster affiliate.

- Indirect payroll should be included in the payroll factor of the common law employer, even though the direct payroll and payroll taxes are paid by the common paymaster affiliate. It is the common law employer who controls the employee's actions and on whose behalf the employee works. Consequently, the common paymaster affiliate would not be considered the employer and the payroll expense would not be included in its payroll factor even though the payroll affiliate is responsible for the payroll taxes.

- *Auditor allocation of labor between affiliates* – Transactions between affiliates are not always at arms-length, so the inter-company labor charges may be nonexistent or for amounts that do not accurately match the cost of labor utilized. If reasonably accurate labor charges are not made, the auditor may consider allocating reasonable labor costs between affiliates.[43]

- *Administrative overhead services provided to the entire affiliated group by the parent's employees* – Employees of one company in an affiliated group may work for several affiliates. For example, a parent corporation provides services for all of its subsidiaries. An inter-company charge is made for the services, but the parent retains control over the employees and the employees are not exclusively performing services for one subsidiary. *Therefore, since the labor is not controlled by the subsidiary and the laborer performs duties on behalf of various subsidiaries, the inter-company charge between the affiliated companies does not represent indirect payroll.* The payroll costs therefore stay with the entity, normally the parent in this example, which pays and controls the employees.

Summary – Payroll Factor Denominator

In summary, payroll costs should be included in the payroll factor of the common law employer, which is typically the entity controlling and utilizing the employees. This entity may not be the one filing employment taxes, such as the FICA tax. Therefore, the payroll factor may include:

- Direct payroll expenses where the taxpayer is responsible for the payroll tax liability and is considered the employer under the common law definition; and

- Indirect payroll expenses where the taxpayer meets the common law definition of an employer but may not be responsible for filing the payroll tax returns.

For laborers that are considered employees under the common law rules, the expenses included in the payroll factor may be categorized as salaries, wages, leased labor cost, administrative fees, and other expenses defined as compensation. In addition, an employee's compensation is never split-up between various entities. The compensation is only reported by one entity for the payroll factor.

Other Topics – Payroll Factor

Cash or Accrual Basis

The payroll factor numerator is the total amount of compensation *paid* in this state during the tax period, and the denominator is the total compensation *paid* everywhere during the tax period.[44] Since the code explicitly states "paid" and not "paid and accrued," we will discuss in the following paragraphs whether the payroll factor must be computed on a cash basis.

State and federal payroll reports (941, 940, W-2, SUTA) are reported on a cash basis. Federal income tax returns and financial statements can be based on either the "cash" or "accrual" methods of accounting, but larger businesses generally use the accrual method.

For purposes of the payroll factor, the total amount "paid" to employees is based on the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued is deemed to have been paid. However, at the *election of the taxpayer*, compensation paid to employees may be included in the payroll factor by use of the *cash method* if the taxpayer is required to report such compensation under the cash method for unemployment compensation purposes.[45] A taxpayer elects the cash method by consistently completing the apportionment schedule, each year, using the cash method.

Auditors may accept the otherwise correct payroll values reported on the apportionment schedule, regardless of whether the cash or accrual method was used, as long as they are consistently applied and do not adversely affect the ratio in such a way that the tax computation does not fairly represent the extent of the taxpayer's business activity within the state.

The formula to reconcile cash basis payroll to accrual basis payroll is:

- **(cash basis payroll) + (current year-end accrued wages payable) – (prior year-end accrued wages payable) = accrued payroll**

The formula to reconcile accrual basis payroll to cash basis payroll is:

- **(accrual basis payroll) + (prior year-end accrued wages payable) – (current year-end accrued wages payable) = cash basis payroll**

Unemployment Reports

Generally, state and federal unemployment tax reports provide helpful support for the apportionment factor values when the common law employer is also the employer who files the state and federal unemployment tax reports. In this case, there is a presumption that the amounts reported for unemployment purposes in each state represent compensation in that state for taxpayers using the cash method. Schedule A of the annual federal unemployment tax return (Form 940) shows every state in which a taxpayer had to pay state wages and lists the FUTA taxable wages by state.

Capitalized In-house Labor

In-house labor used in the construction of a depreciable asset should be included in the payroll factor. For example:

- A taxpayer used some of its employees in the construction of a storage building that, upon completion, is used in the regular course of taxpayer's trade or business. The wages paid to those employees are treated as a capital expenditure by the taxpayer. The amount of such wages is included in the payroll factor.[46]

Imputing Payroll

Generally, auditors should *not* impute payroll where none has been paid or accrued. Two conditions normally exist for payroll factor inclusion: 1) there is control and utilization of the laborers and 2) the taxpayer ultimately bears the labor cost.

If the taxpayer's books and records do not reflect an expense for labor, the auditor generally should *not* impute payroll. However, if the auditor finds that a strict adherence to the apportionment statutes results in an apportionment ratio that does not fairly represent the extent of the taxpayer's business activity in this state, the auditor may request an adjustment under the variance statute.[47] **Variance requests should be rare and infrequent.**

Apportionment Amount and Payroll Deductions

The payroll factor is computed using compensation values *before* any deductions for contributions to a 401(k) or similar deferred compensation plan, cafeteria plans, and sick pay.

Numerator of the Payroll Factor: [48]

Compensation is paid in this state if any one of the following tests, applied consecutively, are met:[49]

- The service is performed entirely in Tennessee;
- The service is performed inside and outside Tennessee, but the service performed outside Tennessee is incidental to the Tennessee service; or
- The service is performed inside and outside Tennessee; and
    - The employee's base of operations[50] (or if there is no base of operations, the place from which the service is directed or controlled) is in the state; or
    - The employee's base of operations (or if there is no base of operations, the place from which the service is directed or controlled) is not in a state in which some part of the service is performed, but the employee's residence is in Tennessee.

The above description of "In Tennessee" payroll is almost identical to payroll that is subject to Tennessee's unemployment insurance, commonly referred to as SUTA. The following chart compares payroll sourcing under the franchise and excise tax apportionment statute and the Tennessee SUTA Handbook for Employers (2019).[51]

Compensation is paid in this state, if:	
Tenn. Code Ann. § 67-4-2012(f)	**SUTA Handbook**
(1) The individual's service is performed entirely inside the state (2) The individual's service is performed both inside and outside the state, but the service performed outside the state is incidental to the individual's service inside the state; or	*TEST (1) - the localization of services test; Wages are reported and premiums are paid to the state in which the service is performed.* Example: An employer in Tennessee has a store in Tennessee and a store in Kentucky with employees at each store. The employer will need a state unemployment insurance Employer Account Number for each state.

	Employees working in Tennessee will be reported to Tennessee, since their services are localized in Tennessee. The employees working in Kentucky will be reported to Kentucky, since their services are localized in Kentucky. If an employee works the first six months of the year in Tennessee and the last six months in Kentucky, the employer will report the employee to Tennessee for the first two calendar quarters of the calendar year and to Kentucky for the last two calendar quarters.

Compensation is paid in this state, if:	
Tenn. Code Ann. § 67-4-2012(f)	**SUTA Handbook**
(3) Some of the service is performed in the state; and (A) The base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state; or	*TEST (2) - employee base of operations test; Wages are reported and premiums are paid to the state in which the employee has his base of operations and performed some services.* Example: An employer in Tennessee has a salesman working out of his home in Alabama. This salesman calls on customers in Alabama, Georgia, and Mississippi. Since there is no localization of service (TEST 1), the employer will need an Alabama unemployment insurance Employer Account Number and will report all of this salesman's wages to Alabama, since the employee's base of operations is in Alabama and the employee performs some services in Alabama. *TEST (3) - employer base of operations test; Wages are reported and premiums are paid to the state from which the service is directed or controlled if the employee performed some service in that state.* Example: An employer in Tennessee is a construction contractor. All employees are hired by, paid by, and receive instructions from the home office in Tennessee. The employees live in various states and work on construction sites as needed in Tennessee, Alabama, and Georgia. Since there is no localization of service (TEST 1) and no employee base of operation (TEST 2), the employer would report these workers to Tennessee, since the employer's base of operations is in Tennessee and the employees performed some services in Tennessee.

Compensation is paid in this state, if:	
Tenn. Code Ann. § 67-4-2012(f)	**SUTA Handbook**
(3) Some of the service is performed in the state; and (B) The base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state	*TEST (4) - place of residence test; Wages are reported and premiums are paid to the state in which the employee lives if some service is performed in that state.* Example: An employer in Tennessee hires a guitarist who lives in Alabama to perform with a band playing at gigs in Alabama, Georgia and Mississippi. Since there is no localization of service (TEST 1), and no employee base of operation (TEST 2), and the employee did not perform any services in Tennessee, the employer's base of operations (TEST 3), the employer will need an Alabama unemployment insurance Employer Account Number and the employer will report the employee's wages to Alabama, since the employee's place of residence is in Alabama and the employee performed some services in Alabama.

Real Estate Construction Project Located in Tennessee

All labor associated with a real estate construction project located in Tennessee should be included in the numerator of the payroll factor, in addition to the denominator. The work of management level employees located outside of the state should be included in the "In Tennessee" numerator for the time spent on real estate projects/jobs located in Tennessee. Labor costs capitalized to the cost of a project are included in the payroll factor of the state in which the project is located and should be included in the payroll factor in the same year in which the related payroll expenses are deducted for federal income tax purposes.[52]

Documents that Support the Payroll Factor Amounts

Auditors may ask for the following documents in an audit of the payroll factor:

- A narrative from the taxpayer that explains:
  - the methodology and records used in arriving at the "In Tennessee" and "Total Everywhere" amounts

- any indirect labor used

- any direct labor not used (including copies of any referenced documents, workpapers, or schedules)

- Copy of the federal income tax return with all schedules and attachments, to identify all labor costs

- Detailed trial balance, to search for accounts that may represent charges for direct and indirect labor (e.g., salaries and wages, management fees, and cost of goods sold labor) and costs for common law employees

- Listing of the "Total Everywhere" payroll factor broken down by state

- State and federal unemployment reports: 940 (FUTA), 940 Schedule A, TN Dept. of Labor and Workforce Development Premium & Wage Report (SUTA).

  - Form 940 – Employer's Annual Federal Unemployment Tax Return, Line 3 shows the total of all wage payments to employees. The related Form 940 Schedule A reports every state in which unemployment tax was paid.

  - The TN SUTA form is filed quarterly, but the 4th quarter report will provide sufficient information to arrive at the annual "direct" payroll for a calendar year filer.

  - Information from SUTA and FUTA forms are helpful, but when these forms are examined in isolation, they are inadequate to identify amounts for direct payroll that should *not* be included in the payroll factor and indirect payroll that *should* be included in the payroll factor.

- If needed, detailed listing of employees that ties, in total, to the federal income tax return and lists each employee's job description, work location, and compensation for the audit period

- If applicable, labor agreements regarding payments made for labor used and controlled by the taxpayer as a common law (indirect) employer. The auditor may need to review journal entries and general ledger accounts to identify any non-labor charges, such as administrative markups that should be excluded from the payroll factor.

- If the taxpayer has an ownership interest in a pass-through entity that is not subject to or filing a franchise and excise return, all of the above-listed information would be needed for the pass-through entity in addition to the K-1 showing the taxpayer's ownership interest.

Audit Procedures – Payroll Factor

- Obtain the applicable documents discussed in the previous section "Documents that Support the Payroll Factor Amounts."

- Identify all direct and indirect payroll costs, including payroll costs from pass-through entities (not subject to the excise tax), that should be included in the payroll factor.

  - Search the federal income tax return and trial balance of the taxpayer and any pass-through entities not subject to Tennessee excise tax. If needed, review general ledger accounts to better understand the accounting entries made in relation to payroll.

- Determine which costs, identified above, meet the common law test and should be included in the payroll factor. When applicable, obtain labor contracts/agreements.

- Based on the taxpayer's narrative and other information obtained, determine whether the cash or accrual method of accounting was used for payroll factor purposes, and if this method was consistently applied.

- Once all sources of "Total Everywhere" payroll have been identified, verify the corresponding "In Tennessee" amounts. The TN state unemployment data (SUTA) should provide the bulk of the support. However, the following adjustments may be needed (similar adjustments should be made to the "Everywhere" values) if the taxpayer uses the accrual method for reporting the payroll factor or if there is indirect payroll.

  For Taxpayer *and* applicable pass-through entities (to the extent (%) owned):

TN wages from SUTA reports	$__________
Add: Payments for "Non-W-2" labor controlled and utilized	$__________
Subtract: SUTA wages for employees not controlled and utilized	$__________
Add or subtract: cash/accrual adjustment for consistent reporting	$__________
"In TN" Payroll Apportionment Factor	$__________

- Write an audit memo explaining the audit work done, documents reviewed, conclusions reached, and adjustments made. If applicable, discuss direct payroll omitted, indirect payroll included, flow-through payroll, and the consistent application of the cash or accrual method.

> ⚠ **Audit Tip: An employee for the payroll factor will also be a position/job for purposes of the job tax credit.**

3. Sales Factor

Sales included in the apportionment factor are ***all gross receipts*** from transactions and activity in the regular course of the taxpayer's trade or business.[53] Gross receipts means all receipts from whatever sources derived before any deductions, but not including actual sales returns and allowances.[54]

However, there are two exceptions where sales are "thrown out" and excluded from both the numerator and denominator of the apportionment ratio:

- Gain from the sale of goodwill[55]

    - Taxpayers using the standard apportionment formula must exclude from both the numerator and the denominator of the sales factor *any gain on the sale of an asset that is designated as goodwill and required to be reported for federal tax purposes as Class VII assets*. When assets that constitute a trade or business are sold, Internal Revenue Code §§ 1060 and 338(b)(5) require that the sales price be allocated among the assets. Federal Form 8594 – Asset Acquisition Statement – shows the allocation, and it is attached to the federal income tax return (Forms 1040, 1041, 1065, 1120, 1120S, etc.) of both the buyer and the seller. This form categorizes the deemed or actual assets transferred into seven classes, with the allocated sales price reported for each class. Goodwill is reported as a Class VII asset. The gain on the sale of goodwill, reported as a Class VII asset, must be excluded from both the numerator and the denominator of the apportionment formula receipts factor. This "throw out" provision excludes any recognition of the sale of goodwill in the sales factor of the standard apportionment formula. Rather, the sales factor includes the sale of the underlying real, tangible, and intangible assets of the business.

- Sales other than the sales of tangible personal property in which the state of assignment cannot be determined under the state's code or Rule 42 and cannot be reasonably approximated.[56] [57]

    - In the event a taxpayer cannot ascertain the state or states to which a sale should be assigned, pursuant to Rule 42 (including using a method of reasonable approximation), using a reasonable amount of effort undertaken in good faith, the sale should be excluded from the numerator and the denominator of the taxpayer's sales factor. For example:

        - Interest and dividend investment income is "thrown out" and not included in the numerator or denominator of the sales factor.

        - See the discussion below on the sourcing of sales other than sales of tangible personal property for tax periods beginning on or after July 1, 2016.

In addition, there are two exceptions to the requirement that *gross* instead of *net* receipts be reported in the sales factor.

- The first exception allows *net* sales to be used when large transactions distort the sales factor. This exception applies when:[58]

    - The gross receipt from an asset disposition are substantial in relation to all other regular business receipts; and

    - The use of the gross receipt amount would cause a distortion to the sales factor.

Under this provision, the apportionment formula more fairly apportions to this state the business earnings of the taxpayer's trade or business. For example, where substantial amounts of gross receipts arise from the sale of fixed assets used in the taxpayer's trade or business, such as the sale of a factory or plant, the taxpayer will exclude the gross receipts from the sales factor. To give proper recognition to the apportionment of business earnings (losses) in such instances, the net gain arising from transaction or activity will be included in the sales factor.

The analysis of whether to use the net profit exception should be made for a specific disposition event and would only apply to that transaction. The Rule addresses using the net gain instead of gross receipts but is silent with regard to a sale that results in a net loss. If gross receipts on an asset sale distort the factor, and there is a net loss, then no value (zero) would be included in the sales factor.

- The second exception also prevents a distortion in the sales factor and concerns cash management or treasury functions.

    - Interest income and gains/losses from working capital investments should be reported in the denominator of the sales factor, rather than the returned amounts of principal invested in the working capital investments.[59]

    - For example, a corporate treasury department consolidates money from its various locations daily and transfers cash in excess of its current needs to a money market type of account that bears interest. *Money is swept in and out of the short-term investment account daily,* as dictated by working capital/cash flow needs. The company would include *only interest income* in the receipts factor *and not the principal amounts from each day's transfers*. To include the daily amounts that are swept out of money market type accounts in the sales factor would distort the factor and allow it to be manipulated.

