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Vendor Beware: Drop Shipments May Result In Unexpected Sales Tax Collection Obligations

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In today's business climate, lean inventories are essential to reduce business costs and remain competitive. Conversely, with the proliferation of the internet marketplace, customers expect immediate delivery. Drop shipments are an attractive way to satisfy these conflicting business demands.

But—Vendor Beware: Vendors that drop ship merchandise to the ultimate consumer on behalf of their customer may create an unexpected obligation to collect and remit sales tax to the state in which the ultimate consumer lives.

What Is A Drop Shipment?

A drop shipment occurs when Company A sells its product to its customer. However, Company A does not stock the product and orders the product from its wholesaler, Company B. Company A then instructs Company B ("Drop Shipper") to ship the product directly to Company A's customer, the ultimate consumer of the product. This transaction obligates the Drop Shipper to collect and remit sales tax on such shipments to the ultimate consumer in California, Massachusetts, Nebraska, Nevada, Rhode Island, Pennsylvania, Tennessee, Texas and Wisconsin.

How Can These States Require A Wholesaler Drop Shipper To Collect and Remit Sales Tax?

The sales tax laws in California, Massachusetts, Nebraska, Nevada, Rhode Island, Tennessee and Wisconsin[1] include statutory provisions that impose sales tax collection obligations on the Drop Shipper. In Pennsylvania and Texas administrative rulings by

[1] Connecticut also has a drop shipment statute, Conn. Gen. Stat. § 12-407(3), however the Connecticut Supreme Court in *Steelcase, Inc. v. Crystal*, 680 A.2d 289,295, held that no retail sale occurred because delivery of the goods was not made in Connecticut. Thus, the Court found that the Connecticut Department of Revenue could not impose sales tax collection obligations on the Drop Shipper. As a result of this decision, the Department is not actively enforcing its statute.

the taxing authority impose sales tax obligations on the Drop Shipper, unless the Drop Shipper obtains a valid resale certificate from its customer.

States with Drop Shipment Statutes

California

The California statute is an example of a typical drop shipment statute. Cal. Rev. & Tax Code § 6007 states:

> When tangible personal property is delivered by an owner or former owner thereof, or by a factor or agent of that owner, former owner, or factor to a consumer or to a person for redelivery to a consumer, pursuant to a retail sale made by a retailer not engaged in business in this state, the person making the delivery shall be deemed the retailer of that property. He or she shall include the retail selling price of the property in his or her gross receipts or sales price.

Generally, the Drop Shipper must report and remit the sales tax based on the retail selling price, *i.e*., the price Company A charged the ultimate consumer.[2] However, if the Drop Shipper does not know the retail selling price, it may calculate the sales tax based on its selling price to its customer plus a mark-up of 10%.[3] In March 2007, the California State Board of Equalization issued a Tax Information Bulletin that illustrates drop shipment transactions and how to calculate the sales tax.[4]

The California Court of Appeals upheld this statute against constitutional challenges. In *Lyon Metal Products, Inc. v. State Bd. of Equalization*,[5] the Court held that the drop shipment statute did not violate the Commerce Clause of the United States Constitution.[6] In that case, Lyon delivered tangible personal property in California at the request of an out-of-state retailer that purchased the goods at wholesale from Lyon and resold them to a California retail customer.[7] The goods in question were warehoused in California, shipped from California and delivered to retail consumers in California.[8] Applying the four-part *Complete Auto Transit* test,[9] the Court upheld the

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[2] Cal. Code Regs. tit. 18 § 1706(c)(1).

[3] Cal. Code Regs. tit. 18 § 1706(c)(2).

[4] This bulletin is available online at www.boe.ca.gov/news/pdf/mar07tib.pdf.

[5] 58 Cal. App. 4th 906 (1997), *cert. denied* 524 U.S. 916.

[6] Art. I, cl. 3, § 8.

[7] *Id*. at 909.

[8] *Id*. at 911.

[9] In *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), the U.S. Supreme Court held that a state tax does not unconstitutionally burden interstate commerce if it satisfies four conditions: (1) the tax

constitutionality of the statute. The Court found sufficient nexus existed because the goods were stored in a California warehouse and were delivered from that warehouse to California consumers.[10] The Court noted that the drop shipment statute was intended to plug a tax loophole that allowed goods to evade tax if an out-of-state intermediary was involved.

Tennessee

The Tennessee Court of Appeals also upheld the similar Tennessee drop shipment statute[11] in *Upper East Tennessee Distributing v. Johnson*.[12] Pursuant to Tenn. Admn. Code § 1320-5-1-.96, the Drop Shipper is required to collect the tax involved on the transaction unless specific and satisfactory arrangements have been made with the Commissioner before the sales and deliveries are made.

