



## **Inside Deloitte**

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Sourcing

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# When Destination Becomes Distortion: Rethinking Tangible Personal Property Sales Sourcing

Posted on Mar. 11, 2026

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In this installment of Inside Deloitte, the authors examine

sourcing rules

for sales of tangible personal property at a time when single sales factor is the dominant state income tax apportionment method.

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Note: This article was written before the publication of *Smithfield Packaged Meats Corp. v. California Franchise Tax Board* and does not directly address the case. However, the court in *Smithfield* concluded that alternative apportionment was appropriate based on the facts presented, which lends support to the view that it may also be appropriate in the situations addressed below.

## Introduction

A fair apportionment system is fundamental for taxpayers to appropriately determine what percentage of their income should be subject to tax in each state based on their operations in each state. With single sales factor as the dominant state income tax apportionment method, long-standing destination sourcing rules for sales of tangible personal property (TPP) may drive outcomes that fail to reasonably reflect how or where taxpayers generate the income states seek to tax. Regarding sales of TPP as steps within modern supply chains, the sales factor often neglects to satisfy its own internal purpose — to represent the market for a taxpayer's goods. Without the support of other factors like property and payroll, this internal sales factor may not accurately reflect the market, failing to achieve the goals of a fair apportionment system. As such, alternative apportionment may be the only viable solution to provide relief for taxpayers selling TPP with distorted apportionment factors under traditional destination sourcing rules.

### Background: The Apportionment Factor and the Rise of the Single Sales Factor

The constitutional restraint of fair apportionment has shaped most states' corporate income tax regimes. Although states are allowed to implement many apportionment and allocation formulas, a state's apportionment method must ensure that only income fairly attributable to the state is taxed.<sup>1</sup> The Supreme Court has held that the "factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated" to establish a constitutionally "fair" apportionment formula as required by the due process and commerce clauses.<sup>2</sup> Accordingly, the purpose of the apportionment formula is to represent the activities of a taxpayer to fairly attribute a portion of the taxpayer's income to the jurisdiction. If a state's standard apportionment formula does not fairly attribute the taxpayer's income, the state must provide a mechanism for relief.

This notion is reflected in section 18 of the Uniform Division of Income for Tax Purposes Act, which allows a reasonable deviation from a state's statutory apportionment formula when its allocation and apportionment provisions do not fairly represent the taxpayer's business activities in the state. UDITPA section 18 and similar state specific provisions stand as the constitutionally required relief mechanism when the standard apportionment factor fails.

Historically, as reflected in UDITPA, most states employed three-factor apportionment methods, weighing a corporate taxpayer's in-state property, payroll, and sales to the everywhere totals of these factors. These multifactor formulas reflected that fair apportionment should account for "the two basic factors, capital and labor, that underlie all production or business activity."<sup>3</sup> However, this notion that a fair apportionment formula must give weight to a company's production activity through a property and payroll factor has not stood the test of time. Driven by economic development concerns, most states have now abandoned property and payroll factors, adopting single-sales-factor apportionment systems instead.

### Single-Sales-Factor Systems and Fair Apportionment

While strong arguments can be (and have been) made that a single-sales-factor system fails to satisfy constitutional fair apportionment requirements, those arguments failed in *Moorman*.<sup>4</sup> In *Moorman*, the Supreme Court declined the opportunity to rule that a single sales factor was per se unconstitutional (unconstitutional in all circumstances). It sustained Iowa's single-sales-factor formula as applied to the limited facts before it in that specific case. However, the Court did not rule that the single sales factor would satisfy fair apportionment requirements in any or all circumstances. *Moorman* leaves the question of the constitutionality of the single sales factor to be decided on a case-by-case basis.<sup>5</sup>

The single sales factor's claim of legitimacy is directly tied to its ability to reflect the market for a taxpayer's goods or services.<sup>6</sup> The claim that identifying the market for a taxpayer's goods and services is a reasonable way to determine how and where a taxpayer generates income.

For purposes of this article, it is not necessary to dispute this claim. We can, for purposes of argument, accept that an apportionment factor that fairly reflects a taxpayer's market satisfies the requirements of fair apportionment. This claim can be accepted at face value and applied to the facts as we find them. Accordingly, the critical question is whether the sales factor in a single-sales-factor system reasonably reflects the taxpayer's market. If not, how can it then fairly reflect the taxpayer's business activities or reasonably reflect how and where the taxpayer earns income — both of which are requirements of fair apportionment? If application of market sourcing rules does not attribute revenue to a taxpayer's actual markets, it serves no purpose other than to shift the tax base away from production activities (that is, property and payroll) — satisfying economic development concerns but none other. A sales factor that does not reflect the taxpayer's market has become disconnected from its purpose and arguably fails to serve any legitimate purpose. If market sourcing does not reflect the taxpayer's true market, it may not satisfy the constitutional requirements of fair apportionment.