Total Everywhere – Denominator

The sales factor includes all gross receipts (except those thrown out) and includes receipts from inventory sales (after returns and allowances), service fees, rents, royalties, the sale of tangible and intangible property, and other activities. Generally, the gross receipt amounts are traceable to the federal income tax return. Federal forms and schedules that report gross receipts or proceeds include:

- Form 1040 Sch's. C (Profit or Loss from Business – Sole Proprietorship), D (Capital Gains and Losses), E (Supplemental Income and Loss), and F (Profit or Loss From Farming)

- Form 4797 – Sales of Business Property

- Form 1065/1120/1120S Schedule D (Capital Gains and Losses)

- Form 6252 – Installment Sale Income

- Form 8594 – Asset Acquisition Statement

- Form 8825 – Rental Real Estate Income & Expenses of a Partnership or S Corporation

- Form 8883 – Asset Allocation Statement
- Form 8949 – Sales and Other Dispositions of Capital Assets

Specifically, the denominator of the sales factor includes:[60]

Sale of Inventory

For purposes of the sales factor, a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "sales" include all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers. Gross receipts for this purpose means gross sales, less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) should be included as part of such receipts if such taxes are passed on to the buyer or included as part of the selling price of the product.

Sale of Equipment

For purposes of the sales factor, if a taxpayer derives receipts from the sale of equipment used in its business, such receipts constitute "sales." For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The *gross receipts* from the sales of the trucks are included in the sales factor.

The sale of business assets is generally reported on federal Form 4797 – Sale of Business Property. Details of the transaction, including the gross sales price, are reported on that form and the "net gain or loss" is reported on the applicable federal income tax return (Form 1120, 1065, etc.). Since the apportionment ratio requires that the gross proceeds be used, Form 4797 is usually the best source for populating the denominator of the sales factor.

> ⚠ **Audit Tip**
> **The total income line from a federal income tax return generally does not reflect <u>gross</u> receipts/proceeds and should not be reported as the denominator of the sales factor.**

Sale – Capital Assets

Sales of capital assets are reported on federal Schedule D. Capital assets include all types of property, but do not include inventory and depreciable or real property used in the business.

The face of the federal income tax return will show the net gain or loss from the sale of capital assets. However, the *gross* proceeds/sales price that is needed for the sales factor is found on Schedule D. Note, the previous discussion concerning the use of net sales when there is factor distortion may apply to certain capital asset sales.

Sale – Like-Kind Exchanges

The gross sales price[61] of replacement property received in a like-kind exchange is included in the sales factor in the year the associated gain or loss is recognized on the federal income tax return. For example, Property A with a book value of $100 and a fair market value of $200 is exchanged for Property B with a fair market value of $200. The taxpayer will report $200 in the sales factor in the year the replacement property (B) is sold, not in the year of the exchange. Federal Form 8824, Part III may show a recognized gain on Line 23 and a deferred gain on line 24. The gross proceeds associated with the deferred gain are not recognized until the like-kind replacement property is sold or otherwise disposed of in a subsequent taxable transaction. Please see Chapter 11 for more information on like-kind exchanges.

Sale – Installment Sale Income

Generally, an installment sale is a disposition of property where at least one payment is received after the end of the tax year in which the disposition occurs. The ordinary and capital gain from an installment sale is computed on federal Form 6252 and reported on Schedule D and Form 4797. Form 6252 is completed for each year of the installment agreement, including the year of final payment, even if a payment wasn't received during the year.

Because installment gain income is included in federal taxable income it is automatically included in the income subject to excise tax. The sales factor of the apportionment ratio will include the installment sale proceeds received in the current year. For example:

- An asset with a basis of $100,000 was sold for $250,000. The proceeds are received in two installments of $125,000; one in the current tax year and one in the subsequent year. The chart below shows where this information is found on federal form 6252. Note form 6252 will be prepared for both years.

- The amount included in the everywhere factor of the apportionment ratio is $125,000 for both years. This is found on Form 6252, Part II, Line 22.

Description	Form	Amount
Selling price	Form 6252, Part I, Line 5	$250,000
Adjusted basis	Form 6252, Part I, Line 13	$100,000

Gross profit	Form 6252, Part I, Line 16	$150,000
Gross profit percentage *($150,000 / $250,000)*	Form 6252, Part II, Line 19	60%
Payment received during year (without interest)	Form 6252, Part II, Line 22	$125,000
Installment sale income (reported on Schedule D and/or Form 4797) *This is $125, 000 times 60%.*	Form 6252, Part II, Line 24	$75,000

Sale – Entire Business

Generally, federal Form 8594 – Asset Acquisition Statement – is filed by both the purchaser and the seller when there is a transfer of a group of assets that make up a trade or business where goodwill or going concern value could, under any circumstances, attach to such assets and the purchaser's basis in such assets is determined solely by the amount paid for the assets. The information reported on this form is not part of the income tax calculation, but it provides good information concerning the sale/purchase of a business. For example, the form names both parties to the transaction, discloses the total sales price, date of sale, and allocation of the sales price by asset class. Class VII includes goodwill.

Sale – Cost Plus Fixed Fee Contracts

In the case of cost-plus fixed fee contracts, such as the operation of a government-owned plant for a fee, "sales" include the entire reimbursed cost, plus the fee.[62]

Sale of Services

In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency or the performance of an equipment service contract or research and development contracts, "sales" include the gross receipts from the performance of such services/contracts including fees, commissions, and similar items.

Rent Receipts

In the case of a taxpayer engaged in renting real or tangible property, "sales" include the gross receipts from the rental, lease, or licensing of the property. All rental income reported on the federal income tax return is includable in the sales factor at its gross amount before rental expenses. However, a taxpayer receiving excess rents[63] from an affiliate reduces its income subject to the excise tax to the extent that excess rent was added back to net earnings of the affiliate. When excess rents received are removed from Tennessee apportioned income, they are also excluded from the sales factor. Receipts received from sub-rentals are included in the sales factor at their gross amounts.

Receipts - Interest Income

Interest on accounts receivable is not "thrown out," but should be sourced in the same manner as the sale that generated the receivable.[64] However, as mentioned above, *investment* interest income reported on the federal income tax return is "thrown out" and not included in the numerator or denominator of the sales factor. For example, bank interest income and interest income from a loan to an affiliate is thrown out under the market-based sourcing rule. See the Rule 42 discussion below.

Receipts – Related to Intangible Property (Royalties)

In the case of a taxpayer engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, "sales" include the gross receipts therefrom. All royalty receipts are included in the sales factor. However, an adjustment may be needed if the taxpayer received intangible income, such as royalties, from an affiliate and the affiliate was not allowed to deduct the intangible expense on its return.[65] In other words, if an affiliate with intangible expenses, either voluntarily or as a result of an audit does not deduct its intangible expenses, then the corresponding intangible income shown on the taxpayer's pro forma federal return should be reversed for purposes of the excise tax and excluded from the sales factor.[66]

Reimbursed Expenses

Receipts received from an affiliate as a reimbursement of costs are included in the sales factor, even if they are posted as a credit to the respective expense account. Note that standard apportionment (Schedule N) and consolidated net worth apportionment (Schedule 170NC) differ in their treatment of these expenses. The consolidated net worth computation requires that transactions between affiliates be eliminated, so there would be no inclusion if Schedule F2 – Consolidated Net Worth – is filed.

For example, a parent allocates to its subsidiary the overhead costs incurred by the parent in managing and overseeing the subsidiary. This transaction could be reported as receipts of management fees or as a reduction of the expenses incurred by the parent; either way, the receipts are included in the receipts factor.

In Tennessee – Numerator

The gross receipts attributable to Tennessee are determined differently for sales of tangible personal property and all other sales.[67]

Tangible Personal Property Sales

Sales of tangible personal property occur in (sourced to) Tennessee if: (1) the property is delivered or shipped to a purchaser, other than the United States government, inside Tennessee, regardless of the F.O.B. point or other conditions of the sale, or (2) the property is shipped from a Tennessee office, store, warehouse, factory, or other place of storage, and the purchaser is the United States government.[68]

In other words, if the purchaser is the U.S. government, the sale is sourced to Tennessee if it *originates* in TN, no matter where it is shipped. Property shipped from Tennessee to the U.S. Government is considered a Tennessee sale. Only sales made directly to the U.S. Government are applicable. Sales by a subcontractor to the prime contractor (the party with the contract with the government) do not constitute government sales.[69]

Nongovernment sales of tangible personal property with a Tennessee *destination* are sourced to Tennessee and would be included in the numerator of the sales/receipts factor. The *destination* of the sale of tangible personal property determines its sourcing. The destination of the taxpayer's shipment or delivery is determinative for the sourcing of the taxpayer's sales. Thus, when tangible personal property is shipped by the taxpayer to a purchaser in Tennessee, the sale is sourced to Tennessee even if the property is ordered from outside the state or the purchaser subsequently moves the property out of state.

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 (drop shipment). 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. Furthermore, sales made to an in-state purchaser but shipped by the taxpayer directly to an out-of-state ultimate recipient are not sourced to Tennessee.[70] However, if a taxpayer begins shipment of merchandise to a destination outside of Tennessee, but due to unforeseen complications the delivery is diverted while in route to the purchaser's place of business in Tennessee, for apportionment purposes the sale is a Tennessee sale.[71]

It makes no difference whether the merchandise is shipped by common carrier from the seller's Tennessee location to the initial out-of-state purchaser, or whether the initial out-of-state purchaser sends his own truck to Tennessee to pick up the merchandise at the Tennessee seller's place of business and takes it to the purchaser's out-of-state location. In both these examples, the sales would not be included in the seller's Tennessee apportionment sales factor. Likewise, an out-of-state seller having tax nexus in Tennessee must include in his apportionment Tennessee sales factor numerator, sales to initial purchasers located in Tennessee. It makes no difference that the Tennessee purchaser sends his trucks to pick up the merchandise at the seller's out-of-state place of business, or that the merchandise was shipped to the Tennessee customer by common carrier, F.O.B. shipping point, from the seller's out-of-state location.[72]

If a purchaser picks up a sales order at the seller's location and the seller cannot determine the destination of the goods by the purchaser, then the sale will be apportioned to the seller's location.

If a seller is not taxable in the destination state, the sales are included in the denominator but not the numerator.

⚠ **Audit Tip**
Tennessee does not have a "throwback provision" (i.e., a sale is thrown back to the sales factor numerator of the state from which the goods were shipped, if the seller is not taxable in the destination state).

- Examples of sales/receipts sourced to Tennessee:

  - Company A sold property to the central purchasing department of Company B, which is located in Alabama, but the goods were shipped directly to B's affiliates located in Tennessee, Kentucky, and Alabama. The portion of the sales shipped to the Tennessee affiliate would be considered Tennessee sales.[73]

  - A taxpayer makes a sale to a purchaser who maintains a warehouse in Tennessee. The warehouse receives purchases before they are reshipped to branch stores in other states for sale to customers. All sales shipped to the warehouse are considered Tennessee sales, because they are considered property "delivered or shipped to a purchaser within Tennessee."[74] It is irrelevant which party arranges for the shipment of the products via common carrier.[75]

- A Tennessee taxpayer 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 Tennessee pursuant to purchaser's instructions. The sale by the taxpayer is sourced to Tennessee.[76]

    - Gross receipts from the sale of tangible personal property (except sales to the United States Government) are in Tennessee if the property is delivered or shipped to a *purchaser within Tennessee* regardless of the f.o.b. point or other conditions of sale. The term "purchaser within Tennessee" includes the ultimate recipient of the property if the taxpayer in Tennessee, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within Tennessee.

- The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While en route the produce is diverted to the purchaser's place of business in Tennessee where the taxpayer is subject to tax. The sale by the taxpayer is attributed to this Tennessee.[77]

    - When property is being shipped by a seller from the state of origin to a consignee in another state is diverted while en route to a purchaser in Tennessee, the sales are in Tennessee.

Other Than Tangible Property Sales - Tax Years Beginning on or after July 1, 2016

Market-based sourcing was adopted for sourcing sales, other than sales of tangible personal property, as part of the Revenue Modernization Act of 2015, effective for tax years beginning on and after July 1, 2016.[78] Market-based sourcing replaced the "cost of performance" (COP) method previously used. The statutes and rules were amended to reflect the legislative change.[79]

As a brief overview, sales of other than tangible personal property (other-than-TPP) are sourced to Tennessee if the taxpayer's market for the sale is in Tennessee. This is interpreted as follows:

- A sale, rental, lease, or license of real or personal property is sourced to Tennessee to the extent the property is located in Tennessee.

- A service is sourced to Tennessee to the extent the service was delivered to a location in Tennessee.

- Receipts from intangible property that is rented, leased, or licensed and receipts from the sale of intangible property that is contingent on its productivity, use, or disposition is sourced to Tennessee to the extent that it is used in Tennessee. If the intangible is used in marketing a good or service, the sale is in Tennessee to the extent the good or service is purchased by a Tennessee consumer.

- Intangible property that is a contract right, government license, etc. is sourced to Tennessee to the extent that it is used in Tennessee. Intangible property used in marketing is considered used in Tennessee if the related good or service is purchased by a Tennessee consumer.

- Receipts from intangible property sales that are contingent on productivity, use, or disposition of the intangible property are sourced to the customer location.

- If intangible property gives authorization to *conduct business in a specific geographical location, it is sourced to Tennessee if the* geographical area includes all or part of the state.

- If the sourcing of receipts by state for other-than-TPP cannot be determined, as provided above, the assignment may be *reasonably approximated*. If it cannot be reasonably approximated, the receipts are *omitted from both the numerator and denominator*.[80]

- Taxpayers may elect to use the prior law cost-of-performance rules if the result is a *highe*r apportionment ratio and the taxpayer has net earnings for the year rather than a net loss.[81]

Rule 42 - Sales Factor-Sales Other than Sales of Tangible Personal Property in this State[82] (market-based sourcing rule) generally states that sales, other than sales of tangible personal property, are in Tennessee if and to the extent that the taxpayer's <u>market for the sales</u> is in Tennessee. The rule discusses: 1) determining whether and to what extent the market for a sale is in Tennessee, 2) reasonably approximating the state or states of assignment where such state or states cannot be determined, and 3) excluding the sale where the state or states of assignment cannot be determined or reasonably approximated.

The Rule establishes uniform *guidance for determining the market* for sourcing purposes. It identifies many types of other-than–TPP receipts and provides *many sourcing examples.* The Rule and this manual discuss:

1. General principles, rule of reasonable approximation, exclusion of sales
2. Rental/license/lease of real property
3. Rental/license/lease of personal property
4. Sales of service
5. License/lease of intangible property
6. License of intangible property
7. Special rules including those for software/digital transactions

1.a. General principles of application[83]

A taxpayer's application of the market-based sourcing rules should be based on objective criteria and should consider all sources of information reasonably available to the taxpayer at the time of its tax filing including, without limitation, the taxpayer's books and records kept in the normal course of business. A taxpayer's method of assigning its sales should be determined in good faith, applied in good faith, and applied consistently with respect to similar transactions and year to year. A taxpayer should *retain contemporaneous records* that explain the determination and application of its method of assigning its sales, including its underlying assumptions. These records should be retained so that they can be submitted to the Department if requested.

There are various *assignment rules that apply sequentially in a hierarchy*. For each sale to which a hierarchical rule applies, a taxpayer must make a reasonable effort to apply the primary rule applicable to the sale before seeking to apply the next rule in the hierarchy (and must continue to do so with each succeeding rule in the hierarchy, where applicable). For example, in some cases, the applicable rule first requires a taxpayer to determine the state or states of assignment, and where the taxpayer cannot do so, the rule then requires the taxpayer to reasonably approximate such state or states. In such cases, the taxpayer must in good faith and with reasonable effort attempt to determine the state or states of assignment (i.e., apply the primary rule in the hierarchy) before it may reasonably approximate such state or states.

1.b. Reasonable approximation[84]

If a taxpayer finds that the Rule does not sufficiently address their business operations they should nonetheless make a good faith effort to source receipts based on all available objective criteria available at the time of filing the return and retain contemporaneous records to support their determination, including a narrative that explains their methodology and underlying assumptions. Taxpayers must follow the Rule's guidance as best they can. More specifically:

- Determining whether and to what extent the market for a sale other than the sale of tangible personal property is in Tennessee is generally found in Rule 42. However, the

Rule has provisions for *"reasonable approximation*," which apply where the state or states of assignment cannot be determined. In some instances, the reasonable approximation must be made in accordance with specific guidance found in Rule 42; like pertaining to professional services.[85] In other cases, the applicable section of the Rule permits a taxpayer to reasonably approximate the state or states of assignment, using a method that reflects an effort to approximate the results that would be obtained under the applicable standards set forth in the Rule.

