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No blanket procedures for compliance in drop shipments; state-by-state scrutiny a must

Sales and use tax compliance in drop shipments requires a determined effort by tax professionals. A company's tax department must conduct a state-by-state survey of those states where business is conducted to ensure that drop shipments to those destinations do not run afoul of sales and use tax laws. In fact, tax managers must scrutinize each state's statutes and regulations regarding how a drop shipment must be documented and which jurisdiction's documents may be used. Whether your company is a mail-order firm, a manufacturer or a lightning-speed Internet company, understanding taxation of drop shipment transactions is a must to remain in compliance and to fend off possible assessments at a later date.

Understanding drop shipments

A drop shipment involves two transactions among three parties. The retailer in the transaction sells an item to its customer. For want of inventory or as an ongoing arrangement, the retailer has its supplier—either a wholesaler or the manufacturer—ship directly to the retailer's customer. Confusion of terms may hinder the novice to drop shipment transactions. Sometimes the retailer in the transaction is actually a wholesaler which drop ships to the customer of a retail store. Or the supplier in the transaction may be a manufacturer. For the sake of discussion, we will term the three parties of the transaction "retailer," "supplier" and "customer."

Problems arise in interstate transactions when the supplier has nexus in the state where the customer is located, but the retailer does not. Proper documentation of the transaction is necessary for the supplier to prove a sale for resale occurred. Lacking the documentation, the supplier must register, collect and remit the tax. But states treat the transaction differently. For sales tax managers, a daunting task lies ahead, says **Marilyn Wethekam**, of Horwood Marcus & Berk in Chicago.

"There's very little consistency among the various states," Wethekam says. "You have to identify the states in which you are doing business, look up their statutes, then decide how you're going to handle it."

While a company's tax department may be inclined to put out a general procedure for employees to follow, the area of drop shipments does not allow for much in the way of uniformity.

"You're not going to be able to put out a blanket procedure to handle drop shipments," Wethekam says. "You have to look at every state's statutes and regulations. It may not be in the same spot in each state. That's what makes this so maddening at times."

If you are the supplier, begin by looking at whether you can accept an out-of-state resale certificate. If you don't have any documentation to back up a sale-for-resale claim, you must collect tax. That means determining which states you must collect tax for and at what rate.

Documentation

Sufficient documentation to prove a sale for resale occurred varies widely. Look at the statutes and regulations of the state in question. Some states accept another state's resale certificate, allowing a pass-through by honoring a sale-for-resale exemption certificate from a supplier's home state in lieu of a certificate issued by the delivery state, says **Diane Yetter**, of Yetter Consulting Services Inc. in Chicago.

Other options may be available. "Some states are more liberal and allow you to supply other certificates or other documents" says **Debra L. Silverman**, of Roberts & Holland LLP in New York.

Certain states will accept a statement bearing the name of the retailer, its address and federal taxpayer's identification number. Some states will allow an affidavit outlining the transaction from the retailer. Many states take the Multistate Tax Commission's multijurisdictional certificate. Though 37 states and the District of Columbia accept the "Uniform Sales & Use Tax Certificate-Multijurisdiction," 24 accompanying footnotes abridge circumstances under which various states will accept the document.

A few, Wethekam says, such as Kansas, will allow a home state registration number to suffice. But Florida demands that if a Florida manufacturer delivers goods to the customer of an unregistered, out-of-state dealer, the manufacturer must collect tax from the dealer (Fla. Admin. Code Ann. r. §12A-1.091(10)(2002).

Silverman notes that New York allows in-state and qualifying out-of-state retailers to use New York's Form ST-120 (Resale Certificate) to make tax-exempt sales for resale. To qualify, an out-of-state purchaser must certify that it is not required to be registered as a New York sales tax vendor (i.e. no nexus); that it is registered with another jurisdiction to collect sales tax or value added tax; and that it is purchasing the item for resale either to be delivered to the customer or to an unaffiliated fulfillment service provider located in New York, or, to be delivered to the vendor in New York for resale from a business located outside New York. The Dept. of Taxation and Finance's TSB-M-98(3)S revised the state's policy to allow this. Previously, Form ST-120 was available only to registered sellers and out-of-state sellers had to apply for an out-of-state resale permit. New York's Reg. 532.4 also gives examples of what the state will consider proper evidence of a sale for resale during an audit, says Silverman.

In some states, the courts have broached the issue. The Connecticut Supreme Court found in *Steelcase Inc. v. Crystal* (1996) that a Michigan furniture maker lacking nexus with Connecticut was not obligated to collect that state's sales and use tax on furniture shipped to the customers of out-of-state retailers. In New Jersey, *Steelcase Inc. v. Div. of Taxation* (1993) determined that a supplier could provide alternative documentation to prove an exempt resale.

Collapsed transactions

Some states collapse the transaction, forcing the supplier to bear the burden of collection. Nine states, including California, adhere to a policy whereby the supplier is deemed to be the seller and is responsible to collect and remit, Wethekam notes. In a Court of Appeals decision, *Lyon Metal Products Inc. v. State Board of Equalization* (1998), a California wholesaler was liable for sales tax on goods sold to an out-of-state retailer and delivered directly from its California warehouse to a California retail customer. A California statute that codifies the drop-shipment rule specifically provides that such a transaction is subject to California sales tax and, because the same tax rate would be applied to the sale if all of the parties were present in California, there was no unconstitutional discrimination.

California requires the supplier to collect and remit tax on an assumed 10% markup. Determining

the retail markup has long been a troublesome area for suppliers. Traditionally, retailers have been reluctant to reveal to suppliers the amount of the retailer's markup, further complicating the issue of drop shipments for suppliers.

Basic compliance

Much of today's Internet transactions amount to simple drop shipments, despite their cyberspace trappings. And drop shipments performed for mail-order companies along with more traditional drop shipments made by manufacturers for retailers are the same in substance. So they are taxed in the same manner. (See the Aug. 1, 2002 *SUTA* article "Fulfillment Houses and the Internet: Agents, Vendors and Nexus.") Knowing the basics of drop shipments is essential, whatever business model your company utilizes, experts agree.

Nonetheless, the rush toward e-commerce several years ago may not have found start-up e-commerce businesses well grounded in compliance.

"I think you may be dealing with more unregistered sellers," Wethekam says. "Just because it's not on the radar, doesn't mean it's not taxable-just not found."

"An Internet retailer's customer has the duty to self-assess use tax if no sales tax is charged on the transaction," Silverman notes.

Yetter adds, "Many companies promote the tax avoidance aspect of buying over the Internet. Small companies are not as likely to be doing this correctly."

And tough competition may be driving Internet businesses to develop new business models that complicate the issue, Yetter adds.

But given the current climate where state revenue departments busy themselves looking for any uncollected funds, tax managers in reviewing drop shipments, like other areas of compliance, would do well to take a second look.

"I think in today's economy, the states are getting more aggressive in auditing overall," Yetter says. "Certainly there is the likelihood that this is one area states might go after."

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