Upper East Tennessee Distributing was a manufacturer of amusement game machines located in Tennessee. Upper East ("Seller") sold, for resale, several machines to Coin Concepts, Inc. ("Buyer").[13] Buyer left the machines at Seller's Tennessee location and resold them to Buyer's customer. Seller agreed to deliver the machines to Buyer's customer.[14]

The Court of Appeals held that although the drop shipments were intended for resale they were nevertheless subject to the tax because no prior arrangements with the Commissioner had been made as required by Rule 1320-5-1.96. Upper East, as the drop shipper, was required to collect and remit the sales tax.[15]

Courts in the remaining states with drop shipment statutes, Massachusetts, Nebraska, Nevada, Rhode Island and Wisconsin, have not reviewed their respective drop shipment statutes. Administrative rulings, in Pennsylvania and Texas, interpret the statutory and regulatory requirements to collect sales tax on delivery of an item unless

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(continued…)

must be applied to an activity with a substantial nexus to the taxing state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce and (4) the tax must be fairly related to services provided by the state.

[10] *Id*. at 913.

[11] The Tennessee Statute states: "Retail sale" or "sale at retail" includes the delivery in this state of tangible personal property by a retailer who has no place of business in this state, if the delivery is made to a consumer in this state or to another person for redelivery to a consumer in the state pursuant to a retail sale made by such retailer to such consumer. Tenn. Code Ann. § 67-6-102(24)(c).

[12] No. 03A01-9701-CH-00011, 1997 Tenn. App. LEXIS 325.

[13] *Id*. at *2.

[14] *Id*. at *2-3.

[15] *Id*. at *8.

the seller collects a proper and complete in-state exemption certificate (requiring a permit number of the buyer).

The Administrative Rulings in Pennsylvania and Texas

Pennsylvania

Under Pennsylvania law, a "sale at retail" subject to sales tax includes a transfer for value of possession of property.[16] Pennsylvania regulations provide: "Where delivery of taxable property or services is made to locations within this Commonwealth, the transactions shall be subject to tax."[17] A "vendor, lessor or serviceperson engaged in business activity" in Pennsylvania must collect tax where property is shipped from a point outside the commonwealth to a point within the commonwealth.[18] In a letter ruling, the Pennsylvania Department of Revenue found that a Drop Shipper with Pennsylvania nexus is required to collect sales tax on its drop shipment unless the Drop Shipper obtains a properly completed exemption certificate.[19]

Texas

A Drop Shipper shipping tangible personal property will be liable for use tax in Texas if it fails to collect a valid resale certificate from its customer. Texas statutes provide that a sale of tangible personal property by a person for delivery in the state is presumed to be a sale for storage, use or consumption in the state unless an exemption certificate is supplied.[20] The Texas Comptroller held that a drop shipper was liable for use tax which it should have collected from Texas customers pursuant to this statutory provision. The drop shipper was liable because it had not collected a resale certificate from its out-of-state purchaser.[21]

Rulings or Laws in New Jersey, Florida, Idaho, Iowa, Illinois and Michigan *Do Not* Require Drop Shippers to Collect and Remit Sales Tax on Drop Shipments

New Jersey

No statute or regulation specifically addresses the taxation of drop shipments in New Jersey. However, two 1993 decisions of the New Jersey Tax Court establish that a

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[16] Pa. Stat. Tit. 72 § 7201(k)(1).

[17] 61 Pa. Code § 32.5(a).

[18] 61 Pa. Code § 32.5(c)(1).

[19] *Legal Letter Ruling* No. SUT-134.

[20] Tex. Tax Code Ann. § 151.104(a).

[21] *In re: * * * Comptroller's Decision*, Hearing No. 22,936, 1989 Tex. Tax LEXIS 127, at *9 (June 22, 1989). The only Texas regulations specifically addressing drop shipments are franchise tax provisions dealing with the allocation of earned surplus and taxable capital to Texas. These regulations provide that the drop shipment of property into Texas "results in Texas gross receipts for the seller (drop shipper) and the purchaser (out-of-state retailer). Tex. Admin. Code tit. 34, §§ 3.549(41)(H), 3.557(37)(H).

vendor making a drop shipment of merchandise to in-state customers of an out-of-state retailer need not collect sales or use tax from the customers if the vendor's sale to the out-of-state retailer was for resale, and the resale exemption is established by a New Jersey resale certificate or other evidence, including the resale certificate of another state.