- Reasonable approximation may be based upon known sales for the sales of services.[86] When a taxpayer can ascertain the state or states of assignment of a substantial portion of its sales of substantially similar services ("assigned sales"), but not all of such sales, and the taxpayer reasonably believes, based on all available information, that the geographic distribution of some or all of the remainder of such sales generally tracks that of the assigned sales, it should include those sales which it believes track the geographic distribution of the assigned sales in its sales factor in the same proportion as its assigned sales.
  - This guidance on reasonable approximation also applies in the context of licenses and sales of intangible property where the substance of the transaction resembles a sale of goods or services.[87]

⚠ **Audit Tip**
A taxpayer's method of assigning its sales, including the use of a method of approximation, where applicable, must reflect an attempt to obtain the most accurate assignment of sales consistent with the standards of Rule 42, rather than an attempt to lower the taxpayer's tax liability. A method of assignment that is reasonable for one taxpayer may not necessarily be reasonable for another taxpayer, depending upon the applicable facts.

1.c. Exclusion of sales[88]

Exclusion of sales from the numerator and the denominator of the sales factor is required in any case in which a taxpayer cannot ascertain the state or states to which a sale is to be assigned pursuant to Rule 42 (including through the use of a method of reasonable approximation, where relevant) using a reasonable amount of effort undertaken in good faith.

For example, when a taxpayer initially tries to determine sales sourcing under the rule, but cannot:

- The taxpayer's next step is to "reasonably approximate" the state(s) of assignment, as provided for in Rule 42. The taxpayer must, in good faith and with reasonable effort, attempt to determine the state(s) of assignment.

- If a taxpayer can ascertain the state(s) of assignment of a substantial portion of its sales of substantially similar services ("assigned sales"), but not all of sales, and the taxpayer reasonably believes, based on all available information, that the geographic distribution of some or all of the remainder of such sales generally tracks that of the assigned sales, it should include those sales which it believes track the *geographic distribution of the assigned sales* in its sales factor in the same proportion as its assigned sales.

- As a last resort, if a taxpayer cannot determine the state(s) to source a receipt pursuant to Rule 42 (including use of the reasonable approximation method) and using a reasonable amount of effort undertaken in good faith, the sale should be *excluded from both the numerator and the denominator* of the taxpayer's sales factor.

    - Interest and dividend income is not sourced based on commercial domicile. A taxpayer filing FAE170 should "throw out" investment interest and dividend income.

⚠ **Investment dividends and interest are not included in the numerator or denominator of the sales/receipts factor because the Rule does not include specific guidance regarding the sourcing of this type of income. Interest from accounts receivable is not thrown out.**

2. The sale, rental, lease, or license of real property

To the extent that rental, lease or license of real property is in Tennessee, the sale is in Tennessee.

3. The rental, lease, or license of tangible personal property

In the case of a rental, lease or license of tangible personal property, the sale is in Tennessee if and to the extent that the property is in Tennessee. If property is mobile property that is located both within and without Tennessee during the period of the lease or other contract, the receipts assigned to Tennessee shall be the receipts from the contract period multiplied by the fraction *used by the taxpayer for property factor purposes* [89] (as adjusted when necessary to reflect differences between usage during the contract period and usage during the taxable year).

4. The sale of a service

The sale of a service is in Tennessee if and to the extent that the service is *delivered* at a location in Tennessee.

a) **In general, the term "delivered" means the** location of the taxpayer's market for the service provided and is not to be construed by reference to the location of the property or payroll of the taxpayer as otherwise determined for corporate apportionment purposes. The rules to determine the location of the delivery of the following types of service are discussed below:

- In-person services (b)
- Services Delivered to the Customer or on Behalf of the Customer, or Delivered Electronically Through the Customer (c)
- Professional Services (d)
- Broadcast Advertising (e)

b) **In-Person Services** generally are services that are physically provided in person by the taxpayer, where the customer or the customer's real or tangible property upon which the services are performed is in the same location as the service provider at the time the services are performed.

This rule includes situations where the services are provided on behalf of the taxpayer by a third-party contractor.

- Examples of in-person services include, without limitation, warranty and repair services; cleaning services; plumbing services; carpentry; construction contractor services; pest control; landscape services; medical and dental services, including medical testing and x- rays and mental health care and treatment; child care; hair cutting and salon services; live entertainment and athletic performances; and in-person training or lessons.

In-person services include services within the description above that are performed at *a location*:

- that is owned or operated by the service provider; or

- of the customer, including the location of the customer's real or tangible personal property. Various professional services, including legal, accounting, financial and consulting services, and similar professional services,[90] although they may involve some amount of in-person contact, are not treated as in-person services within the meaning of this section.

Assignment of sales for in-person service is the location where the service is received, with the exception noted below. The delivery of the service is at the location where the service is received. Therefore, the sale is in Tennessee if and to the extent the customer receives the in-person service in Tennessee. In assigning sales of in-person services, a taxpayer must consider the "*rule of determination*" and the "*rule of reasonable approximation*."

Under the "*rule of determination*", a taxpayer should first attempt to determine the location where a service is received, as follows:

- Where the service is performed with respect to the body of an individual customer in Tennessee (e.g. hair cutting or x-ray services) or in the physical presence of the customer in Tennessee (e.g. live entertainment or athletic performances), the service is received in Tennessee.

⚠ **Definition**

"Individual customer" means any customer who is not a business customer.

- Where the service is performed with respect to the customer's real estate in Tennessee or where the service is performed with respect to the customer's tangible personal property at the customer's residence or in the customer's possession in Tennessee, the service is received in Tennessee.

- Where the service is performed with respect to the customer's tangible personal property and the tangible personal property is to be shipped or delivered to the customer, whether the service is performed in Tennessee or outside Tennessee, the service is received in Tennessee if such property is shipped or delivered to the customer in Tennessee.

Under the "*rule of reasonable approximation*," any instance in which the state or states where a service is actually received cannot be determined, but the taxpayer has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, the taxpayer shall reasonably approximate such state or states.

c) **Sales of services delivered to the customer or on behalf of the customer, or delivered electronically through the customer**[91] where the service provided by the taxpayer is not an in-person service [92] or a professional service[93] and the service is delivered to or on behalf of the customer, or delivered electronically through the customer, the sale is in Tennessee if and to the extent that the service is delivered in Tennessee.

- For purposes of this section, a service that is delivered "to" a customer is a service in which the customer and not a third party is the recipient of the service. A service that is delivered "on behalf of" a customer is one in which a customer contracts for a service but one or more third parties, rather than the customer, is the recipient of the service, such as fulfillment services or the direct/indirect delivery of advertising to the customer's intended audience; both discussed below.

A service that is delivered electronically "through" a customer is a service that is delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to an end user or other third-party recipient. Except in the instance of a service that is delivered through a customer (where the service must be delivered electronically), a service is included within the meaning of this section, irrespective of the method of delivery, e.g., whether such service is delivered by a physical means or through an electronic transmission.

The assignment of a sale to a state or states in the instance of a service that is delivered to the customer or on behalf of the customer, or delivered electronically through the customer, depends upon the method of delivery of the service and the nature of the customer. Separate rules of assignment apply to services delivered by physical means and services delivered by electronic transmission. (For purposes of this section, a service delivered by an electronic transmission shall not be considered a delivery by a physical means). In any instance where, applying the rules set forth in this section, the rule of assignment depends on whether the customer is an individual or a business customer, and the taxpayer acting in good faith cannot reasonably determine whether the customer is an individual or business customer, the taxpayer shall treat the customer as a business customer.

⚠ **Definition**

"<u>Business customer</u>" means a customer that is a business operating in any form, including an individual who operates a business through the form of a sole proprietorship. Sales to a non-profit organization, to a trust, to the U.S. Government, to any foreign, state or local government, or to any agency or instrumentality of such government shall be treated as sales to a business customer and shall be assigned consistent with the rules that apply to such sales."

- *<u>Delivery to or on Behalf of a Customer by Physical Means, Whether to an Individual or Business Customer</u>*
  Services delivered to a customer or on behalf of a customer through a physical means include, for example, product delivery services where property is delivered to the customer or to a third party on behalf of the customer; the delivery of brochures, fliers or other direct mail services; the delivery of advertising or advertising-related services to the customer's intended audience in the form of a physical medium; and the sale of custom software (e.g., where software is developed for a specific customer in a case where the transaction is properly treated as a service transaction for purposes of corporate taxation) where the taxpayer installs the custom software at the customer's site. The rules in this subsection apply whether the taxpayer's customer is an individual customer or a business customer.

  - <u>Rule of Determination</u> - In assigning the sale of a service delivered to a customer or on behalf of a customer through a physical means, a taxpayer must first attempt to determine the state or states where such services are delivered. Where the taxpayer can determine the state or states where the service is delivered, it shall assign the sale to such state or states.

  - <u>Rule of Reasonable Approximation</u> - Where the taxpayer cannot determine the state or states where the service is actually delivered, but has sufficient information regarding the place of delivery from which it can reasonably approximate the state or states where the service is delivered, it shall reasonably approximate such state or states.

- *<u>Examples</u> - Assume in each of the following six examples that the taxpayer that provides the service is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012.*

  <u>Example 1</u>: Direct Mail Corp, a corporation based outside Tennessee, provides direct mail services to its customer, Business Corp. Business Corp transacts with Direct Mail Corp to deliver printed fliers to a list of customers that is provided to it by Business Corp. Some of Business Corp's customers are in Tennessee and some of those customers are in other states. Direct Mail Corp will use the postal service to deliver the printed fliers to Business Corp's customers. The sale of Direct Mail Corp's services to Business Corp is assigned to Tennessee to the extent that the services are delivered on behalf of Business Corp to Tennessee customers (i.e., to the extent that the fliers are delivered on behalf of Business Corp to Business Corp's intended audience in Tennessee).

  <u>Example 2</u>: Ad Corp is a corporation based outside Tennessee that provides advertising and advertising-related services in Tennessee and in neighboring states. Ad Corp enters into a contract at a location outside Tennessee with an individual customer who is not a Tennessee resident to design advertisements for billboards to be displayed in Tennessee, and to design fliers to be mailed to Tennessee residents. All the design work is performed outside Tennessee. The sale of the design services is in Tennessee because the service is physically delivered on behalf of the customer to the customer's intended audience in Tennessee.

  <u>Example 3</u>: Same facts as Example 2, except that the contract is with a business customer that is based outside Tennessee. The sale of the design services is in Tennessee because the services are physically delivered on behalf of the customer to the customer's intended audience in Tennessee.

  <u>Example 4</u>: Fulfillment Corp, a corporation based outside Tennessee, provides product delivery fulfillment services in Tennessee and in neighboring states to Sales Corp, a corporation located outside Tennessee that sells tangible personal property through a mail order catalog and over the Internet to customers. In some cases when a customer purchases tangible personal property from Sales Corp to be delivered in Tennessee, Fulfillment Corp will, pursuant to its contract with Sales Corp, deliver that property from its fulfillment warehouse located outside Tennessee. The sale of the fulfillment services of Fulfillment Corp to Sales Corp is assigned to Tennessee to the extent that Fulfillment Corp's deliveries on behalf of Sales Corp are to recipients in Tennessee.

Example 5: Software Corp, a software development corporation, enters into a contract with a business customer, Buyer Corp, which is physically located in Tennessee, to develop custom software to be used in Buyer Corp's business. Software Corp develops the custom software outside Tennessee, and then physically installs the software on Buyer Corp's computer hardware located in Tennessee. The development and sale of the custom software is properly characterized as a service transaction, and the sale is assigned to Tennessee because the software is physically delivered to the customer in Tennessee.

Example 6: Same facts as Example 5, except that Buyer Corp has offices in Tennessee and several other states but is commercially domiciled outside Tennessee and orders the software from a location outside Tennessee. The receipts from the development and sale of the custom software service are assigned to Tennessee because the software is physically delivered to the customer in Tennessee.

- *Delivery to a Customer by Electronic Transmission*
  Services delivered by electronic transmission include, without limitation, services that are transmitted through the means of wire, lines, cable, fiber optics, electronic signals, satellite transmission, audio or radio waves, or other similar means, whether or not the service provider owns, leases or otherwise controls the transmission equipment. In the case of the delivery of a service by electronic transmission to a customer, the following rules apply.

  - Services Delivered by Electronic Transmission to an Individual Customer

    - Rule of Determination - In the case of the delivery of a service to an individual customer by electronic transmission, the service is delivered in Tennessee if and to the extent that the taxpayer's customer receives the service in Tennessee. If the taxpayer can determine the state or states where the service is received, it shall assign the sale to such state or states.

- Rules of Reasonable Approximation - If the taxpayer cannot determine the state or states where the customer actually receives the service, but has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, it shall reasonably approximate such state or states. Where a taxpayer does not have sufficient information from which it can determine or reasonably approximate the state or states in which the service is received, it shall reasonably approximate such state or states using the customer's billing address.

⚠ **"Billing address" means the location indicated in the books and records of the taxpayer as the primary mailing address relating to a customer's account as of the time of the transaction as kept in good faith in the normal course of business and not for tax avoidance purposes.**

- Services Delivered by Electronic Transmission to a Business Customer

  - Rule of Determination - In the case of the delivery of a service to a business customer by electronic transmission, the service is delivered in Tennessee if and to the extent that the taxpayer's customer receives the service in Tennessee. If the taxpayer can determine the state or states where the service is received, it shall assign the sale to such state or states. For purposes of this section, it is intended that the state or states where the service is received reflect the location at which the service is directly used by the employees or designees of the customer.

  - Rules of Reasonable Approximation - If the taxpayer cannot determine the state or states where the customer actually receives the service, but has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, it shall reasonably approximate such state or states.

  - Secondary Rule of Reasonable Approximation - In the case of the delivery of a service to a business customer by electronic transmission where a taxpayer does not have sufficient information from which it can determine or reasonably approximate the state or states in which the service is received, such state or states shall be reasonably approximated as set forth in this section. In such cases, unless the taxpayer can apply the safe harbor shown in the section below,[94] the taxpayer shall reasonably approximate the state or states in which the service is received as follows:

- First, by assigning the sale to the state where the contract of sale is principally managed by the customer;

- Second, if the state where the customer principally manages the contract is not reasonably determinable, by assigning the sale to the customer's place of order; and

⚠ **Definition**

"State where a contract of sale is principally managed by the customer" means the primary location at which an employee or other representative of a customer serves as the primary contact person for the taxpayer with respect to the implementation and day-to-day execution of a contract entered into by the taxpayer with the customer.

"Place of order" means the physical location from which a customer places an order for a sale other than a sale of tangible personal property from a taxpayer, resulting in a contract with the taxpayer.

- Third, if the customer's place of order is not reasonably determinable, by assigning the sale using the customer's billing address; provided, however, that in any instance in which the taxpayer derives more than 5% of its sales of services from a customer, the taxpayer is required to identify the state in which the contract of sale is principally managed by that customer.

- Safe Harbor[95] - In the case of the delivery of a service to a business customer by electronic transmission a taxpayer may not be able to determine, or reasonably approximate.[96] the state or states in which

the service is received. In these cases, the taxpayer may, in lieu of the secondary rule of reasonable approximation[97], apply the safe harbor stated in this section.
Under this safe harbor, a taxpayer may assign its sales to a particular customer *based upon the customer's billing address* in any taxable year in which the taxpayer

- engages in substantially similar service transactions with more than 250 customers, whether business or individual, and

- does not derive more than 5% of its sales of services from such customer. This safe harbor applies only for purposes of Rule to services delivered by electronic transmission to a business customer, and not otherwise.[98]

- Assume in the following examples that the taxpayer that provides the service is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012. Assume where relevant, unless otherwise stated, that the safe harbor described above and set forth at Rule 1320- 06-01-.42(4)(c)2(ii)(II)IV does not apply.

