

# Tax Trends

The newsletter of the Illinois State Bar Association's Section on State & Local Taxation

## Co-Editors' Note

BY MARY ANN CONNELLY & STANLEY KAMINSKI

This edition of *Tax Trends* features an article written by Stanley R. Kaminski and Lauren A. Ferrante on the sourcing of sales of tangible personal property for income tax purposes. In determining the amount of income a state can tax, the state uses factor apportionment. One of those factors is the sales factor. As a result, how you determine the sales that go into the

numerator of the sales factor will impact the amount of income that can be taxed by the state. The article addresses the destination and delivery rules used by various states to source sales of tangible personal property. The article discusses how these rules differ and how they are the same depending on how the state interprets them. ■

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Sourcing of TPP: When Destination and Delivery Dovetail

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## Sourcing of TPP: When Destination and Delivery Dovetail

BY STANLEY R. KAMINSKI & LAUREN A. FERRANTE

Courts and commentators have recently spilled much ink grappling with state tax apportionment laws and the divergent interpretation of those laws. As one would expect, the apportionment of receipts from the sale of services and intangible property make up much of this discussion, especially considering the prevalence of those sales in the U.S. economy and the somewhat amorphous nature of those products.<sup>1</sup> However, the sourcing of the sales of tangible personal property (TPP) is still a hot topic and one that surprises practitioners with its various twists and turns.

Ohio's recent decisions serve as a good example of the sourcing issues that continue to arise in the sale of TPP.<sup>2</sup> These cases deal with the concepts of delivery, receipt, and

destination and how these terms may not mean the same thing depending on the state. These cases also serve as a reminder that, like the sourcing of services and intangibles, sourcing of TPP can be complex and nuanced in some circumstances.

Ohio's recent cases applied Ohio's commercial activity tax (CAT) TPP sourcing provision, which states in part:

Gross receipts from the sale of tangible personal property shall be situated to this state if the property is received in this state by the purchaser. In the case of delivery of tangible personal property by motor carrier or by other means of transportation, the place at which such property is ultimately received after all transportation has been completed shall be considered the place where the purchaser receives the property.<sup>3</sup>

Several other states, including Louisiana, North Carolina, and South Carolina, use a similar "ultimately received" standard for the income tax sourcing of TPP,<sup>4</sup> and several states have adopted a destination sourcing rule for this property, including dock sales of TPP (when a customer picks up goods at a seller's location and has them transported to a destination out-of-state).<sup>5</sup>

The CAT TPP sourcing statute was at the center of the dispute in *Greenscapes*,<sup>6</sup> which essentially was a dock sale fact pattern case. *Greenscapes Home and Garden Products Inc.* was a Georgia corporation selling lawn and garden products at wholesale to primarily big box retailers.<sup>7</sup> *Greenscapes* did not have property or employees in Ohio and did not market in Ohio.<sup>8</sup> *Greenscapes's*

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customers were headquartered outside Ohio but had distribution centers in the state.<sup>9</sup> When customers placed orders, they provided Greenscapes with a delivery address, and the company prepared a bill of lading reflecting that address.<sup>10</sup> Customers arranged for their purchases to be picked up at the company's Georgia facility,<sup>11</sup> and on pickup Greenscapes provided the driver with the bill of lading.<sup>12</sup> Greenscapes had no ability to track the product after it left the Georgia facility.<sup>13</sup> On audit, the Ohio Department of Taxation assessed CAT against Greenscapes based on the bills of lading, concluding that those listing Ohio delivery addresses were Ohio sales under the TPP sourcing statute.<sup>14</sup>