Historically, any distortive impact a single factor may have on the apportionment formula was often mitigated by the other factors, and the formula could still provide a reasonable reflection of how a taxpayer's income was generated. The use of equally weighted three-factor apportionment formulas is a thing of the past as most states have moved to a single-sales-factor apportionment formula. Accordingly, many taxpayers may be left with no relief for distortive sales factors in the standard apportionment formula.

## The Sales Factor

In the states that use single-sales-factor apportionment, broadly speaking, a corporation's state tax liability is calculated by multiplying together the corporation's business income, the corporation's state sales factor, and the applicable corporate state income tax rate. The sales factor is traditionally a fraction, the numerator of which is the total sales of the corporation in that state during the tax year, and the denominator of which is the total sales of the taxpayer everywhere during the tax year.<sup>7</sup> However, some sales are excluded or thrown out of the sales factor altogether, depending on the state's sourcing rules. A discussion of throw-out sales is outside the scope of this article but is another factor to consider when evaluating the inherent fairness in a single-sales-factor system.

The basic purpose of the sales factor is to reflect the market for the taxpayer's goods and services.<sup>8</sup> UDITPA section 17 provides: "(a) Receipts, other than receipts described in Section 16, are in this State if the taxpayer's market for the sales in this state." One can argue whether fairly reflecting the market for the taxpayer's goods and services satisfies fair apportionment standards; however, the point of this article is to consider single-sales-factor systems when the sales factor may not fairly reflect the market and, as a result, becomes disconnected from any articulated purpose for the apportionment formula.

## The Issue — Sourcing Sales of TPP Under Destination/Delivery-Based Sourcing Rules

The sales factor most often fails to reflect taxpayers' market when taxpayers sell to intermediate distributors delivering their products to concentrated distribution centers before the distributor then sells to the broader consumer market.

States use destination sourcing rules to source sales of TPP. In other words, sales of TPP are sourced to the place the TPP is delivered. Under UDITPA, sales of TPP are attributable to a state when the TPP is "delivered . . . to a purchaser" in that state, whether or not that state represents the market for the taxpayers' goods.

UDITPA section 16 provides:

Receipts from the sale of tangible personal property are in this State if:

*(a) the property is delivered or shipped to a purchaser, other than the United States Government, within this State regardless of the f.o.b. point or other conditions of the sale. [Emphasis added.]*

Section 16's TPP sales factor sourcing "delivery" rule, which is unchanged since the initial adoption of UDITPA in 1957, should be contrasted with section 17's sales factor sourcing "delivery" rule — which applies to sales of services. Section 17's delivery rule is explicitly intended to reflect the taxpayer's market, with that guidance written directly into the model statute when it was revised in 2015.<sup>9</sup> The 2015 updates to section 17's delivery rule provide a look-through approach when sourcing sales of services. Section 16's delivery rule lacks similar guidance, has never been revised, and has been interpreted over the years in ways that may fail to reflect the market.

Traditional destination-based sourcing rules were drafted for and interpreted in a three-factor world, where property and payroll tempered sales factor abnormalities. In a single-sales-factor regime, the property and payroll factors no longer serve to mitigate potential problems with the sales factor.

Some states provide that sales of TPP should be sourced to the "ultimate destination" of the TPP.<sup>10</sup> Case law has also developed interpreting the UDITPA sourcing rule to mean ultimate destination.<sup>11</sup> However, most states do not interpret ultimate destination rules as requiring taxpayers to look through to a taxpayer's customer's customer in the context of sales to wholesalers or distribution centers. As a result, destination-based sourcing rules for sales of TPP often may fail to reflect a taxpayer's true market when sales are made through these third-party intermediaries.

## Sales Directly to Consumers vs. Sales Using Distributors

In some instances, sourcing sales of TPP to the place of delivery accurately reflects the taxpayer's market. For example, if a taxpayer is selling TPP directly to consumers, destination/delivery-based sourcing works to correctly source sales to the taxpayer's market. For this reason, destination sourcing may be a more accurate way to reflect the market for direct-to-consumer retailer transactions than it is for a business-to-business wholesale transaction.

In instances when TPP is sold to third-party distributors, the sales are not often sourced to the market for the taxpayers' goods but are sourced to concentrated points in the distribution system. As supply chains and distribution systems have become more complex and nuanced, destination sourcing of any particular sale may not accurately reflect the taxpayer's ultimate market. For example, a taxpayer may have a broad market but a limited number of distributors across the country. Under some destination-based sourcing rules, these sales would be concentrated at the location of the distribution centers and not reflect the actual market for the taxpayers' goods.