  Example 1: Support Corp, a corporation that is based outside Tennessee, provides software support and diagnostic services to individual and business customers that have previously purchased certain software from third-party vendors. These individual and business customers are located in Tennessee and other states. Support Corp supplies its services on a case-by-case basis when directly contacted by its customer. Support Corp generally provides these services through the Internet but sometimes provides these services by phone. In all cases, Support Corp verifies the customer's account information before providing any service. Using the information that Support Corp verifies before performing a service, Support Corp can determine where its services are received, and therefore must assign its sales to these locations. The sales made to Support Corp's individual and business customers are in Tennessee to the extent that Support Corp's services are received in Tennessee.[99]

Example 2: Online Corp, a corporation based outside Tennessee, provides web-based services through the means of the Internet to individual customers who are residents of Tennessee and other states. These customers access Online Corp's web services primarily in their states of residence, and sometimes, while traveling, in other states. For a substantial portion of its sales, Online Corp either can determine the state or states where such services are received, or, where it cannot determine such state or states, it has sufficient information regarding the place of receipt to reasonably approximate such state or states. However, Online Corp cannot determine or reasonably approximate the state or states of receipt for all such sales. Assuming that Online Corp reasonably believes, based on all available information, that the geographic distribution of the sales for which it cannot determine or reasonably approximate the location of the receipt of its services generally tracks those for which it does have this information, Online Corp must assign to Tennessee the sales for which it does not know the customers' location in the same proportion as those sales for which it has this information.[100]

Example 3: Same facts as in Example 2, except that Online Corp reasonably believes that the geographic distribution of the sales for which it cannot determine or reasonably approximate the location of the receipt of its web-based services do not generally track the sales for which it does have this information. Online Corp must assign the sales of its services for which it lacks information as provided to its individual customers using the customers' billing addresses.[101]

Example 4: Net Corp, a corporation based outside Tennessee, provides web-based services to a business customer, Business Corp, a company with offices in Tennessee and two neighboring states. Particular employees of Business Corp access the services from computers in each Business Corp office. Assume that Net Corp determines that Business Corp employees in Tennessee were responsible for 75% of Business Corp's use of Net Corp's services, and Business Corp employees in other states were responsible for 25% of Business Corp's use of Net Corp's services. In such case, 75% of the sale is received in Tennessee, and therefore 75% of the sale is in Tennessee.[102] Assume alternatively that Net Corp lacks sufficient information regarding the location or locations where Business Corp's employees used the services to determine or reasonably approximate such location or locations. Under these circumstances, if Net Corp derives 5% or less of its sales from Business Corp, Net Corp must assign the sale in accordance with the "Secondary Rule of Reasonable Approximation in the case of the delivery of a service to a business customer by electronic transmission;"[103] to the state where Business Corp principally managed the contract, or if that state is not reasonably determinable, to the state where Business Corp placed the order for the services, or if that state is not reasonably determinable, to the state of Business Corp's billing address. If Net Corp derives more than 5% of its sales of services from Business Corp, Net Corp is required to identify the state in which its contract of sale is principally managed by Business Corp and must assign the receipts to that state.

Example 5: Net Corp, a corporation based outside Tennessee, provides web-based services through the means of the Internet to more than 250 individual and business customers in Tennessee and in other states. Assume that for each customer Net Corp cannot determine the state or states where its web services are actually received and lacks sufficient information regarding the place of receipt to reasonably approximate such state or states. Also, assume that Net Corp does not derive more than 5% of its sales of services from any single customer. Net Corp may apply the safe harbor[104] and may assign its sales using each customer's billing address.

- *Services Delivered Electronically Through or on Behalf of an Individual or Business Customer*
  A service delivered electronically "on behalf of" the customer is one in which a customer contracts for a service to be delivered electronically but one or more third parties, rather than the customer, is the recipient of the service, such as the direct or indirect delivery of advertising on behalf of a customer to the customer's intended audience. A service delivered electronically "through" a customer to third-party recipients is a service that is delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to end users or other third-party recipients.

  - Rule of Determination - In the case of the delivery of a service by electronic transmission, where the service is delivered electronically to end users or other third-party recipients through or on behalf of the customer, the service is delivered in Tennessee if and to the extent that the end users or other third-party recipients are in Tennessee. For example, in the case of the direct or indirect delivery of advertising on behalf of a customer to the customer's intended audience by electronic means, the service is delivered in Tennessee to the extent that the audience for such advertising is in Tennessee. In the case of the delivery of a service to a customer that acts as an intermediary in reselling the service in substantially identical form to third-party recipients, the service is delivered in Tennessee to the extent that the end users or other third-party recipients receive such services in Tennessee. The rules in this subsection apply whether the taxpayer's customer is an individual customer or a business customer and whether the end users or other third-party recipients to whom the services are delivered through or on behalf of the customer are individuals or businesses.

- Rule of Reasonable Approximation - If the taxpayer cannot determine the state or states where the services are actually delivered to the end users or other third-party recipients either through or on behalf of the customer, but has sufficient information regarding the place of delivery from which it can reasonably approximate the state or states where the services are delivered, it shall reasonably approximate such state or states.

- Select Secondary Rules of Reasonable Approximation - Where a taxpayer's service is the direct or indirect electronic delivery of advertising on behalf of its customer to the customer's intended audience, if the taxpayer lacks sufficient information regarding the location of the audience from which it can determine or reasonably approximate such location, the taxpayer shall reasonably approximate the audience in a state for such advertising using the following secondary rules of reasonable approximation. Where a taxpayer is delivering advertising directly or indirectly to a known list of subscribers, the taxpayer shall reasonably approximate the audience for advertising in a state using a percentage that reflects the ratio of the state's subscribers in the specific geographic area in which the advertising is delivered relative to the total subscribers in such area. For a taxpayer with less information about its audience, the taxpayer shall reasonably approximate the audience in a state using the percentage that reflects the ratio of the state's population in the specific geographic area in which the advertising is delivered relative to the total population in such area.
Where a taxpayer's service is the delivery of a service to a customer that then acts as the taxpayer's intermediary in reselling such service to end users or other third-party recipients, if the taxpayer lacks sufficient information regarding the location of the end users or other third-party recipients from which it can determine or reasonably approximate such location, the

taxpayer shall reasonably approximate the extent to which the service is received in a state by using the percentage that reflects the ratio of the state's population in the specific geographic area in which the taxpayer's intermediary resells such services, relative to the total population in such area.

Assume in each of the following examples that the taxpayer that provides the service is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012.

Example 1: Web Corp, a corporation that is based outside Tennessee, provides Internet content to viewers in Tennessee and other states. Web Corp sells advertising space to business customers pursuant to which the customers' advertisements will appear in connection with Web Corp's Internet content. Web Corp receives a fee for running the advertisements that is determined by reference to the number of times the advertisement is viewed or clicked upon by the viewers of its website. Web Corp's sale of advertising space to its business customers is assigned to Tennessee to the extent that the viewers of the Internet content are in Tennessee, as measured by viewings or clicks.[105] If Web Corp is unable to determine the actual location of its viewers, and lacks sufficient information regarding the location of its viewers to reasonably approximate such location, Web Corp must approximate the amount of its Tennessee sales by multiplying the amount of such sales by a percentage that reflects the Tennessee population in the specific geographic area in which the content containing the advertising is delivered relative to the total population in such area.[106]

Example 2: Retail Corp, a corporation that is based outside of Tennessee, sells tangible property through its retail stores located in Tennessee and other states, and through a mail order catalog. Answer Co, a corporation that operates call centers in multiple states, contracts with Retail Corp to answer telephone calls from individuals placing orders for products found in Retail Corp's catalogs. In this case, the phone answering services of Answer Co are being delivered to Retail Corp's customers and prospective customers. Therefore, Answer Co is delivering a service electronically to Retail Corp's customers or prospective customers on behalf of Retail Corp and must assign the proceeds from this service to the state or states from which the phone calls are placed by such customers or prospective customers. If Answer Co cannot determine the actual locations from which phone calls are placed, and lacks sufficient information regarding the locations to reasonably approximate such locations, Answer Co must approximate the amount of its Tennessee sales by multiplying the amount of its fee from Retail Corp by a percentage that reflects the Tennessee population in the specific geographic area from which the calls are placed relative to the total population in such area.[107]

Example 3: Web Corp, a corporation that is based outside of Tennessee, sells tangible property to customers via its Internet website. Design Co designed and maintains Web Corp's website, including making changes to the site based on customer feedback received through the site. Design Co.'s services are delivered to Web Corp, the proceeds from which are assigned pursuant to the section on "(delivery to customer by electronic transmission).[108] The fact that Web Corp's customers and prospective customers incidentally benefit from Design Co.'s services, and may even interact with Design Co in the course of providing feedback, does not transform the service into one delivered "on behalf of" Web Corp to Web Corp's customers and prospective customers.

Example 4: Wholesale Corp, a corporation that is based outside Tennessee, develops an Internet-based information database outside Tennessee and enters into a contract with Retail Corp whereby Retail Corp will market and sell access to this database to end users. Depending on the facts, the provision of database access may be either the sale of a service or the license of intangible property or may have elements of both. Assume that on the particular facts applicable in this example Wholesale Corp is selling database access in transactions properly characterized as involving the performance of a service. When an end user purchases access to Wholesale Corp's database from Retail Corp, Retail Corp in turn compensates Wholesale Corp in connection with that transaction. In this case, Wholesale Corp's services are being delivered through Retail Corp to the end user. Wholesale Corp must assign its sales to Retail Corp to the state or states in which the end users receive access to Wholesale Corp's database. If Wholesale Corp cannot determine the state or states where the end users actually receive access to Wholesale Corp's database, and lacks sufficient information regarding the location from which the end users access the database to reasonably approximate such location, Wholesale Corp must approximate the extent to which its services are received by end users in Tennessee by using a percentage that reflects the ratio of the Tennessee population in the specific geographic area in which Retail Corp regularly markets and sells Wholesale Corp's database relative to the total population in such area.[109] Note that it does not matter for purposes of the analysis whether Wholesale Corp's sale of database access constitutes a service or a license of intangible property, or some combination of both.[110]

d) Professional Services

Except as otherwise provided in the next section,[111] professional services are services that require specialized knowledge and, in some cases, require a professional certification, license or degree. Professional services include, without limitation, management services, bank and financial services, financial custodial services, investment and brokerage services, fiduciary services, tax preparation, payroll and accounting services, lending and credit card services, legal services, consulting services, video production services, graphic and other design services, engineering services, and architectural services.

When there is an overlap with other categories of services:

- Certain services that fall within the definition of "professional services" (described above)[112] are nevertheless treated as "in-person services" within the meaning of the rule concerning "in-person services,"[113] and are assigned under rule section on in-person services.[114] Specifically, professional services that are physically provided in person by the taxpayer such as carpentry, certain medical and dental services or child care services, where the customer or the customer's real or tangible property upon which the services are provided is in the same location as the service provider at the time the services are performed, are "in-person services" and are assigned as such, notwithstanding that they may also be considered to be "professional services". However, professional services where the service is of an intellectual or intangible nature, such as legal, accounting, financial and consulting services, are assigned as professional services under rule section on professional services[115] notwithstanding the fact that such services may involve some amount of in-person contact.

- Professional services may in some cases include the transmission of one or more documents or other communications by mail or by electronic means. However, in such cases, despite this transmission, the assignment rules that apply are those described in the section on professional services,[116] and not those set forth in the section on "services delivered to the customer or on behalf of the customer, or delivered electronically through the customer"[117], pertaining to services delivered to a customer or through or on behalf of a customer.

Assignment of Sales:

- In the case of a professional service, it is generally possible to characterize the location of delivery in multiple ways by emphasizing different elements of the service provided, no one of which will consistently represent the market for the services. Therefore, for purposes of consistent application of the market-sourcing rule stated in Tenn. Code Ann. § 67-4-2012, the Commissioner has concluded that the location of delivery in the case of professional services is not susceptible to a general rule of determination and must be reasonably approximated. The assignment of a sale of a professional service depends in many cases upon whether the customer is an individual or business customer. In any instance in which the taxpayer, acting in good faith, cannot reasonably determine whether the customer is an individual or business customer, the taxpayer shall treat the customer as a business customer. For purposes of assigning the sale of a professional service, a taxpayer's customer is the person who contracts for such service, irrespective of whether another person pays for or also benefits from the taxpayer's services.

  - General Rule – Sales of professional services other than architectural and engineering services,[118] discussed in the next section, are assigned as follows:

    - *Professional Services Delivered to Individual Customers*. Except as otherwise provided in this section (professional services), in any instance in which the service provided is a professional service and the taxpayer's customer is an individual customer, the state or states in which the service is delivered shall be reasonably approximated as set forth above in this section. In particular, the taxpayer should assign the sale to the customer's state of primary residence, or, if the taxpayer cannot reasonably identify the customer's state of primary residence, to the state of the customer's billing address; provided, however, in any instance in which the taxpayer derives more than 5% of its sales of services from an individual customer, the taxpayer is required to identify the customer's state of primary residence and must assign the receipts from the service or services provided to that customer to that state.

- *Professional Services Delivered to Business Customers.* Except as otherwise provided in this section[119] in any instance in which the service provided is a professional service and the taxpayer's customer is a business customer, the state or states in which the service is delivered shall be reasonably approximated as set forth in this section.[120] In particular, unless the taxpayer may use the safe harbor, described below, the taxpayer should assign the sale as follows:

  First, by assigning the receipts to the state where the contract of sale is principally managed by the customer;

  Second, if such place of customer management is not reasonably determinable, to the customer's place of order; and

  Third, if such customer's place of order is not reasonably determinable, to the customer's billing address;

  However, in any instance in which the taxpayer derives more than 5% of its sales of services from a customer, the taxpayer is required to identify the state in which the contract of sale is principally managed by the customer.

- *Safe Harbor; Large Volume of Transactions.* Notwithstanding the rules set forth in the two prior sections[121] a taxpayer may assign its sales to a particular customer based on the customer's billing address in any taxable year in which the taxpayer

  - engages in substantially similar service transactions with more than 250 customers, whether individual or business, and

  - does not derive more than 5% of its sales of services from such customer.

  This safe harbor applies only for purposes of sale of professional services other than architectural and engineering[122] not otherwise.

- *Architectural and Engineering Services with Respect to Real or Tangible Personal Property*

  Architectural and engineering services with respect to real or tangible personal property are professional services within the meaning of this section.[123] However, unlike in the case of the general rule that applies to professional services,

    - the sale of such an architectural service is assigned to a state or states if and to the extent that the services are with respect to real estate improvements located, or expected to be located, in such state or states; and

    - the sale of such an engineering service is assigned to a state or states if and to the extent that the services are with respect to tangible or real property located in such state or states, including real estate improvements located in, or expected to be located in, such state or states. These rules apply whether the customer is an individual or business customer. In any instance in which architectural or engineering services are not described in this section[124] the sale of such services shall be assigned under the general rule for professional services.

  Example 1: Architecture Corp provides building design services as to buildings located, or expected to be located, in Tennessee to individual customers who are residents of Tennessee and other states, and to business customers that are based in Tennessee and other states. Architecture Corp's sales are assigned to Tennessee because the locations of the buildings to which its design services relate are in Tennessee or are expected to be in Tennessee. For purposes of assigning these sales, it is not relevant where, in the case of an individual customer, the customer primarily resides or is billed for such services, and it is not relevant where, in the case of a business customer, the customer principally manages the contract, placed the order for the services or is billed for such services. Further, such sales are assigned to Tennessee even if Architecture Corp's designs are either physically delivered to its customer in paper form in a state other than Tennessee or are electronically delivered to its customer in a state other than Tennessee.[125]

Example 2: Law Corp provides legal services to individual clients who are residents of Tennessee and other states. In some cases, Law Corp may prepare one or more legal documents for its client as a result of these services and/or the legal work may be related to litigation or a legal matter that is ongoing in a state other than where the client is resident. Assume that Law Corp knows the state of primary residence for many of its clients, and where it does not know this state of primary residence, it knows the client's billing address. Also assume that Law Corp does not derive more than 5% of its sales of services from any one individual client. Where Law Corp knows its client's state of primary residence, it shall assign the sale to that state. Where Law Corp does not know its client's state of primary residence, but rather knows the client's billing address, it shall assign the sale to that state. For purposes of the analysis, it is irrelevant whether the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or the litigation or other legal matter that is the underlying predicate for the services is in another state.[126]

Example 3: Law Corp provides legal services to several multistate business clients. In each case, Law Corp knows the state in which the agreement for legal services that governs the client relationship is principally managed by the client. In one case, the agreement is principally managed in Tennessee; in the other cases, the agreement is principally managed in a state other than Tennessee. Where the agreement for legal services is principally managed by the client in Tennessee, the sale of the services shall be assigned to Tennessee; in the other cases, the sale is not assigned to Tennessee. In the case of the sale that is assigned to Tennessee, the sale shall be so assigned even if (1) the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or (2) the litigation or other legal matter that is the underlying predicate for the services is in another state.[127]

Example 4: Consulting Corp, a company that provides consulting services to law firms and other customers, is hired by Law Corp in connection with legal representation that Law Corp provides to Client Co. Specifically, Consulting Corp is hired to provide expert testimony at a trial being conducted by Law Corp on behalf of Client Co. Client Co pays for Consulting Corp's services directly. Assuming that Consulting Corp knows that its agreement with Law Corp is principally managed by Law Corp in Tennessee, the sale of Consulting

Corp's services shall be assigned to Tennessee. It is not relevant for purposes of the analysis that Client Co is the ultimate beneficiary of Consulting Corp's services, or that Client Co pays for Consulting Corp's services directly.[128]

Example 5: Advisor Corp, a corporation that provides investment advisory services, provides such advisory services to Investment Co. Investment Co is a multistate business client of Advisor Corp that uses Advisor Corp's services in connection with investment accounts that it manages for individual clients, who are the ultimate beneficiaries of Advisor Corp's services. Assume that Investment Co.'s individual clients are persons that are residents of numerous states, which may or may not include Tennessee. Assuming that Advisor Corp knows that its agreement with Investment Co is principally managed by Investment Co in Tennessee, the sale of Advisor Corp's services shall be assigned to Tennessee. It is not relevant for purposes of the analysis that the ultimate beneficiaries of Advisor Corp's services may be Investment Co.'s clients, who are residents of numerous states.[129]

Example 6: Design Corp is a corporation based outside Tennessee that provides graphic design and similar services in Tennessee and in neighboring states. Design Corp enters into a contract at a location outside Tennessee with an individual customer to design fliers for the customer. Assume that Design Corp does not know the individual customer's state of primary residence and does not derive more than 5% of its sales of services from the individual customer. All the design work is performed outside Tennessee. The sale is in Tennessee if the customer's billing address is in Tennessee.[130]

e) Broadcast Advertising Services

Notwithstanding anything herein to the contrary, receipts from a broadcaster's sale of advertising services to a broadcast customer are assigned to Tennessee if the commercial domicile of the broadcast customer is in Tennessee. For purposes of this provision, "advertising services" means an agreement to include the broadcast customer's advertising content in the broadcaster's film programming.