Greenscapes disputed the department's conclusion and argued that even though the goods were delivered to customers' Ohio distribution facilities, the goods were not taxable by the state because they were ultimately received by the customer outside Ohio.<sup>15</sup> Greenscapes read the sourcing statute as allowing for the sourcing of sales at the destination where the products are ultimately transported by the customer, and contended that because the goods delivered to Ohio warehouses were destined for sale at its customers' retail stores in other states, they should not be taxable by Ohio. However, because of the auditor's reliance on the bills of lading showing an Ohio "ship to" address, the state looked to Greenscapes to present evidence that the purchases actually ended up outside Ohio for sale.<sup>16</sup> Greenscapes lacked the records to show where the goods were ultimately received because it could not track the goods after they were loaded onto the carrier's truck in Georgia.<sup>17</sup> The Board of Tax Appeals (BTA) used this fact as the basis to deny Greenscapes's argument, writing: "While it may be true that the goods appellant sells may be removed from Ohio, after being shipped from appellant to Ohio, for ultimate sale in one of its customers' retail locations, the lack of information about any such further transportation forecloses appellant's argument."<sup>18</sup> As a result, the BTA relied on the shipping information and bills of lading

maintained by Greenscapes to conclude that where the goods were ultimately received for purposes of sourcing was Ohio, rejecting the company's argument that Ohio was merely the delivery location.

Since *Greenscapes*, the BTA relied on the decision in two similar instances to find that sales of TPP were ultimately received at their delivery location, also rejecting taxpayer arguments to the contrary.

In *Mia Shoes*, the BTA held that a wholesaler's goods shipped to retailers' Ohio warehouses for distribution nationwide were Ohio sales under the CAT TPP sourcing statute.<sup>19</sup> *Mia Shoes* was a wholesaler of footwear headquartered in Florida.<sup>20</sup> The footwear was manufactured abroad and shipped to California or Florida.<sup>21</sup> There, *Mia Shoes* transported the footwear by common carrier to its national retailer customers, some of which had Ohio distribution facilities.<sup>22</sup> *Mia Shoes* lost the ability to track the goods on delivery to its customers.<sup>23</sup> On audit, the department assessed CAT on the goods shipped to the Ohio facilities, and *Mia Shoes*, as in *Greenscapes*, challenged the assessment on the basis that while the goods were initially received at warehouses in Ohio, they were transported by the customer to out-of-state to customers' stores where they were ultimately received.<sup>24</sup> Also like *Greenscapes*, the commissioner and BTA rejected this argument.<sup>25</sup>

As a proxy for identifying where the footwear was ultimately received, *Mia Shoes* sought to source sales shipped to a customer's Ohio warehouse based on the customer's percentage of retail stores in Ohio versus out-of-state stores.<sup>26</sup> The BTA rejected this alternative: "As was the case in *Greenscapes*, the evidence shows that *Mia Shoes* shipped its goods to Ohio, knew it was shipping goods to Ohio, and lost visibility of the goods once they were delivered to the customers in Ohio."<sup>27</sup>

The BTA followed its decision in *Mia Shoes* with a similar one in *Henry Rac Holding Corp.*<sup>28</sup> In this case, the taxpayer, an out-of-state rifle and shotgun manufacturer, sold and delivered guns to distributors, some of which

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were located in Ohio.<sup>29</sup> The distributors, in turn, sold the guns to retailers, which sold to consumers.<sup>30</sup> On audit, the department issued the taxpayer an estimated CAT assessment based on its estimated gross receipts derived from gun sales to Ohio distributors.<sup>31</sup> Before the BTA, one of the taxpayer's arguments was that because its sales of guns to its customers were ultimately transported outside Ohio by its customers, the gun purchases were not ultimately received in Ohio and thus were not taxable under the CAT TPP sourcing statute.<sup>32</sup> The BTA succinctly rejected this argument by citing *Greenscapes* and *Mia Shoes*<sup>33</sup>:

The facts of this case are analogous to both *Greenscapes* and *Mia Shoes*. In all three cases, an out of state producer shipped products into Ohio, and the three companies knew the products were shipped into Ohio. All three made the argument that some products were destined for locations outside of Ohio but did not prove *how many* or *which* products were transported outside of Ohio.<sup>34</sup>

