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Definition of a Drop Shipment

- Retailer accepts order from a customer
- Retailer places order with a manufacturer/wholesaler
- Retailer instructs manufacturer/wholesaler to ship directly to the customer
- Retailer bills customer, manufacturer/wholesaler bills retailer

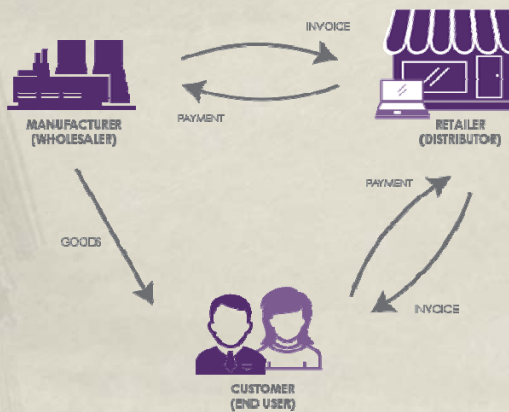
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Drop Shipments

THE DROP SHIPMENT MODEL



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Sales and Use Tax Issues

- Will the state recognize the sale between the retailer and manufacturer as a sale for resale?
- What documentation will the state accept from the non-registered retailer?

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Sales and Use Tax Issues

- What if the customer is reselling the goods?
- What if the customer is an exempt entity?

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Sales and Use Tax Issues

- What if the manufacturer delivers the goods from an in-state vs. an out-of-state inventory location?
- Do shipping terms affect the taxability of the drop shipment?
- What if the manufacturer delivers via own truck, common carrier, or ships goods COD?
- What if the end customer picks up the goods at the manufacturer's location rather than shipping it?

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Sales and Use Tax Issues

- What is the tax base if the manufacturer is responsible for collecting the tax rather than the retailer?
- Can retailer reimburse itself by passing tax to customer? How can it be displayed? Does the sales tax reduce the use tax?

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Drop Shipments Transactions Classification

- Will the state recognize the sale between the retailer and manufacturer as a sale for resale?
 - The transaction between the retailer and customer is the taxable retail transaction
 - There is no retail transaction between the manufacturer and customer
 - The transaction between the manufacturer and retailer is a transaction for resale

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Drop Shipments Transactions Classification

BUT

- How do you claim a resale transaction?
- States require a valid resale exemption certificate for the ship to state
 - Should this be only a certificate for the ship to state?
 - What if the retailer isn't registered in the ship to state?
- What documentation will the state accept from the non-registered retailer?

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Documentation

- Many jurisdictions will allow alternative documentation if a retailer is not registered
 - Written statement asserting retailer does not have nexus and is engaged in business of reselling (ID, LA)
 - Any documentation as long as it contains the required components i.e. retailer name, address, signature
 - Multi-jurisdictional certificate, Border States Uniform Sale for Resale Certificate, certificate from retailer's home state, SSTP certificate

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Documentation (cont.)

- Some jurisdictions will accept another state's registration number on their own exemption certificate (NY)
- Retailer may be forced to register if the state only accepts its own registration number (CA)

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End Customer Status

- What if the customer is reselling the goods?
 - If the state otherwise won't accept alternative documentation, if the customer is registered as a retailer, they may accept the customer's resale certificate (MA)
- What if the customer is an exempt entity?
 - Some states will allow a pass-through exemption if end customer is an exempt entity or also reselling (TN)

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Inventory Location & Shipping

- What if the manufacturer delivers the goods from an in-state vs. an out-of-state inventory location?
 - If the inventory is located in the same state as the ship to customer location, some states view the sale as occurring wholly within the state and therefore require an in-state registration number to claim the resale exemption (FL)
- Do shipping terms affect the taxability of the drop shipment? What if the manufacturer delivers via own truck, common carrier, or ships goods COD?
 - If delivery is made in the vendor's own truck, this is no longer an "interstate delivery" so some states won't accept alternative documentation (FL, KS)

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Dock Sales

- What if the retailer's customer picks up the item at the dock, is it still considered a drop shipment?
 - Deemed an instate sales so any states with inventory location rules will be impacted
 - Rules generally say "delivery" which doesn't necessarily mean "ship"
 - Lack of guidance on issue