⚠ **Definition**

"Broadcast customer" means a person, corporation, partnership, limited liability company, or other entity, such as an advertiser or a platform distribution company, that has a direct connection or contractual relationship with the broadcaster under which revenue is derived by a broadcaster.

"Broadcaster" means a taxpayer that is a television broadcast network, a cable program network, or a television distribution company. The term "broadcaster" does not include a platform distribution company.

"Commercial domicile" means the principal place from which the trade or business of a business entity is directed or managed.

"Film programming" means one or more performances, events, or productions (or segments of performances, events, or productions) intended to be distributed for visual and auditory perception, including but not limited to news, entertainment, sporting events, plays, stories, or other literary, commercial, educational, or artistic works.

5. Rental, lease, or license of intangible property

a) General rule

The receipts from the rental, lease, or license of intangible property are in Tennessee if and to the extent the intangible is used in Tennessee. In general, the term "use" shall be construed to refer to the location of the taxpayer's market for the use of the intangible property that is being rented, leased, or licensed and is not to be construed to refer to the location of the property or payroll of the taxpayer.

In general, a rental, lease, or license of intangible property that conveys all substantial rights in such property is treated as a sale of intangible property for tax purposes.[131] See section on the license of intangible property below. Note, however, that for purposes of this section and the following section ("license of intangible property,"[132] a sale or exchange of intangible property is treated as a license of such property where the receipts from the sale or exchange derive from payments that are contingent on the productivity, use or disposition of the property.

Intangible property rented, leased, or licensed as part of the sale or lease of tangible property is treated under Rule 1320-06-01-.42 as the sale or lease of tangible property.

b) <u>License of a Marketing Intangible</u>

Where a license is granted for the right to use intangible property in connection with the sale, rental, lease, license, or other marketing of goods, services, or other items (i.e., a marketing intangible), the royalties or other licensing fees paid by the licensee for such right are assigned to Tennessee to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by customers in Tennessee. Examples of a license of a marketing intangible include, without limitation, the license of a service mark, trademark, or trade name; certain copyrights and a franchise agreement. In each of these instances the license of the marketing intangible is intended to promote consumer sales. In the case of the license of a marketing intangible, where a taxpayer has actual evidence of the amount or proportion of its receipts that is attributable to Tennessee, it shall assign such amount or proportion to Tennessee. In the absence of actual evidence of the amount or proportion of the licensee's receipts that are derived from Tennessee customers, the portion of the licensing fee to be assigned to Tennessee shall be reasonably approximated by multiplying the total fee by a percentage that reflects the ratio of the Tennessee population in the specific geographic area in which the licensee makes material use of the intangible property to regularly market its goods, services or other items relative to the total population in such area. Where the license of a marketing intangible is for the right to use the intangible property in connection with sales or other transfers at wholesale rather than directly to retail customers, the portion of the licensing fee to be assigned to Tennessee shall be reasonably approximated by multiplying the total fee by a percentage that reflects the ratio of the Tennessee population in the specific geographic area in which the licensee's goods, services, or other items are ultimately marketed using the intangible property relative to the total population of such area.

c) <u>License of a Production Intangible</u>

Where a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, and the license is to be used in a production capacity (a “production intangible”), the licensing fees paid by the licensee for such right are assigned to

Tennessee to the extent that the use for which the fees are paid takes place in Tennessee. Examples of a license of a production intangible include, without limitation, the license of a patent, a copyright, or trade secrets to be used in a manufacturing process, where the value of the intangible lies predominately in its use in such process. In the case of a license of a production intangible, it shall be presumed that the use of the intangible property takes place in the state of the licensee's commercial domicile (where the licensee is a business) or the licensee's state of primary residence (where the licensee is an individual) unless the taxpayer or the Commissioner can reasonably establish the location(s) of actual use. Where the Commissioner can reasonably establish that the actual use of intangible property pursuant to a license of a production intangible takes place in part in Tennessee, it shall be presumed that the entire use is in Tennessee except to the extent that the taxpayer can demonstrate that the actual location of a portion of the use takes place outside Tennessee.

d) License of a Broadcasting Intangible

Where a broadcaster grants a license to a broadcast customer for the right to use film programming, the licensing fees paid by the licensee for such right are assigned to Tennessee to the extent that the broadcast customer is located in Tennessee. In the case of business customers, the broadcast customer's location shall be determined using the broadcast customer's commercial domicile. In the case of individual customers, the broadcast customer's location shall be determined using the address of the broadcast customer listed in the broadcaster's records.

e) License of a Mixed Intangible

Where a license of intangible property includes both a license of a marketing intangible and a license of a production intangible (a "mixed intangible") and the fees to be paid in each instance are separately and reasonably stated in the licensing contract, the Commissioner will accept such separate statement for purposes of this section if it is reasonable. Where a license of intangible property includes both a license of a marketing intangible and a license of a production intangible and the fees to be paid in each instance are not separately and reasonably stated in the contract, it shall be presumed that the licensing fees are paid entirely for the license of the marketing intangible except to the extent that the taxpayer or the Commissioner can reasonably establish otherwise.

f) License of Intangible Property where Substance of Transaction Resembles a Sale of Goods or Services

- ***In general.*** In some cases, the license of intangible property will resemble the sale of an electronically-delivered good or service rather than the license of a marketing intangible or a production intangible. In such cases, the receipts from the licensing transaction shall be assigned by applying the rules set forth in the section on "sales of services delivered to the customer or on behalf of the customer, or delivered electronically through the customer"[133] as if the transaction were a service delivered to an individual or business customer or delivered electronically through an individual or business customer, as applicable. Examples of transactions to be assigned under this section include, without limitation, the license of database access, the license of access to information, the license of digital goods[134] and the license of certain software (e.g., where the transaction is not the license of pre-written software that is treated as the sale of tangible personal property, discussed in the section on special rules.[135]

- ***Sublicenses.*** Pursuant to the above paragraph (general guidance), the earlier section of the rule on "services delivered electronically through or on behalf of an individual or business customer"[136] may apply where a taxpayer licenses intangible property to a customer that in turn sublicenses the intangible property to end users as if the transaction were a service delivered electronically through a customer to end users. In particular, the rules [137] that apply to services delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to end users or other recipients may also apply with respect to licenses of intangible property for purposes of sublicense to end users, provided that for this purpose the intangible property sublicensed to an end user shall not fail to be substantially identical to the property that was licensed to the sublicensor merely because the sublicense transfers a reduced bundle of rights with respect to such property (e.g., because the sublicensee's rights are limited to its own use of the property and do not include the ability to grant a further sublicense), or because such property is bundled with additional services or items of property.

g) Examples

Assume in each of the following examples that the taxpayer that licenses the intangible property is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012.

Example 1: Crayon Corp and Dealer Co enter into a license contract under which Dealer Co as licensee is permitted to use trademarks that are owned by Crayon Corp in connection with Dealer Co.'s sale of certain products to retail customers. Under the contract, Dealer Co is required to pay Crayon Corp a licensing fee that is a fixed percentage of the total volume of monthly sales made by Dealer Co of products using the Crayon Corp trademarks. Under the contract, Dealer Co is permitted to sell the products at multiple store locations, including store locations that are both within and without Tennessee. Further, the licensing fees that are paid by Dealer Co are broken out on a per-store basis. The licensing fees paid to Crayon Corp by Dealer Co represent fees from the license of a marketing intangible. The portion of the fees to be assigned to Tennessee shall be determined by multiplying the fees by a percentage that reflects the ratio of Dealer Co.'s receipts that are derived from its Tennessee stores relative to Dealer Co.'s total receipts. [138]

Example 2: Network Corp is a broadcaster that licenses rights to its film programming to both platform distribution companies and individual customers. Platform distribution companies pay licensing fees to Network Corp for the rights to distribute Network Corp's film programming to the platform distribution companies' customers. Network Corp's individual customers pay access fees to Network Corp for the right to directly access and view Network Corp's film programming. Network Corp's receipts from each platform distribution company will be assigned to Tennessee if the broadcast customer's commercial domicile is in Tennessee. Network Corp's receipts from each individual broadcast customer will be assigned to Tennessee if the address of the broadcast customer listed in the broadcaster's records is in Tennessee.[139]

⚠ **Definition**

"Platform distribution company" means a cable service provider, a direct broadcast satellite system, an Internet content distributor, or any other distributor that directly charges viewers for access to any film programming.

Example 3: Moniker Corp enters into a license contract with Wholesale Co. Pursuant to the contract Wholesale Co is granted the right to use trademarks owned by

Moniker Corp to brand sports equipment that is to be manufactured by Wholesale Co or an unrelated entity, and to sell the manufactured equipment to unrelated companies that will ultimately market the equipment to consumers in a specific geographic region, including a foreign country. The license agreement confers a license of a marketing intangible, even though the trademarks in question will be affixed to property to be manufactured. In addition, the license of the marketing intangible is for the right to use the intangible property in connection with sales to be made at wholesale rather than directly to retail customers. The component of the licensing fee that constitutes the Tennessee sales of Moniker Corp is determined by multiplying the amount of the fee by a percentage that reflects the ratio of the Tennessee population in the specific geographic region relative to the total population in such region.[140]

Example 4: Formula, Inc. and Appliance Co enter into a license contract under which Appliance Co is permitted to use a patent owned by Formula, Inc. to manufacture appliances. The license contract specifies that Appliance Co is to pay Formula, Inc. a royalty that is a fixed percentage of the gross receipts from the products that are later sold. The contract does not specify any other fees. The appliances are both manufactured and sold in Tennessee and several other states. Assume the licensing fees are paid for the license of a production intangible, even though the royalty is to be paid based upon the sales of a manufactured product (i.e., the license is not one that includes a marketing intangible). Because the Commissioner can reasonably establish that the actual use of the intangible property takes place in part in Tennessee, the royalty is assigned based on the location of such use rather than to location of the licensee's commercial domicile, in accordance with the rule on the license of a production intangible[141]. It is presumed that the entire use is in Tennessee except to the extent that the taxpayer can demonstrate that the actual location of some or all of the use takes place outside Tennessee. Assuming that Formula, Inc. can demonstrate the percentage of manufacturing that takes place in Tennessee using the patent relative to such manufacturing in other states, that percentage of the total licensing fee paid to Formula, Inc. under the contract will constitute Formula, Inc.'s Tennessee sales. [142]

Example 5: Axel Corp enters into a license agreement with Biker Co in which Biker Co is granted the right to produce motor scooters using patented technology owned by Axel Corp, and also to sell such scooters by marketing the fact that the scooters were manufactured using the special technology. The contract is a license of both a marketing and production intangible, i.e., a mixed intangible. The scooters are manufactured outside Tennessee. Assume that Axel Corp lacks actual information regarding the proportion of Biker Co.'s receipts that are derived from Tennessee customers. Also assume that Biker Co is granted the right to sell the scooters in a U.S. geographic region in which the Tennessee population constitutes 25% of the total population during the period in question. The licensing contract requires an upfront licensing fee to be paid by Biker Co to Axel Corp and does not specify what percentage of the fee derives from Biker Co.'s right to use Axel Corp's patented technology. Because the fees for the license of the marketing and production intangible are not separately and reasonably stated in the contract, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible, unless either the taxpayer or Commissioner reasonably establishes otherwise. Assuming that neither party establishes otherwise, 25% of the licensing fee constitutes Tennessee sales.[143]

Example 6: Same facts as Example 5, except that the license contract specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing contract constitutes both the license of a marketing intangible and the license of a production intangible. Assuming that the separately stated fees are reasonable, the Commissioner will: (1) assign no part of the licensing fee paid for the production intangible to Tennessee, and (2) assign 25% of the licensing fee paid for the marketing intangible to Tennessee.[144]

Example 7: Better Burger Corp, which is based outside Tennessee, enters into franchise contracts with franchisees who agree to operate Better Burger restaurants as franchisees in various states. Several of the Better Burger Corp franchises are in Tennessee. In each case, the franchise contract between the individual and Better Burger provides that the franchisee is to pay Better Burger Corp an upfront fee for the receipt of the franchise and monthly franchise fees, which cover, among other things, the right to use the Better Burger name and service marks, food processes and cooking know-how, as well as fees for management services. The upfront fees for the receipt of the Tennessee franchises constitute fees paid for the licensing of a marketing intangible. These fees constitute Tennessee sales because the franchises are for the right to make Tennessee sales. The monthly franchise fees paid by Tennessee franchisees constitute fees paid for (1) the license of marketing intangibles (the Better Burger name and service marks), (2) the license of production intangibles (food processes and expertise) and (3) personal services (management fees). The fees paid for the license of the marketing intangibles and the production intangibles constitute Tennessee sales because in each case the use of the intangibles is to take place in Tennessee.[145] The fees paid for the personal services are to be assigned pursuant to the above section on sale of a service. [146]

Example 8: Online Corp, a corporation based outside Tennessee, licenses an information database through the means of the Internet to individual customers that are residents of Tennessee and other states. These customers access Online Corp's information database primarily in their states of residence, and sometimes, while traveling, in other states. The license is a license of intangible property that resembles a sale of goods or services and shall be assigned in accordance with the above section on license of intangible property where substance of the transaction resembles a ale of goods or services.[147] If Online Corp can determine or reasonably approximate the state or states where its database is accessed, then it must do so. Assuming that Online Corp cannot determine or reasonably approximate the location where its database is accessed, Online Corp must assign the sales made to the individual customers using the customers' billing addresses to the extent known. Assume, for purposes of this example that Online Corp knows the billing address for each of its customers. In this case, Online Corp's sales made to its individual customers are in Tennessee in any case in which the customer's billing address is in Tennessee.[148]

Example 9: Net Corp, a corporation based outside Tennessee, licenses an information database through the means of the Internet to a business customer, Business Corp, a company with offices in Tennessee and two neighboring states. The license is a license of intangible property that resembles a sale of goods or services and shall be assigned in accordance with the above section on "license of intangible property where substance of the transaction resembles a sale of goods or services."[149] Assume that Net Corp cannot determine where its database is accessed but reasonably approximates that 75% of Business Corp's database access took place in Tennessee, and 25% of Business Corp's database access took place in other states. In such case, 75% of the receipts from database access is in Tennessee. Assume alternatively that Net Corp lacks sufficient information regarding the location where its database is accessed to reasonably approximate such location. Under these circumstances, if Net Corp derives 5% or less of its receipts from database access from Business Corp, Net Corp must assign the sale under the above section on "services delivered by electronic transmission to a business customer"[150] to the state where Business Corp principally managed the contract, or if that state is not reasonably determinable to the state where Business Corp placed the order for the services, or if that state is not reasonably determinable to the state of Business Corp's billing address. If Net Corp derives more than 5% of its receipts from database access from Business Corp, Net Corp is required to identify the state in which its contract of sale is principally managed by Business Corp and must assign the receipts to that state.[151]

Example 10: Net Corp, a corporation based outside Tennessee, licenses an information database through the means of the Internet to more than 250 individual and business customers in Tennessee and in other states. The license is a license of intangible property that resembles a sale of goods or services and shall be assigned in accordance with the above section "license of intangible property where substance of the transaction resembles a sale of goods or services."[152] Assume that Net Corp cannot determine or reasonably approximate the location where its information database is accessed. Also, assume that Net Corp does not derive more than 5% of its sales of database access from any single customer. Net Corp may apply the safe harbor stated above concerning services delivered by electronic transmission to a business customer, [153] and may assign its sales to a state or states using each customer's billing address.