Looking to the ultimate destination of the transportation between the seller and buyer continues to be the sourcing test used in Ohio. But, as the Ohio decisions have shown, this is different than where the buyer may later transport the property for subsequent sale after the initial sale. As the Ohio Tax Commission recently held in *Rezolex Ltd. Co.*, citing the above BTA cases:

The statute's second sentence requires that, whenever delivery involves transportation, the gross receipts from the sale of tangible personal property must be situated to the location at which the purchaser ultimately receives it after all transportation (*between the seller and the purchaser*) has come to an end.<sup>35</sup>

So in the cases discussed here, while it was argued that the TPP at issue was only initially delivered to warehouse locations where the purchaser intended to temporarily store it until the purchaser shipped it to its ultimate destination, the law on the other hand looks to apportion the seller's sales to "the place at which such property is ultimately received after all transportation has been completed."<sup>36</sup> As a result, in all three Ohio cases, "all transportation has been completed" from the seller's perspective when the TPP reached its Ohio (delivery) location;

the taxpayers' lack of evidence showing continuing transportation supports this notion. Further, even if the tribunals were to require (rather than allow) taxpayers to pay CAT based on where a customer, on its own accord, ultimately located the TPP after delivery, compliance with Ohio's TPP sourcing statute could be administratively burdensome, if not impossible. Moreover, as demonstrated here, the taxpayers simply did not have or could not obtain information regarding where their customers shipped the TPP. And, more importantly, it would appear directly contrary to the statute since the transportation between the seller and buyer was completed for their sale when the products reached the buyer's distribution facilities.

The Ohio cases interpreting the CAT statute plainly demonstrate that the sourcing of TPP is not always a straightforward issue. While delivery location, ultimate destination, and ultimate receipt location can be considered different concepts, they are closely related in some circumstances and in practice may be deemed to have the same meaning.■

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1. See, e.g., *LendingTree LLC v. State of Washington Department of Revenue*, 460 P.3d 640 (Wash. Ct. App. 2020); see cases discussed in Stephen P. Kranz and Lauren A. Ferrante, "Market Sourcing: State's Look-Through Approach Rejected Again," *Tax Notes State*, Oct. 26, 2020, p. 341; and Kranz, Ferrante, and Kathleen M. Quinn, "Performance-Based Sourcing Law Remix: Costly Taxpayer Win," *Tax Notes State*, Aug. 31, 2020, p. 879.
2. The term "goods" is used interchangeably with TPP in this article.
3. Ohio Rev. Code section 5751.033(E).
4. See La. Rev. Stat. section 47:245(F)(3); N.C. Gen. Stat. section 105-130.4(l)(3); S.C. Code section 12-6-2280(B).
5. Many states have adopted the Uniform Division of Income for Tax Purposes Act rule for sourcing sales of TPP, which provides in part that sales are in-state sales if "the property is delivered or shipped to a purchaser . . . within this state." UDITPA section 16(a). Despite language sourcing to the delivery location, many courts have interpreted the UDITPA rule as an ultimate destination rule. See, e.g., *Powerex Corp. v. Department of Revenue*, 346 P.3d 476, 483 (Or. 2015) ("Given the text, context, and history of the Uniform Act, most legal authorities have acknowledged that section 16(a) of the Uniform Act is best read as embodying an ultimate-destination theory of sales apportionment.") (citations omitted). See also *Indiana Department of Revenue v. Miller Brewing Co.* 975 N.E.2d 800 (Ind. 2012) (products picked up out-of-state by Indiana distributors were sourced to Indiana under UDITPA section 16(a) language despite an administrative regulation to the contrary); *McDonnell Douglas Corp. v. Franchise Tax Board*, 26 Cal. App. 4th 1789 (Cal. Ct. App. 1994) (interpreting UDITPA section 16(a) language to conclude that aircraft delivered to out-of-state

