

PUBLICATION

Spotlight on Tennessee: Department of Revenue Addresses Manufacturer's Sourcing of Drop Shipment Receipts

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For Tennessee excise and franchise tax purposes, a taxpayer that has business activities taxable both inside and outside this state must apportion its business net earnings and net worth using a three-factor apportionment formula. That formula utilizes a property factor, payroll factor and a double-weighted receipts factor. Manufacturers taxable in Tennessee are, in many instances, penalized in this apportionment computational process for having significant property and payroll in this state even though the ultimate recipient of the manufactured products may be located outside Tennessee. Although not addressing the punitive aspects of the property and payroll factors, the Tennessee Department of Revenue (Department) has again, as in 2004, provided some clarification with regard to the formula's receipts factor in the context of a manufacturer initiating drop shipments involving affiliated sales companies.

A drop shipment transaction occurs when a manufacturer/supplier (manufacturer) receives an order from a sales company/seller (sales company) to supply and ship a product to the sales company's customer. Transfer of legal title (and a sale) occurs from the manufacturer to the sales company and then legal title transfers (and a second sale occurs) from the sales company to the sales company's customer. These title transfers can occur at different times or may occur almost simultaneously when, for instance, the product is loaded on the carrier at the manufacturer's "dock" or during shipment or at the customer's destination. Actual physical possession of the product moves directly from the manufacturer to the sales company's customer -- with the sales company never receiving possession.

In Letter Ruling #13-14, posted by the Department on February 6, 2014, the manufacturer operated a Tennessee manufacturing facility and stored its manufactured products in a warehouse that was owned and operated by the manufacturer. An affiliated sales company issued orders for products to the manufacturer and directed the manufacturer to ship those products directly to the sales company's customers. The customers were located both inside and outside Tennessee. Depending on the customer and the order, either the manufacturer arranged for shipment or the sales company made the shipping arrangements. Title to the products passed to the sales company at the manufacturer's "dock" (warehouse) when the products were loaded onto a common carrier for shipment, and then title again transferred from the sales company to its customer at the customer's location. Occasionally, in "direct sales" transactions (as compared to drop sales transactions), the manufacturer received orders from the affiliated sales company to ship products directly to the sales company at its warehouse location outside Tennessee.

The Department ruled that it was irrelevant which party (that is, the manufacturer or the affiliated sales company) arranged for shipment of the products. More significantly, the Department ruled it was irrelevant that legal title to the products passed from the manufacturer to the affiliated sales company in Tennessee. Where the affiliated sales company did not receive possession of the products in Tennessee, and to the extent the ultimate destinations of the products (the location of sales company's customers) were outside Tennessee, the Department ruled that the gross receipts from the manufacturer's drop shipment transactions were to be included in the manufacturer's Tennessee receipts factor denominator but excluded from the numerator. In essence, the gross receipts in such situations are to be sourced outside Tennessee. The same sourcing result was applied to the manufacturer's direct sales transactions involving its affiliated sales companies.

As noted earlier, manufacturers are often times penalized in the apportionment computational process for having significant property and payroll in Tennessee where the ultimate destination of the manufactured product is outside this state. If you are a manufacturer or other type of taxpayer and would like to discuss Letter Ruling #13-14 or the drop shipment transactions addressed in that Ruling, or perhaps discuss other types of affiliated or unaffiliated transactions involving Tennessee and other states, please contact one of the attorneys in the Firm's Tax Group.