Example 11: Web Corp, a corporation based outside of Tennessee, licenses an Internet-based information database to business customers who then sublicense the database to individual end users that are residents of Tennessee and other states. These end users access Web Corp's information database primarily in their states of residence, and sometimes, while traveling, in other states. Web Corp's license of the database to its customers includes the right to sublicense the database to end users, while the sublicenses provide that the rights to access and use the database are limited to the end users' own use and prohibit the individual end users from further sublicensing the database. Web Corp receives a fee from each customer based upon the number of sublicenses issued to end users. The license is a license of intangible property that resembles a sale of goods or services and shall be assigned by applying the rules set forth in the prior section "services delivered electronically through or on behalf of an individual or business customer."[154] See the prior section "license of intangible property where substance of the transaction resembles a sale of goods or services."[155] If Web Corp can determine or reasonably approximate the state or states where its database is accessed by end users, then it must do so. Assuming that Web Corp lacks sufficient information from which it can determine or reasonably approximate the location where its database is accessed by end users, Web Corp must approximate the extent to which its database is accessed in Tennessee using a percentage that represents the ratio of the Tennessee population in the specific geographic area in which Web Corp's customer sublicenses the database access relative to the total population in such area.[156]

6. Sale of intangible property

a) **Assignment of Sales**

The assignment of a sale to a state or states in the instance of a sale or exchange of intangible property depends upon the nature of the intangible property sold. For purposes of this section, a sale or exchange of intangible property includes a license of such property where the transaction is treated, for tax purposes, as a sale of all substantial rights in the property and the receipts from transaction are not contingent on the productivity, use or disposition of the property. For the rules that apply where the consideration for the transfer of rights is contingent on the productivity, use or disposition of the property.[157]

- Contract Right or Government License that Authorizes Business Activity in Specific Geographic Area
  - In the case of a sale or exchange of intangible property where the property sold or exchanged is a contract right, government license or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area, the sale is assigned to a state if and to the extent that the intangible property is used or otherwise associated with the state. Where the intangible property is used in, or otherwise associated with, only Tennessee, the taxpayer shall assign the sale to Tennessee. Where the intangible property is used in or is otherwise associated with Tennessee and one or more other states, the taxpayer shall assign the sale to Tennessee to the extent that the intangible property is used in, or associated with, Tennessee, through the means of a reasonable approximation.

- Agreement Not to Compete
  - An agreement or covenant not to compete in a specified geographic area requires the contract party to refrain from conducting certain business activity in that specified area. In the case of an agreement or covenant not to compete, the receipts are to be assigned to a state based upon the percentage that reflects the state's population in the U.S. geographic area specified in the contract relative to the total population in such area.

- Sale that Resembles a License (Receipts are Contingent on Productivity, Use or Disposition of the Intangible Property)

  - In the case of a sale or exchange of intangible property where the receipts from the sale or exchange are contingent on the productivity, use or disposition of the property, the receipts from the sale shall be assigned by applying the rules set forth in Rule 1320-06-01-.42(5) (pertaining to the license or lease of intangible property).

- Sale that Resembles a Sale of Goods and Services

  - In the case of a sale or exchange of intangible property where the substance of the transaction resembles a sale of goods or services and where the receipts from the sale or exchange do not derive from payments contingent on the productivity, use or disposition of the property, the receipts from the sale shall be assigned by applying the rules set forth in Rule 1320-06-01-.42(5)(f) (relating to licenses of intangible property that resemble sales of goods and services). Examples of such transactions include those that are analogous to the license transactions cited as examples in Rule 1320-06-01-.42(5)(f).

- Except as otherwise provided in this section, the sale of intangible property that is not referenced in the first, second and fourth bulleted sections above should be excluded from the numerator and the denominator of the taxpayer's sales factor.

b) <u>Examples</u>

Assume, in each of these examples, that the taxpayer that provides the service is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012.

<u>Example 1</u>: Airline Corp, a corporation based outside Tennessee, sells its rights to use several gates at an airport located in Tennessee to Buyer Corp, a corporation that is based outside Tennessee. The contract of sale is negotiated and signed outside of Tennessee. The sale is in Tennessee because the intangible property sold is a contract right that authorizes the holder to conduct a business activity solely in Tennessee. See the first item in section (6)(a) above.[158]

Example 2: Wireless Corp, a corporation based outside Tennessee, sells a license issued by the Federal Communications Commission (FCC) to operate wireless telecommunications services in a designated area in Tennessee to Buyer Corp, a corporation that is based outside Tennessee. The contract of sale is negotiated and signed outside of Tennessee. The sale is in Tennessee because the intangible property sold is a government license that authorizes the holder to conduct business activity solely in Tennessee. See the first item in section (6)(a) above.

Example 3: Same facts as in Example 2 except that Wireless Corp sells to Buyer Corp an FCC license to operate wireless telecommunications services in a designated area in Tennessee and an adjacent state. Wireless Corp must attempt to reasonably approximate the extent to which the intangible property is used in or associated with Tennessee. For purposes of making this reasonable approximation, Wireless Corp may rely upon credible data that identifies the percentage of persons that use wireless telecommunications in the two states covered by the license.[159]

Example 4: Sports League Corp, a corporation that is based outside Tennessee, sells the rights to broadcast the sporting events played by the teams in its league in all 50 U.S. states to Network Corp. Although the games played by Sports League Corp will be broadcast in all 50 states, the games are of greater interest in the southeast region of the country, including Tennessee. Because the intangible property sold is a contract right that authorizes the holder to conduct a business activity in a specified geographic area, Sports League Corp must attempt to reasonably approximate the extent to which the intangible property is used in or associated with Tennessee. For purposes of making this reasonable approximation, Sports League Corp may rely upon audience measurement information that identifies the percentage of the audience for its sporting events in Tennessee and the other states.[160]

Example 5: Business Corp, a corporation based outside Tennessee engaged in business activities in Tennessee and other states, enters into a covenant not to compete with Competition Corp, a corporation that is based outside Tennessee, in exchange for a fee. The agreement requires Business Corp to refrain from engaging in certain business activity in Tennessee and other states. The component of the fee that constitutes a Tennessee sale is determined by multiplying the amount of the fee by a fraction represented by the percentage of the Tennessee population over the total population in the specified geographic region.[161]

<u>Example 6:</u> Inventor Corp, a corporation that is based outside Tennessee, sells patented technology that it has developed to Buyer Corp, a business customer that is based in Tennessee. Assume that the sale is not one in which the receipts derive from payments that are contingent on the productivity, use or disposition of the property. See the discussion on “sale that resembles a sale of goods and services” discussed in the prior section.[162] Inventor Corp understands that Buyer Corp is likely to use the patented technology in Tennessee, but the patented technology can be used anywhere (i.e., the rights sold are not rights that authorize the holder to conduct a business activity in a specific geographic area). The sale of the patented technology shall be excluded from the numerator and denominator of Inventor Corp’s sales factor. See the prior section on when the sale of intangible property is excluded from both the numerator and denominator.[163]

7. Special rules

a) <u>Software Transactions</u>

A license or sale of pre-written software for purposes other than commercial reproduction (or other exploitation of the intellectual property rights), when transferred on a tangible medium, is treated as the sale of tangible personal property, rather than as either the license or sale of intangible property or the performance of a service. In such cases, the receipts are assigned to Tennessee as a sale of tangible personal property. <u>In all other cases</u>, the receipts from a license or sale of software are to be assigned to Tennessee as determined otherwise under this market-based sourcing rule.[164]

<u>For example</u>, depending on the facts, as the *development and sale of custom software* see the above section on “sale of a service – services delivered to the customer or on behalf of the customer or delivered electronically through the customer”,[165] as a *license of a marketing intangible*, see the above section on “rental, lease, or license of intangible property – license of a marketing intangible,[166] *as a license of a production intangible*, see the above section on “rental, lease, or license of intangible property – license of a production intangible,”[167] as a license of intangible property where the substance of the transaction *resembles a sale of goods or services,* see the above section on “rental, lease, or license of intangible property – license of intangible property where substance of transaction resembles a sale of goods or services,”[168] or as a *sale of intangible property*, see the above section on "sale of intangible property."[169]

b) Sales or Licenses of Digital Goods or Services

In the case of a sale or license of digital goods or services, including, among other things, the sale of various video, audio and software products or similar transactions, the receipts from the sale or license should be assigned by applying the guidance discussed in the prior section on "sales of services delivered to the customer or on behalf of the customer, or delivered electronically through the customer – delivery to customer by electronic transmission and – services delivered electronically through or on behalf of an individual or business customer," as if the transaction were a service delivered to an individual or business customer or delivered through or on behalf of an individual or business customer. For purposes of the analysis, it is not relevant what the terms of the contractual relationship are or whether the sale or license might be characterized, depending upon the particular facts, as, for example, the sale or license of intangible property or the performance of a service.[170]

c) Enforcement of Legal Rights

Receipts attributable to the protection or enforcement of legal rights of a taxpayer through litigation, arbitration, or settlement of legal disputes or claims, including the filing and pursuit of claims under insurance contracts, shall be excluded from the numerator and denominator of the taxpayer's sales factor. For purposes of this rule, in the case of a settlement agreement, it shall not be relevant how the parties to the agreement characterize the payment made under the agreement.

Other Than Tangible Property Sales – Tax Years Beginning before July 1, 2016

Before the Revenue Modernization Act of 2015 other-than-TPP sales were in this state if the "*earnings producing activity"* was performed: 1) in this state, or 2) both in and outside this state, and a greater proportion of the earnings producing activity was performed in this state than in any other state, based on "*costs of performance*" (COP).[171] The statutory test is an "all or nothing" proposition. If the earnings producing activity is performed entirely in Tennessee or the greater proportion of the earnings producing activity is performed in Tennessee, then the entire sale proceeds are sourced to Tennessee. Otherwise, the entire gross proceeds are sourced to another state. However, as explained below, a taxpayer may have numerous earnings producing activities, and each would be evaluated separately.

- "*Earnings producing activity*" means the transactions and activity *directly* engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit, but does not include transactions and activities performed on behalf of a taxpayer (e.g., activities conducted by an independent contractor). It applies to each separate item of income.[172]

- Earnings producing activity incudes:

    - The rendering of personal services by employees or the use of tangible and intangible property by the taxpayer in performing a service.

    - The sale, rental, leasing, or licensing or other use of real property.

    - The rental, leasing, licensing or other use of tangible personal property.

    - The sale, licensing or other use of intangible personal property. However, simply holding intangible personal property is not, of itself, an earnings producing activity.

- *"Costs of performance"* means direct costs as determined by GAAP and in accordance with accepted conditions or practices in the trade or business of the taxpayer. Direct costs do not include transactions and activities performed on behalf of a taxpayer (e.g., activities conducted by an independent contractor). "Outsourcing" costs are also excluded from the analysis since they are, by definition, not direct costs.

"In TN" Gross Receipts for Other-Than-TPP (Tax Years Beg. before July 1, 2016):

- Gross receipts from the rental, lease, licensing of real and tangible personal property are "in Tennessee" if the property is located in the state.[173]

- The rental or other use of tangible personal property in this state is a *separate earnings producing activity* from the use of the same property while located in another state.

    - For example, Taxpayer is the owner of 10 railroad cars. During the year, the total of the days each railroad car was present in this state was 50 days. The receipts attributable to the use of each of the railroad cars in this state are a separate item of income.

- **Tennessee Receipts = ((10 X 50 = 500) / 3,650) X Total Receipts**

- When services are performed in more than one state, the services performed in each state will often constitute *a separate earnings producing activity*. The gross receipts for the performance of services attributable to this state are determined by the ratio of time spent in performing the services in this state to the total time spent in performing such services everywhere.

- Time spent in performing services includes the amount of the time expended in the performance of a contract or other obligation that gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation (e.g., time expended in negotiating the contract) is excluded from the computation.)

  - Taxpayer gave theatrical performances at various locations in State X and in Tennessee during the tax period. All gross receipts from performances given in this state are attributed to this state.

  - Taxpayer, a public opinion survey corporation, conducted a poll by its employees in State X and in Tennessee for the sum of $9,000. The project required 600 man-hours to obtain the basic data and prepare the survey report. 200 of the 600 man-hours were expended in Tennessee. The receipts attributable to Tennessee are:

$$\$3,000 = \frac{(200 \text{ man-hours} \times \$9,000)}{600 \text{ man-hours}}$$

  - A taxpayer receiving royalty/license income based on Tennessee sales or activities should source the royalty/license fee income to Tennessee. Usually, royalty/license agreements provide that a certain percentage of product sales will be paid to the holder of the intellectual property as a royalty or license fee. These fees for products sold to Tennessee customers would be sourced to Tennessee.[174]

  - The numerator value of interest and dividend income that are business earnings are generally sourced to the taxpayer's commercial domicile;[175] in other words, where the investments are managed and controlled.

Telecommunication Industry – Special Sales Sourcing Rules

The telecommunication industry computes Tennessee other-than-TPP receipts for the standard apportionment factor by using an average of the cost-of-performance and market-based sourcing methods.[176, 177] The "In TN" sales factor is:

- Receipts from sales of tangible personal property, plus
- The *average* of receipts from other-than-TPP sales calculated under the cost-of-performance method[178] and the market-based sourcing method.[179]

The above methodology applies only to those who principally sell telecommunication services, internet access, video programing, satellite-television, etc. and are in an affiliated group that either incurs qualified expenditures greater than $150 million during the tax period or makes sales subject to the sales & use tax in excess of $150 million (qualified members[180] of a qualified group).[181] Qualified expenditures are purchases of tangible personal property placed in Tennessee or payroll for employees in Tennessee.

⚠ **Audit Tip**
Telecom taxpayers should retain detailed records to support their unique calculation of the sales factor.

Telecom taxpayers report Tennessee and everywhere receipts for tangible and other-than-tangible sales on Schedule N and retain detailed records to support their calculations.

The cost of performance method was used by all taxpayers to source other-than-TPP sales prior to July 1, 2016, but after this date this method is only used by taxpayers providing telecommunication and similar services. Rule 34, revised September 2016, discusses the cost of performance methodology, but it now only applies to qualified members of a qualified group; namely those providing telecommunication and similar services.

Dealer in Securities

A taxpayer that is a dealer in securities under 26 USC §475 is subject to a specific apportionment provision of the Tennessee code.[182] The net gain or income from the sale of a security is sourced to Tennessee if the dealer's customer is located in Tennessee. If the residence or commercial domicile of the customer is unknown, the receipt is sourced based on the billing address as shown in the dealer's records.

In other words, receipts equal to the net gain or income from the sale of a security made by a person who is a dealer in such security (26 U.S.C. § 475) should be attributed to Tennessee if such person's customer is located in Tennessee and such receipt is not otherwise attributed under the Tennessee code as a receipt from the sale if an asset (tangible or intangible).[183] A customer is in this state if the customer is an individual, trust, or estate that is a resident of this state and, for all other customers, if the customer's commercial domicile is in this state. Unless the dealer has actual knowledge of the residence or commercial domicile of a customer during a taxable year, the customer shall be deemed to be a customer in this state if the billing address of the customer, as shown in the records of the dealer, is in this state.

Audit Procedures – Sales Factor – Standard Apportionment (Schedule N)

- Identify the business entities that should be included in the sales factor. Consider:
    - Owned pass-through entities not filing excise tax returns on their own
    - Disregarded entities

- Determine that the correct apportionment schedule was used. Consider if the taxpayer is required to file on a non-standard apportionment schedule (Schedules O, P, R, S) or if the taxpayer is a qualified member in the telecommunication industry, and therefore, has special apportionment calculation requirements.

- Identify all sources of income (e.g., product sales, service sales, rents, interest, property disposition, dividends, other).

- Determine that receipts reported in the sales factor were valued at their gross amounts. If applicable, include a narrative in the audit file to explain the use of net receipts.