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Drop Shipment and Export

- Are export sales similar to drop shipments? If so, how? What documentation should you maintain for export sales?
 - Export sales may be similar to drop shipments if the goods are shipped to someone other than the purchaser
 - If the goods are shipped to an export broker address in a state hired by the customer, the seller should obtain the export documentation from the export broker or customer upon export
 - If the goods are picked up by the customer or the customer's agent who is not an export broker, tax generally applies

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Taxable Basis - Wholesale vs. Retail

- What is the tax base if the manufacturer is responsible for collecting the tax rather than the retailer?
- Whether tax is based on the retail or wholesale price will depend on the state's rules
 - California requires either the retail price or the wholesale price plus a 10% mark-up
 - Florida requires the retail price to the consumer if known
 - Kentucky requires the selling price to the distributor plus shipping & delivery charges

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Tax Reimbursement

- Can an unregistered retailer reimburse itself by passing tax to customer? How can it be displayed? Does the sales tax reduce the use tax?
 - California prohibits the retailer from reimbursing itself
 - Connecticut indicates that the tax should be collected from the consumer rather than the retailer
 - Florida and Maryland allow the retailer to reimburse itself but can not show it as "tax" on the invoice
 - Michigan allows the retailer to indicate the tax is being passed through to the consumer and is not a tax being collected and remitted by the retailer, as the retailer is not registered for Michigan taxes.

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Streamlined Sales Tax Project Drop Shipments Issue Paper

- Under SSTP, member states must allow manufacturers to accept a resale exemption certificate from the retailer regardless of whether the retailer is registered to collect and remit sales and use taxes in the ship to state when the sale is made
- As a result, many member states have had to change their rules on what is considered acceptable documentation
- Tennessee will have to change once they become full member state

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Good Faith Acceptance

- Good faith acceptance – If a vendor accepts a certificate adopted by the taxing authority, the vendor will be relieved of any tax liability and the Department may require a purchaser to validate the claimed deduction or exemption

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Drop Shipment and Nexus

- Businesses involved in drop shipment transaction may create tax collection and nexus issues as well
- “Click-Through” and affiliate nexus rules often apply in drop shipment business structures
- Unregistered retailers should not advertise that no sales tax applies on the orders

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Drop Shipment and Nexus

- Use of 3rd party agents in the drop shipment business structure is often overlooked in determining where a retailer is required to be registered
- Ownership of inventory at the fulfillment house will create nexus for retailer by the drop shipper

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Drop Shipment and Nexus

- Some fulfillment activities performed on behalf of the retailer may create nexus
- Most states are taking position that most activities create nexus
 - Packing and shipping orders (DC, FL)
 - Accepting and processing product returns (NY)
 - Accepting phone and mail orders (AL)

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Practical Issues

- Manufacturers can be held liable for non collection of tax in states where they have nexus – should they require ship to state certificates?
- Retailers won't pay tax on items they buy for resale so if they are charged they will short pay.
- How much time is spent trying to resolve these issues?

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Practical Issues

- How should you handle customers that refuse to pay the sales tax and cannot provide the required documentation? Do you credit the tax and reduce your taxable sales or do you remit the tax to the appropriate jurisdiction?
 - Registered sellers that don't have appropriate exemption documentation should remit tax regardless of whether their customer paid it to minimize their audit risk and tax liability

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Practical Issues

- Retailers are not required to register to collect tax if they don't have nexus.
- In states that require registration to issue a resale certificate, retailers may be "forced" to voluntarily register.
- What are the implications of voluntary registration?

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Practical Issues

- In states that require the manufacturer to invoice the tax on a basis other than their selling price, how can they do this in their billing system?
 - Does the manufacturer know the retail selling price?
 - If there is a MSRP, but retailer can bill a different amount, what should the manufacturer use?
 - What if the known retail price is greater than 10% in California?

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Practical Issues

- Customers that accrue use tax on drop shipment purchases may end up paying use tax on an invoice that already includes some or all of the tax paid by the retailer. What should they do?
 - Do customers have the right to ask for documentation of tax paid?
 - Will this documentation reduce their use tax obligation?
 - Should customers avoid purchasing where a drop shipment might apply if the retailer is not registered?

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Resources

- CCH Incorporated Drop Shipment Study
 - <http://www.yettertax.com/published/drop-shipments-taxation-compliance-and-planning-2012/>
 - Enter discount code **USTP-BXYY10182** for 40% off the Drop Shipment Study
- The Institute for Professionals in Taxation (IPT)
 - Published bi-annually
- Other state tax publications

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Questions/Comments

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