### Distribution Center Distortion: Company A and DC Corp.

Consider Company A, a hypothetical European-based taxpayer that manufactures technology products. Company A sells substantial amounts of its products to consumers throughout the United States. Company A's U.S. sales are made through DC Corp., a national distributor with a main distribution hub in Alabama. DC Corp. resells the goods it purchases from Company A to retailers and end customers in all 50 states.

Under the general sourcing rules for TPP in UDITPA section 16, 100 percent of Company A's U.S. TPP sales and income would be sourced to Alabama — simply because of the delivery destination at the DC Corp. Alabama distribution center. This result disregards where Company A's customers reside and does not reflect Company A's true market for its product. Accordingly, Company A will be taxed as though its market is limited to Alabama, and all its U.S. income is attributable to Alabama, even though its only contact with Alabama is its distribution center. Company A may also owe tax in other jurisdictions whose rules require ultimate destination sourcing, thus requiring Company A to pay tax on more than 100 percent of its income.

### Third-Party Logistics Providers

The Company A example becomes even more disconnected from a reasonable view of the taxpayer's market when DC Corp. is not a traditional wholesale distributor but rather a third-party logistics provider (3PL). A 3PL acts more as a logistics services provider than a traditional wholesale distributor by acting as an intermediary for Company A, usually assuming regulatory, compliance, and reporting burdens for a service fee. In these situations, Company A and the 3PL work together to efficiently supply the products to consumers throughout the United States. Nonetheless, the 3PL is often the purchaser of record for many high-value manufacturers. Again, under the general sourcing rules for TPP in UDITPA section 16, all of Company A's sales would be sourced to the 3PL as a result of the intermediary sale of products to the 3PL, again failing to represent Company A's true market for its product.

The situation is further complicated by customers requiring taxpayers such as Company A to use 3PLs during sales. In this scenario, the direct purchaser of the products — the 3PL — is even more separated from Company A because the customer is requiring the intermediary sale to the 3PL. Sourcing these sales to the 3PL would undoubtedly not represent Company A's market.

A full description of the role of 3PLs in our distribution systems is beyond the scope of this article. But as their name suggests, 3PLs are in the business of providing logistics services. They are often the purchaser of record, but they generally do not represent the commercial market for the taxpayer's goods.

## State Relief for Certain Taxpayers

Some states provide relief for specific taxpayers, in narrow situations, that address the destination sourcing issue to more accurately reflect a taxpayer's market. Tennessee provides a certified distribution sales election. Under the election, qualifying sales — sales of TPP of at least \$1 billion made in Tennessee to a qualifying distributor that are resold for ultimate use or consumption outside Tennessee — are excluded from the numerator of the taxpayer's sales factor for franchise and excise tax apportionment purposes.<sup>12</sup> A gross receipts tax is paid on those qualifying sales that do not stay in Tennessee in lieu of the franchise and excise tax. Thus, tax is still paid on the sale of TPP into the state, but this election can result in significantly less tax than would have been due under the standard apportionment method of apportioning income and net worth to Tennessee based on sales that stop at a distributor in the state but are ultimately destined outside the state.

Mississippi has adopted specific apportionment methods for pharmaceutical suppliers. Mississippi provides that a major medical or pharmaceutical supplier of a Mississippi distribution facility, whose business activity is taxable both within and without the state, must apportion its business income using a three-factor formula based on a double-weighted payroll factor, a double-weighted property factor, and a single-weighted sales factor.<sup>13</sup> The statute defines a major medical or pharmaceutical supplier as a "company or group of affiliated companies who ship medial or pharmaceutical products to a Mississippi distribution facility."<sup>14</sup> A Mississippi distribution facility is defined as "a distribution facility that received funding from the 'Mississippi Industry Financing Revolving Fund' to open a facility in Mississippi and construction on the facility began between July 1, 2010, and December 31, 2010."<sup>15</sup> This formula favors out-of-state pharmaceutical suppliers that maintain little or no property and payroll within Mississippi, but it does not address the overarching issue of the single-sales-factor system for sales of TPP.<sup>16</sup>

While Tennessee and Mississippi offer some relief to a narrow set of targeted taxpayers, most states have not addressed and do not provide a solution for any group of taxpayers. Further, not all taxpayers qualify for the relief granted in these states. By providing relief for at least some taxpayers, it seems these states are acknowledging the issue. Accordingly, alternative apportionment may be a viable solution for other similarly situated taxpayers.

## Alternative Apportionment as a Viable Solution

UDITPA section 18 allows reasonable deviation from a state's statutory apportionment formula when the allocation and apportionment provisions do not fairly represent the taxpayer's business activities in the state. Under traditional single-sales-factor sourcing, the standard apportionment formula does not always fairly reflect the taxpayer's business activities when a taxpayer sells TPP. Destination sourcing of distribution center and 3PL sales in a taxpayer's sales factor is often not a fair reflection of taxpayer's business activity in a state. Accordingly, alternative apportionment may be an important remedy to address these potentially distortive sales factors.