- Identify sources of income from other-than-TPP sales.
    - For tax years beginning before July 1, 2016, determine whether the greater of "costs of performance" occurred in Tennessee.
    - For tax years beginning on or after July 1, 2016, verify that the receipts were sourced based on Rule 42 for market-based sourcing.[184]
    - Include a narrative in the audit workpapers to explain the audit work done, documents relied on, and the conclusions reached regarding the sourcing.

- Document how you determined the "In Tennessee" receipts for tangible property sales. Describe what documents you relied on and any errors or weaknesses you found in the taxpayer's supporting schedules.

- Determine whether the apportionment methodology used fairly represents the taxpayer's business activity within the state; if it does not, consider requesting a variance, pursuant to Tenn. Code Ann. §§ 67-4-2014 and 67-4-2112.

Variances from the Standard Apportionment Formula

The franchise and excise tax statutes[185] provide for the use of alternative tax computation, allocation or apportionment methods, which are referred to as *variances*. These provisions of the tax code are not routine and are seldom used. However, they *are* applied when application of the law does not result in an equitable tax calculation, based on the taxpayer's unique circumstances. Establishing that a variance is necessary is often a subjective determination. Variances can either be requested by the taxpayer or imposed by the Department. The notion that a variance will increase or decrease a taxpayer's tax liability is not, in and of itself, a reasonable basis for requesting a variance. Variances are usually requested based on an odd or unique fact pattern that causes a hardship or unusual result in the computation of the taxpayer's franchise and excise tax liability.

A variance may apply to all or any part of a taxpayer's business activity and may result in:

- Separate accounting;

- The exclusion of any one or more of the apportionment factors;

- The inclusion of one or more additional apportionment factors that will fairly represent the taxpayer's business activity in this state;

- The use of any other method to source receipts for purposes of the sales factor of the apportionment formula numerator; or

- The employment of any other method to effectuate an equitable computation, allocation and apportionment of the taxpayer's net worth and net earnings (or losses) that fairly represents the extent of the taxpayer's business activity in Tennessee.

A departure from the statutory tax computation, allocation and apportionment provisions is only permitted in limited and specific cases where unusual fact patterns (which ordinarily will be unique and nonrecurring) produce incongruous results under the provisions contained in the franchise and excise tax laws. The Commissioner may require combined reports covering members of an affiliated group of corporations. For example, in the event of intercompany activity in the manufacture, production or sale of products, the Commissioner may require a combined report, if necessary, to obtain an equitable and appropriate result.

Variance requests from taxpayers must be addressed to the Commissioner with the filing of a petition, in writing, setting forth the reasons why application of the statutory tax computation, allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in this state. It must be shown by clear and cogent evidence that peculiar or unusual circumstances exist that would cause application of the said statutory provisions to work a hardship or injustice against the taxpayer. Such application must also include a proposed alternative method of tax computation, allocation or apportionment to be used by the taxpayer and be submitted by the taxpayer on or before the statutory due date of the return. In the event that a variation from the statutory provisions is adopted, then such method will continue in effect so long as the circumstances justifying the variation remain substantially unchanged. It is the duty of the taxpayer to furnish each subsequent year such information with the filing of its return as will establish the fact that the circumstances remain substantially unchanged.[186]

Special Apportionment for Common Carriers

Taxpayers may not use the standard apportionment formula reflected on Schedule N, as discussed above, if their principal business in the state (more than 50%) is that of a common carrier of property or persons. Common carriers serve the public. Schedule O, P, or R should be used if the business is that of a common carrier (railroads, motor carriers, pipelines, and barges), air carrier, or air express carrier, respectively. All of these schedules use two-factor apportionment formulas involving revenue and miles factors.[187]

A carrier that does not offer services to the public is not a common carrier. For example, an LLC owns an airplane and transports related parties across the country. The LLC is not a common carrier because its services are not offered to the public. Apportionment guidance for this situation is not addressed in the code. However, the Department has allowed non-common carriers to use the standard, three-factor apportionment formula on Schedule N; however, when computing the revenue/sales factor, the guidance for air carriers reporting on Schedule P should be followed.[188]

1. Schedule O – Apportionment – Common Carriers

The standard, three-factor apportionment formula (Schedule N) is not used when the taxpayer's principal business in the state is that of a common carrier of persons or property for hire. Railroads, motor carriers, pipelines, and barges that are common carriers apportion on Schedule O[189] by computing the average of two ratios:

- In-state to everywhere miles; and
- Intrastate receipts to everywhere receipts.

Miles operated in the state are the actual miles traveled within the state, and the origin or destination of the load is not an issue.[190] Common carriers generally will have detailed computer printouts of the miles traveled by state for a variety of reasons, including state and federal reporting.[191] The miles reported on Schedule O should agree with these printouts and filings and should correlate to the applicable gross receipts, since carriers often charge their customers by the mile.

⚠ **Audit Tip**
Auditors may request a printout of odometer miles for the tax period. Also, they may request copies of federal and state reports filed that substantiate the in-state and everywhere miles. Similar documents may be requested for non-motor carrier common carriers filing on Schedule O.

Mileage by type of common carrier:

- Railroad miles are mileage "owned and operated" plus mileage "leased and operated."
- Pipeline miles are miles owned, operated, or owned and operated.
- Barge miles are miles operated.
    - Miles operated in Tennessee is 50% of the miles operated on the Mississippi River adjacent to the Tennessee shoreline, plus all miles operated on inland waterways within the state;
    - "Mile operated" means one mile of movement of each barge.

The second ratio is the taxpayer's gross receipts from business operations beginning and ending entirely within this state (intrastate), as compared with its entire gross receipts from such operations within and without Tennessee. For example, the gross receipts from a load picked up in Memphis and delivered to Nashville would be included in the numerator as an "In Tennessee" intrastate receipt. Receipts from travel entering or passing through any other state are not intrastate receipts for this ratio. Motor carriers may have limited Tennessee intrastate receipts because most loads may either originate or end outside of the state.

For barges, the gross receipts ratio is the revenue from the transportation of cargo loaded in Tennessee compared with the entire revenue from the transportation of cargo loaded in and outside the state.

> ⚠ **Audit Tip: Auditors may request a schedule of intrastate activity to verify the total intrastate receipts reported on Schedule O.**

If a common carrier is part of an affiliated group that has elected to use *consolidated net worth* (Schedule F2)[192] to compute their franchise tax net worth base, the common carrier affiliated group member should compute the numerator of its property factor on Schedule 170NC as follows:

- The numerator should include the average value of the taxpayer's real and tangible personal property, excluding exempt inventory,[193] that is owned or rented and used in this state during the tax period;

- In determining the average value of mobile property to be included in the numerator, the value of such property will be multiplied by a fraction, the numerator of which is the total in-state miles of similarly-classified mobile property and the denominator of which is the total everywhere miles of similarly-classified mobile property; and

    - In-state miles and everywhere miles should be calculated in the same manner as the miles reported on Schedule O.[194]

    - Mobile property should be similarly-classified as the groupings used for the excise tax apportionment ratio.[195] The classification groupings enumerated in Tenn. Code Ann. § 67-4-2013(a)(1)-(7) should be used.

2. Schedule P – Apportionment – Air Carriers

Air carriers also apportion using a two-factor apportionment formula.[196] The first factor is the originating revenue within Tennessee divided by the entire originating revenue both within and without Tennessee. The "In Tennessee" amount will be receipts from all flights originating in the state, regardless of where the flights terminate. The second factor is the ratio of the total air miles flown within Tennessee to the total air miles flown within and without Tennessee. Air miles flown within the state should only include miles in Tennessee from flights originating from and/or ending in the state.

3. Schedule R – Apportionment – Air Express Carriers

Air express carriers operate in the air and on the ground in making deliveries. The apportionment ratio is calculated by taking the average of the following ratios:

- The originating revenue within the state divided by the entire originating revenue within and without the state.

- The total air miles flown and ground miles traveled within Tennessee divided by the total air miles flown and ground miles traveled within and without Tennessee.

    - Air miles flown within the state only include miles in Tennessee from flights originating from and/or ending in Tennessee.

    - Ground miles traveled within Tennessee or traveled within and without Tennessee only include miles traveled with respect to the actual common carriage of persons or property for hire.[197]

Apportionment Examples

A taxpayer's apportionment formula will differ depending on the type of taxpayer and whether certain elections are made. Below are four apportionment examples and a chart detailing the scenarios covered. Note that these examples do not discuss the apportionment formula used by financial institutions or financial institution affiliated group members, or taxpayers that are common carriers, air carriers or air express carriers.

The **first example** shows the standard apportionment formula calculation that is applied to both the franchise and excise tax bases when no elections have been made by the taxpayer. The **second example** shows the apportionment calculation for the franchise tax base when a consolidated net worth election is in effect and an affiliated group member (not the taxpayer) has elected to use a single sales factor ("SSF"). The **third example** shows the franchise and excise tax apportionment calculations for a manufacturer that is a member of a consolidated net worth affiliated group and the manufacturer has made the SSF election. The **fourth example** shows the apportionment calculations for a manufacturer that has made the SSF election but is not a member of an affiliated group electing to use consolidated net worth.

Example	Taxpayer Type	Standard Apportion-ment	Taxpayer is a member of a consolidated net worth affiliated group and an affiliate elected SSF	Taxpayer is a member of a consolidated net worth affiliated group and taxpayer elected SSF	Taxpayer elected SSF and is not a member of a consolidated net worth affiliated group	FAE 170 Apportion-ment Schedule
1	Any Type	X				Sch. N (franchise & excise tax)
2	Any Type		X			Sch. 170NC (franchise) Sch. N (excise)
3	Mfr. electing SSF			X		Sch. 170SC (franchise) Sch. S (excise)
4	Mfr. electing SSF				X	Sch. S (franchise & excise tax)

1. Example - Standard Apportionment - Franchise and Excise Tax for ABC, LLC

Taxpayers with the right to apportion, that have not made any special elections, will compute their apportionment ratio by averaging their "in state" to "everywhere" apportionment factors, as shown below. This computation is made on Form FAE 170, Schedule N.

I. ABC, LLC net worth before apportionment is $150,000

Assets	$200,000
Liabilities	50,000

Equity (net worth)	**150,000**

II. Apportionment Factors for ABC, LLC

Factors in Tennessee:

Property (tax basis cost) – beginning of year	$400,000
Property (tax basis cost) – end of year	400,000
Payroll	10,000
Sales	15,000

Factors Everywhere:

Property (tax-basis cost) – beginning of year	$800,000
Property (tax-basis cost) – end of year	800,000
Payroll	20,000
Sales	100,000

III. Franchise apportionment ratio (Schedule F1, Line 5) - ABC, LLC

	In TN	Everywhere	Ratio TN / Everywhere
Property (average)	$400,000	$800,000	0.500000
Payroll	10,000	20,000	0.500000
Sales	15,000	100,000	.0150000
Sales	15,000	100,000	.0150000
Sales	15,000	100,000	.0150000
			1.450000
Divide by the number of factors with everywhere values			5
Apportionment ratio			0.290000
ABC, LLC franchise tax base ($150,000 x .290000) =			$43,500

IV. Excise apportionment ratio (standard apportionment) - ABC, LLC

ABC, LLC had taxable net income of $20,000 before apportionment.

	In TN	Everywhere	Ratio TN / Everywhere
Property (average)	$400,000	$800,000	0.500000
Payroll	10,000	20,000	0.500000
Sales	15,000	100,000	.0150000
Sales	15,000	100,000	.0150000
Sales	15,000	100,000	.0150000
			1.450000
Divide by the number of factors with everywhere values			5
Apportionment ratio			0.290000
ABC, LLC taxable net income before apportionment			$20,000
ABC, LLC excise tax base		($20,000 x .290000) =	$5,800

2. Example – Franchise Tax Consolidated Net Worth Apportionment - ABC, Inc.

Taxpayers that are members of an affiliated group that has made the consolidated net worth election will compute their apportionment ratio by averaging their "in state" to "the group's everywhere" apportionment factors, as shown below. This computation is made on Form FAE 170, Schedule 170NC.

In this example, the consolidated net worth affiliated group is comprised of ABC, Inc. (non-manufacturer) and MFG, Inc. (manufacturer). Both corporations will file their own franchise tax returns and compute their franchise tax based on their respective Form FAE 170 Schedules F2. The following calculations are for ABC's franchise and excise tax return and will not change if MFG, Inc. makes the SSF election.

I. Consolidated net worth before apportionment is $430,000

	ABC, Inc.	MFG, Inc.	Consolidated
Assets	$200,000	$300,000	$500,000
Liabilities	50,000	20,000	70,000
Equity (net worth)	150,000	280,000	**430,000**

II. Apportionment factors of consolidated net worth Affiliated Group Members

	ABC, Inc.	MFG, Inc.	Total
Factors in Tennessee:			
Property (tax basis cost) – beginning of year	$400,000	$900,000	$1,300,000
Property (tax basis cost) – end of year	400,000	900,000	1,300,000
Payroll	10,000	40,000	50,000
Sales	15,000	60,000	75,000
Factors Everywhere:			
Property (tax basis cost) – beginning of year	$800,000	$900,000	$1,700,000
Property (tax basis cost) – end of year	800,000	900,000	1,700,000
Payroll	20,000	80,000	100,000
Sales	100,000	120,000	220,000

III. Franchise apportionment ratio reported on Schedule F2 by ABC, Inc.

	ABC, Inc.	Total all members everywhere	Ratio
Property (average)	$400,000	$1,700,000	0.235294
Payroll	10,000	100,000	0.100000
Sales	15,000	220,000	0.068182
Sales	15,000	220,000	0.068182
Sales	15,000	220,000	0.068182
			0.539840
Divide by			5
			0.107968

ABC, LLC franchise tax base ($430,000 x .107968) = $46,426

IV. Excise apportionment ratio (standard apportionment) - ABC, Inc.

ABC, LLC had taxable net income of $20,000 before apportionment.

	In TN	Everywhere	Ratio TN/Everywhere
Property (average)	$400,000	$800,000	0.235294
Payroll	10,000	20,000	0.100000
Sales	15,000	100,000	0.068182
Sales	15,000	100,000	0.068182
Sales	15,000	100,000	0.068182
			1.450000
Divide by			5
Apportionment ratio			0.290000
ABC, Inc. net income before apportionment			$20,000
ABC, Inc. excise tax base ($20,000 x .290000) =			$5,800

3. Example – Consolidated Net Worth and Single Sales Factor Elections

Manufacturers[198] may make a five-year election to apportion based solely on a single sales/gross receipts factor. In the following example, MFG, Inc., a consolidated net worth affiliated group member, has made the SSF election.

I. Consolidated net worth before apportionment is $430,000

	ABC, Inc.	MFG, Inc.	Consolidated
Assets	$200,000	$300,000	$500,000
Liabilities	50,000	20,000	70,000
Equity (net worth)	150,000	280,000	**430,000**

II. Apportionment factors of consolidated net worth affiliated group members

	ABC, Inc.	MFG, Inc.	Total
Factors in Tennessee:			
Property (book basis cost) – beginning of year	$400,000	$900,000	$1,300,000
Property (book basis cost) – end of year	400,000	900,000	1,300,000
Payroll	10,000	40,000	50,000
Sales	15,000	60,000	75,000
Factors in Everywhere:			
Property (book basis cost) – beginning of year	$800,000	$900,000	$1,700,000
Property (book basis cost) – end of year	800,000	900,000	1,700,000
Payroll	20,000	80,000	100,000
Sales	100,000	120,000	220,000

III. Franchise apportionment ratio calculated on Schedule 170SC and reported on Schedule F2 by MFG, Inc.

	In TN MFG, Inc.	Total all members everywhere	Ratio
Property (average)	n/a	$1,700,000	n/a
Payroll	n/a	100,000	n/a
Sales	60,000	220,000	0.272727
			0.272727

MFG, Inc. franchise tax base ($430,000 x .272727) = $117,273

IV. Excise apportionment ratio calculated on Schedule S and reported on Schedule J of MFG, Inc.'s excise tax return

MFG, Inc. had taxable net income of $20,000 before apportionment

	In TN MFG, Inc.	Everywhere MFG, Inc.	Ratio
Property (average)	n/a	$1,700,000	n/a
Payroll	n/a	100,000	n/a
Sales	60,000	120,000	0.500000
			0.500000

MFG, Inc. net income before apportionment $20,000

MFG, Inc. excise tax base (SSF elected) ($20,000 x .500000) = $10,000

The consolidated net worth election does not impact the excise tax calculation of a taxpayer electing SSF.