- purchasers in California and destined for use outside the state were out-of-state sales). Older Ohio Supreme Court franchise tax cases interpreting a TPP sourcing rule that is virtually identical to the CAT's rule echo other state courts' holdings that destination prevails over delivery location. See *Dupps Co. v. Lindley*, 405 N.E.2d 716 (Ohio 1980) (finding goods picked up in Ohio by out-of-state customers were out-of-state sales); *House of Seagram Inc. v. Porterfield*, 271 N.E.2d 827 (Ohio 1971) (finding goods shipped to an Ohio purchaser and ultimately received in Ohio were Ohio sales, despite seller delivery to common carrier in New York).
6. *Greenscapes Home and Garden Products Inc. v. Testa*, 129 N.E.3d 1060 (Ohio Ct. App. 2019), appeal denied, 123 N.E.3d 1042 (Ohio 2019).
  7. *Id.* at 1062-63.
  8. *Id.* at 1062-64.
  9. *Id.* at 1063.
  10. *Id.*
  11. *Id.*
  12. *Greenscapes Home and Garden Products Inc. v. Testa*, No. 2016-350, 2017 WL 3183334, at \*2 (Ohio Bd. Tax. App. July 19, 2017).
  13. *Greenscapes*, 129 N.E.3d at 1063.
  14. See *id.* at 1064. Greenscapes also filed claims for refund on grounds that gross receipts from goods shipped to Ohio were not Ohio sales under the CAT TPP sourcing statute. See *Greenscapes*, 2017 WL 3183334, at \*1.
  15. *Greenscapes*, 2017 WL 3183334, at \*1-2; *Greenscapes*, 129 N.E.3d at 1063. The BTA, rather than the court of appeals, primarily addressed the sourcing issue. Although Greenscapes appealed the issue, its arguments before the appeals court focused on constitutional issues. *Greenscapes*, 129 N.E.3d at 1067-68. On appeal, Greenscapes argued that Ohio's imposition of CAT in this case was prohibited under the commerce clause and due process clause of the U.S. Constitution because Greenscapes lacked nexus with Ohio. See *id.* As a result of the court's rejection of these arguments (see *id.* at 1069-76), under the CAT's factor presence nexus standard, its sourcing determination also determined nexus. As economic nexus standards replace traditional physical standards post-*Wayfair*, nexus and sourcing inquiries are at risk of collapse in other state and local tax regimes as well. *Id.* at 1073 ("we conclude that R.C. 5751.033 creates a nexus with Ohio by siting gross receipts to this state because the tangible personal property involved was ultimately received in this state."). See also Ohio Rev. Code sections 5751.02(A) (CAT imposed on "persons with substantial nexus with" Ohio), 5751.01(H)(3) ("substantial nexus" includes a "bright-line presence in this state"), 5751.01(I)(3) ("bright-line presence" includes "taxable gross receipts" of at least \$500,000).
  16. *Greenscapes*, 2017 WL 3183334, at \*1.
  17. See *id.* at 2.
  18. *Id.*
  19. *Mia Shoes Inc. v. McClain*, No. 2016-282, 2019 WL 4013504 (Ohio Bd. Tax. App. Aug. 8, 2019), appeal dismissed, 2019 Ohio 4667 (Ohio 2019).
  20. *Id.* at \*1.
  21. *Id.*
  22. *Id.*
  23. *Id.* at \*3.
  24. *Id.* at \*1. *Mia Shoes*, like *Greenscapes*, raised constitutional challenges, but these were not addressed. See *id.* at \*1, 4.
  25. See *id.* at \*1.
  26. *Id.* at \*3.
  27. *Id.*
  28. *Henry Rac Holding Corp. v. McClain*, No. 2019-787 (Ohio Bd. Tax. App. Nov. 10, 2020) (appeal pending before the Ohio Supreme Court).
  29. *Id.* at 2.
  30. *Id.*
  31. *Id.* at 2-3.
  32. *Id.* at 4.
  33. *Id.* at 4-5.
  34. *Id.* at 5 (emphasis in original).
  35. *Rezolex Ltd. Co.*, Assessment No. 100000711327, at 5 (Nov. 27, 2020) (parenthetical original to opinion, emphasis added).
  36. Ohio Rev. Code section 5751.033(E).