UDITPA section 18 provides:

(a) If the allocation and apportionment provisions of this Article *do not fairly represent the extent of the taxpayer's business activity in this State*, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(b)

(1) If the allocation and apportionment provisions of this Article do not fairly represent the extent of business activity in this State of taxpayers engaged in a particular industry or in a particular transaction or activity, the tax administrator may, in addition to the authority provided in section (a), establish appropriate rules or regulations for determining alternative allocation and apportionment methods for such taxpayers.

(2) A regulation adopted pursuant to this section shall be applied uniformly, except that with respect to any taxpayer to whom such regulation applies, the taxpayer may petition for, or the tax administrator may require, adjustment pursuant to Section 18(a).

[Emphasis added.]

As discussed throughout this article, the general sourcing rules for sales of TPP can inaccurately represent a taxpayer's market when TPP is sold through third-party distributors. In a single-sales-factor world, without the property or payroll factors to mitigate any distortive effect, the apportionment factor may not accurately represent the taxpayer's business activity in the state in these scenarios. Ultimately, alternative apportionment may be the most viable option for taxpayers seeking relief from distorted apportionment factors under traditional destination sourcing rules.

The Tennessee and Mississippi relief provisions discussed above provide two potential alternative apportionment relief mechanisms: (1) look-through sourcing that allows the sales factor to accurately reflect the taxpayer's market, and (2) the inclusion of other factors such as property and payroll to offset the sales factor distortion. Both of these mechanisms may provide taxpayers with relief from flawed apportionment factors as a result of TPP sales through third-party distributors.

Regardless of what relief mechanism is used, TPP destination sourcing in single-sales-factor systems often fails to meet the constitutional fair apportionment requirements and may make some form of relief necessary.<sup>17</sup>

## FOOTNOTES

<sup>1</sup> See *Complete Auto Transit Inc. v. Brady*, [430 U.S. 274](#) (1977).

<sup>2</sup> *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983); Jerome R. Hellerstein, Walter Hellerstein, and Andrew Appleby, *State Taxation* section 9.15 (updated Aug. 2025).

<sup>3</sup> Complaint, *Florida v. California*, [No. 22O163](#) (U.S. Oct. 28, 2025) (citing Paul Studenski, "The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist's Viewpoint," 46 *Va. L. Rev.* 1121, 1122-1223 (1960)).

<sup>4</sup> *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

<sup>5</sup> The Los Angeles County Superior Court recently concluded that a taxpayer qualified as an "agricultural business" under Cal. Rev. & Tax. Code section 25128(b) and therefore must use an equally weighted three-factor apportionment formula based on property, payroll, and sales. Notably, the court further concluded that even if the taxpayer did not qualify as an agricultural business, it would be entitled to relief under section 25137 because the application of California's single-sales-factor formula did not fairly represent the extent of the taxpayer's business activity in California. *Smithfield Packaged Meats Corp. v. California Franchise Tax Board*, [Case No. 21STCV39637](#) (Cal. Super. Ct. Los Angeles Cnty. Jan. 26, 2026).

<sup>6</sup> See generally Hellerstein, Hellerstein, and Appleby, *supra* note 2, at sections 9.15, 9.18; *Moorman*, 437 U.S. 267.

<sup>7</sup> See, e.g., Cal. Rev. & Tax. Code section 25120(a).

<sup>8</sup> *Appeal of Finnigan*, 88 SBE 022-A (Cal. St. Bd. of Equal. Aug. 25, 1988) (citing George Tilden Altman and Frank Morton Keesling, *Allocation of Income in State Taxation* 126-128 (1950)); *Appeals of Pacific Telephone and Telegraph Co.*, [78-SBE-028](#) (Cal. St. Bd. of Equal. May 4, 1978); California Franchise Tax Board, "Multistate Audit Technique Manual," [ch. 7500](#).

<sup>9</sup> In July 2015 the Multistate Tax Commission adopted several amendments to UDITPA.

<sup>10</sup> La. Rev. Stat. Ann. section 47:245(F)(3).

<sup>11</sup> *Department of Revenue v. Parker Banana Co.*, 391 So. 2d 762 (Fla. Dist. Ct. App. 1980).

<sup>12</sup> Tenn. Code Ann. section 67-4-2023(c)(1).

<sup>13</sup> Miss. Code Ann. section 27-7-24.8.

<sup>14</sup> *Id.*

<sup>15</sup> Miss. Code Ann. sections 27-7-24.8 and 27-13-13(d)(ii).

<sup>16</sup> Mississippi generally imposes a single sales factor on corporations doing business in the state but does provide a three-factor apportionment formula for manufacturers. 35-III Miss. Code R. section 08.06.402.08.

<sup>17</sup> This article contains general information only, and Deloitte is not, by means of this article, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This article is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this article.

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## END FOOTNOTES