4. Example – Manufacturer Single Sales Factor Apportionment

Manufacturers[199] may make a five-year election to apportion based solely on a single sales/gross receipts factor. In the following example, MFG, Inc. is not a consolidated net worth affiliated group member but has made the SSF election.

I. MFG, Inc. net worth before apportionment is $280,000

Assets	$300,000
Liabilities	20,000
Equity (net worth)	**280,000**

II. Apportionment Factors for MFG, Inc.

Factors in Tennessee:

Property	n/a
Payroll	n/a
Sales	60,000

Factors Everywhere:

Property (tax basis cost) – beginning of year	n/a
Payroll	n/a
Sales	120,000

III. Franchise apportionment ratio calculated on Schedule S and reported on Schedule F1

	In TN MFG, Inc.	Everywhere	TN/Everywhere Ratio
Property	n/a	n/a	n/a
Payroll	n/a	n/a	n/a
Sales	60,000	120,000	0.500000
			0.500000

MFG, Inc. franchise tax base ($280,000 x .500000) = $140,000

IV. Excise apportionment ratio calculated on Schedule S and reported on Schedule J

MFG, Inc. had taxable net income of $20,000 before apportionment.

	In TN MFG, Inc.	Everywhere MFG, Inc.	TN/Everywhere Ratio
Property	n/a	n/a	n/a
Payroll	n/a	n/a	n/a
Sales	60,000	120,000	0.500000
			0.500000

MFG, Inc. net income before apportionment	$20,000
MFG, Inc. excise tax base ($20,000 x .500000) =	$10,000

[1] Tenn. Code Ann. §§ 67-4-2012, 67-4-2013, 67-4-2112, 67-4-2113; TENN. COMP. R. & REGS. 1320-06-01-.27, .34, .35, .38, and .42

[2] http://www.mtc.gov/

[3] Tenn. Code Ann. § 67-4-2004(4)

[4] Tenn. Code Ann. § 67-4-2010(b)

[5] Tenn. Code Ann. § 67-4-2011(a)-(e) – allocation of earnings

[6] Tenn. Code Ann. §§ 67-4-2004(14)(A), 67-4-2010, 67-4-2110

[7] A 1959 federal law known as Public Law 86-272 prohibits a state from imposing an income tax on a company if the company is only soliciting orders for sales of tangible personal property that are sent outside the state for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the state.

[8] Tenn. Code Ann. § 67-4-2012(*l*)

[9] The sales factor is double weighted for tax years beginning before July 1, 2016. Public Chapter 514 (2015).

[10] TENN. COMP. R. & REGS. 1320-06-01-.27, .30, and .32

[11] Tenn. Code Ann. §§ 67-4-2111(*l*) and 67-4-2012(*l*). The single sales factor provision is effective for tax years beginning on or after January 1, 2017.

[12] The Tennessee Supreme Court has stated that when a statute does not define a term, it is proper to look to common usage to determine the term's meaning. *See, e.g., Beare Co. v. Tenn. Dep't of Revenue*, 858 S.W.2d 906, 908 (Tenn. 1993); *see also Tenn. Farmers Assurance Co. v. Chumley*, 197 S.W.3d 767, 782-83 (Tenn. Ct. App. 2006).

[13] Important Notice #17-11

[14] The standard apportionment method should be used when an electing taxpayer is no longer a qualifying manufacturer.

[15] Tenn. Code Ann. §§ 67-4-2012(m) and 67-4-2111(m)

[16] A publicly traded partnership is an entity that is treated as a partnership for federal income tax purposes, files with the SEC, and its shares are traded on a registered national securities exchange or national securities exchange of a foreign country. Tenn. Code Ann. § 67-4-2012(m)(2)(D).

[17] Tenn. Code Ann. § 67-4-2012(m)(2)(D)

[18] Tenn. Code Ann. § 67-4-2023

[19] "Domestic person" means any person with more than twenty percent (20%) of the average of its property, payroll and receipts factors, as each factor is calculated for a separate entity under § 67-4-2111, in the United States; therefore, non-domestic persons are persons who do *not* meet the 20% threshold.

[20] The market-based sourcing rule does not specifically address interest or dividend receipts, but it does establish the "throw out" provision in TENN. COMP. R. & REGS. 1320-06-01-.42(1)(f).

[21] Tenn. Code Ann. §§ 67-4-2012(b), (e), and (g)

[22] Tenn. Code Ann. §§ 67-4-2108(a)(6)(E)

[23] Tenn. Code Ann. §§ 67-4-2006(b)(1)(J) and (b)(2)(L). This reversal was made on Schedules J1, J2, J3, or J4 prior to 2017.

[24] Tenn. Code Ann. §§ 67-4-2012(b)-(d) and 67-4-2111(b); TENN. COMP. R. & REGS. 1320-06-01-.27 and .29
[25] TENN. COMP. R. & REGS. 1320-06-01-.27(3)
[26] TENN. COMP. R. & REGS. 1320-06-01-.28(1)(a)
[27] TENN. COMP. R. & REGS. 1320-06-01-.28(2)
[28] TENN. COMP. R. & REGS. 1320-06-01-.28(2)(a)
[29] TENN. COMP. R. & REGS. 1320-06-01-.18(1); Revenue Ruling 01-06
[30] "Reasonable rent" means rent that does not exceed 2% per month of the appraised value for property tax purposes. Tenn. Code Ann. § 67-4-2006(b)(1)(N).
[31] TENN. COMP. R. & REGS. 1320-06-01-.28(2)(b)
[32] Tenn. Code Ann. § 67-4-2108(a)(6)(C) defines "finished goods inventory."
[33] Tenn. Code Ann. § 67-4-2111(b)(1)
[34] Tenn. Code Ann. § 67-4-2012
[35] TENN. COMP. R. & REGS. 1320-06-01-.28(1)(b)
[36] TENN. COMP. R. & REGS. 1320-06-01-.27(2)
[37] TENN. COMP. R. & REGS. 1320-06-01-.29
[38] Tenn. Code Ann. § 67-4-2115(b)
[39] Tenn. Code Ann. § 67-4-2012(e)
[40] Tenn. Code Ann. § 67-4-2004(12)
[41] TENN. COMP. R. & REGS. 1320-06-01-.30(1)(d)
[42] *Id.*
[43] Tenn. Code Ann. § 67-4-2014
[44] Tenn. Code Ann. § 67-4-2012(e)
[45] TENN. COMP. R. & REGS.1320-06-01-.30(1)(b)
[46] *Id.*
[47] Tenn. Code Ann. § 67-4-2014
[48] Tenn. Code Ann. § 67-4-2012(f)
[49] TENN. COMP. R. & REGS. 1320-06-01-.31
[50] Base of operations generally is the permanent place where the employee begins and ends work each day and where they receive instructions, communicate with customers, and perform other business functions.
[51] State of Tennessee Department of Labor and Workforce Development Division of Employment Security Handbook For Employers, June 13, 2019 – *Having Employees in More Than One State*, page 26/60.
[52] TENN. COMP. R. & REGS. 1320-06-01-.38(2)(c)
[53] Tenn. Code Ann. § 67-4-2004(46)
[54] Tenn. Code Ann. § 67-4-2004(20)
[55] Tenn. Code Ann. §§ 67-4-2012(k), 67-4-2111(k); Important Notice #12-05
[56] TENN. COMP. R. & REGS. 1320-06-01-.42(1)(e)-(f)
[57] Tenn. Code Ann. §§ 67-4-2012(i) and 67-4-2111(i)
[58] TENN. COMP. R. & REGS. 1320-06-01-.32(1)(b)
[59] *Sherwin-Williams Co. v. Johnson*, 989 S.W.2d 710 (Tenn. Ct. App. 1998)
[60] TENN. COMP. R. & REGS. 1320-06-01-.32(1)(a)1-6

[61] Includes cash received, fair market value of other property received, net liabilities assumed by other party, and fair market value of like-kind property received.
[62] TENN. COMP. R. & REGS. 1320-06-01-.32(1)(a)2
[63] Tenn. Code Ann. § 67-4-2006(b)(1)(N)
[64] TENN. COMP. R. & REGS. 1320-06-01-.32(1)(a)1
[65] Tenn. Code Ann. § 67-4-2006(b)(2)(N)
[66] Tenn. Code Ann. § 67-4-2006(b)(2)(O)
[67] Tenn. Code Ann. §§ 67-4-2012(h) and (i)
[68] Tenn. Code Ann. §§ 67-4-2012(h)(1) and (2)
[69] TENN. COMP. R. & REGS. 1320-06-01-.33(2)
[70] TENN. COMP. R. & REGS. 1320-06-01-.33(1)(d); Letter Ruling 13-14
[71] TENN. COMP. R. & REGS. 1320-06-01-.33(1)(e)
[72] Revenue Rulings 95-05, 95-27, 04-12, and 13-14
[73] TENN. COMP. R. & REGS. 1320-06-01-.33(1)(b)
[74] TENN. COMP. R. & REGS. 1320-06-01-.33(1)(c)
[75] Revenue Ruling 13-14
[76] TENN. COMP. R. & REGS. 1320-06-01-.33(1)(d)
[77] TENN. COMP. R. & REGS. 1320-06-01-.33(1)(e)
[78] Public Chapter 514 (2015)
[79] Tenn. Code Ann. § 67-4-2012(i); TENN. COMP. R. & REGS. 1320-06-01-.42
[80] Tenn. Code Ann. §§ 67-4-2012(i)(2) and (3)
[81] Tenn. Code Ann. § 67-4-2012(i)(4)
[82] TENN. COMP. R. & REGS. 1320-06-01-.42
[83] TENN. COMP. R. & REGS.1320-06-01-.42(1)(d)
[84] TENN. COMP. R. & REGS. 1320-06-01-.42(1)(e)
[85] TENN. COMP. R. & REGS.1320-06-01-.42(4)(d)(3)(i)(I)
[86] TENN. COMP. R. & REGS. 1320-06-01-.42(4)
[87] TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f) and (6)(a)(4)
[88] TENN. COMP. R. & REGS. 1320-06-01-.42(1)(f)
[89] Tenn. Code Ann. § 67-4-2012(c)(2)
[90] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)
[91] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)
[92] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(b)
[93] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)
[94] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)IV
[95] *Id.*
[96] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)II
[97] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)III
[98] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)
[99] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(I) and (II)
[100] TENN. COMP. R. & REGS. 1320-06-01-.42(1)(e)2
[101] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(I)II
[102] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)

[103] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)III
[104] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)IV
[105] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)(I)
[106] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)(III)
[107] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)(III)I
[108] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)
[109] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)(III)II
[110] TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f)
[111] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)2
[112] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)1
[113] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(b)
[114] *Id.*
[115] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)
[116] *Id.*
[117] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)
[118] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(ii)
[119] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)
[120] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i)(II)
[121] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i)(I) and (II)
[122] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i)
[123] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)
[124] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(ii)
[125] *Id.*
[126] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)2(ii) and 3(i)(I)
[127] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)2(ii) and 3(i)(II)
[128] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i)(II)
[129] *Id.*
[130] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i)(I)
[131] TENN. COMP. R. & REGS. 1320-06-01-.42(6)
[132] TENN. COMP. R. & REGS. 1320-06-01-.42(5) and (6)
[133] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii) and (iii)
[134] TENN. COMP. R. & REGS. 1320-06-01-.42(7)(b)
[135] TENN. COMP. R. & REGS. 1320-06-01-.42(7)(a)
[136] TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)
[137] *Id.*
[138] TENN. COMP. R. & REGS. 1320-06-01-.42(5)(b)
[139] TENN. COMP. R. & REGS. 1320-06-01-.42(5)(d)
[140] TENN. COMP. R. & REGS. 1320-06-01-.42(5)(b)
[141] TENN. COMP. R. & REGS. 1320-06-01-.42(5)(c)
[142] *Id.*
[143] TENN. COMP. R. & REGS. 1320-06-01-.42(5)(b) and (e)
[144] TENN. COMP. R. & REGS. 1320-06-01-.42(5)(e)
[145] TENN. COMP. R. & REGS. 1320-06-01-.42(5)(b)-(c)

[146] Tenn. Comp. R. & Regs. 1320-06-01-.42(4)
[147] Tenn. Comp. R. & Regs. 1320-06-01-.42(5)(f)
[148] Tenn. Comp. R. & Regs. 1320-06-01-.42(4)(c)2(ii)(I)
[149] Tenn. Comp. R. & Regs. 1320-06-01-.42(5)(f)
[150] Tenn. Comp. R. & Regs. 1320-06-01-.42(4)(c)2(ii)(II)
[151] *Id.*
[152] Tenn. Comp. R. & Regs. 1320-06-01-.42(5)(f)
[153] Tenn. Comp. R. & Regs. 1320-06-01-.42(4)(c)2(ii)(II)IV
[154] Tenn. Comp. R. & Regs. 1320-06-01-.42(4)(c)2(iii)
[155] Tenn. Comp. R. & Regs. 1320-06-01-.42(5)(f)
[156] Tenn. Comp. R. & Regs. 1320-06-01-.42(4)(c)2(iii)(II)
[157] Tenn. Comp. R. & Regs. 1320-06-01-.42(5)(a) and (6)(a)3
[158] Tenn. Comp. R. & Regs. 1320-06-01-.42(6)(a)1
[159] *Id.*
[160] *Id.*
[161] Tenn. Comp. R. & Regs. 1320-06-01-.42(6)(a)2
[162] Tenn. Comp. R. & Regs. 1320-06-01-.42(6)(a)4
[163] Tenn. Comp. R. & Regs. 1320-06-01-.42(6)(a)5
[164] Tenn. Comp. R. & Regs. 1320-06-01-.42
[165] Tenn. Comp. R. & Regs. 1320-06-01-.42(4)(c)
[166] Tenn. Comp. R. & Regs. 1320-06-01-.42(5)(b)
[167] Tenn. Comp. R. & Regs. 1320-06-01-.42(5)(c)
[168] Tenn. Comp. R. & Regs. 1320-06-01-.42(5)(f)
[169] Tenn. Comp. R. & Regs. 1320-06-01-.42(6)
[170] Tenn. Comp. R. & Regs. 1320-06-01-.42(5)(f) and (6)(a)5
[171] Tenn. Code Ann. § 67-4-2012(i), prior to Revenue Modernization Act of 2015
[172] Tenn. Comp. R. & Regs. 1320-06-01-.34(2), prior to September 2016 revision
[173] Tenn. Comp. R. & Regs. 1320-06-01-.34(4)(b)1-2, prior to September 2016 revision
[174] Tenn. Code Ann. § 67-4-2012(j), prior to Revenue Modernization Act of 2015
[175] Tenn. Code Ann. § 67-4-2004(10)
[176] Tenn. Code Ann. § 67-4-2012(j).
[177] Tenn. Comp. R. & Regs. 1320-06-01-.34
[178] Tenn. Code Ann. § 67-4-2012(j)(1)(B)
[179] Tenn. Code Ann. § 67-4-2012(i)
[180] Tenn. Code Ann. § 67-4-2012(j)(2)(C)
[181] Tenn. Code Ann. § 67-4-2012(j)(2)(B)
[182] Tenn. Code Ann. § 67-4-2013(b)(3)(H)
[183] Tenn. Code Ann. § 67-4-2013(b)(3)(G)
[184] Tenn. Comp. R. & Regs. 1320-06-01-.42
[185] Tenn. Code Ann. §§ 67-4-2014 and 67-4-2112
[186] Tenn. Comp. R. & Regs. 1320-06-01-.35
[187] Tenn. Code Ann. § 67-4-2013
[188] Tenn. Code Ann. § 67-4-2013(a)(5)

[189] Tenn. Code Ann. § 67-4-2013(a)(1)-(4), (7)
[190] The Federal Motor Carrier Act of 1980 deregulated the routes that motor carriers could use and the geographic regions they could serve, and as a result, the "franchise miles" wording in Tenn. Code Ann. § 67-4-2013(a)(2)(B) is meaningless.
[191] An International Fuel Tax Agreement (IFTA) report is filed by motor carriers quarterly and includes the mileage traveled by state.
[192] Tenn. Code Ann. § 67-4-2111(b)(3)
[193] Tenn. Code Ann. § 67-4-2108(a)(6)(B)
[194] Tenn. Code Ann. § 67-4-2013(a)
[195] Tenn. Code Ann. § 67-4-2013(a)(1)-(7)
[196] Tenn. Code Ann. § 67-4-2013(a)(5)
[197] Tenn. Code Ann. §§ 67-4-20013(a)(6) and 67-4-2113(7)
[198] See Tenn. Code Ann. §§ 67-4-2012(*l*) and 67-4-2111(*l*) for the criteria to be considered a manufacturer for the purpose of making the SSF election.
[199] *Id.*