In *Steelcase, Inc. v. Director, Division of Taxation*[22] the New Jersey Tax Court considered whether use tax could be imposed on a manufacturer doing business in New Jersey that drop shipped office furniture to the in-state customers of an out-of-state retailer. Steelcase, the manufacturer, maintained its principal place of business in Michigan but was also doing business in New Jersey. In the drop shipments at issue in the case, most of the furniture was delivered via common carrier from Steelcase's warehouses outside New Jersey to New Jersey customers, although a small amount of furniture was delivered via common carrier from Steelcase's warehouse in New Jersey to New Jersey customers.

The Division of Taxation sought to impose a use tax obligation on Steelcase but, as the court points out, its theory of taxation was not entirely clear. The Division argued that a transfer of possession -- from the common carrier to the customer on delivery -- occurred in the state, that this transfer of possession qualified as a "sale" under New Jersey statutes, and that Steelcase must collect sales or use tax on the sale.

By concluding that the "first" sale to the out-of-state retailer was exempt, the court purports to dispose of all issues, never directly addressing whether Steelcase can be obligated to collect tax by virtue of its drop shipment in the "second" sale between the retailer and the New Jersey customer. However, other language in the opinion focuses on the absence of privity between Steelcase and the customer. The court aptly characterized the issues as follows:

> A drop-shipment transaction is a three-party transaction which masks the fact that there are actually two transactions, the sale from Steelcase to the out-of-state dealer and the sale from the out-of-state dealer to the dealer's customer in New Jersey. If Steelcase were to ship its product to the out-of-state dealer, the New Jersey sales and use tax could not be imposed on that transaction. If the out-of-state dealer has no nexus with New Jersey and ships the product to the New Jersey customer by common carrier, *Quill* prevents New Jersey from imposing a tax collection obligation on the dealer. Director here seeks to telescope these two separate transactions into a sale by Steelcase to the New Jersey customer in order to impose on Steelcase the obligation to collect either a sales tax or a use tax on the transactions. Two obvious problems arise. Is Director seeking to collect a tax on the wholesale price of the Steelcase-dealer

[22] 13 N.J. Tax 192 (1993).

> transaction or the retail price of the dealer-New Jersey customer transaction? Can Steelcase be expected to collect tax on the retail price, which it does not know? If it must collect tax on the wholesale price, then it is apparent that it is the sale from Steelcase to the dealer that is being taxed.[23]

Further, the court states:

> Although a transfer of possession may occur in New Jersey, it is not between seller and purchaser. In reality, the sale is between the non-nexus, out-of-state dealer and the New Jersey purchaser.[24]

Two conclusions may be drawn from this decision: 1) the court was very concerned about the absence of a transactional nexus between the manufacturer and the customer, suggesting that the manufacturer could not be saddled with a use tax collection duty with regard to the subsequent sale; and 2) the court never entertained the notion that the out-of-state retailer established nexus with the state through use of Steelcase as a drop shipper.

In *Solo Cup Co. v. Director, Division of Taxation*,[25] the manufacturer of paper products contested the state's imposition of use tax. The manufacturer Solo Cup had its principal place of business in Illinois and was also doing business in New Jersey. Solo Cup sold products to out-of-state buyers ("wholesalers") not registered for business in New Jersey. These wholesalers resold the products to customers located in New Jersey. Solo Cup delivered products directly from its warehouses located outside of New Jersey to the wholesaler's New Jersey customers. The Division of Taxation claimed that Solo Cup should have collected use tax, apparently on the theory that the sales to the wholesalers were not exempt sales-for-resales because the wholesalers had not presented valid New Jersey exemption certificates. The Tax Court determined that the holding of Steelcase applied to these facts, and ordered that the Division of Taxation examine "other evidence" that the sales to the wholesalers were exempt sales for resale. As to the drop shipment transaction, the Tax Court stated:

> Title to all merchandise sold passed from Solo Cup to the out-of-state wholesaler when the goods were delivered to the common carrier from Solo Cup's out-of-state warehouse.
>
> The New Jersey parties to which the products are shipped are customers of the out-of-state wholesalers. Solo Cup has no contractual relationship with these customers, having contracts solely with the out-of-state wholesalers who pay

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[23] *Id*. at 193 (citations omitted).

[24] *Id*. at 194.

[25] No. 07-14-1301-91ST, 1993 N.J. Tax LEXIS 13 (N.J. Tax Court Apr. 5, 1993).

> Solo Cup for the products. Solo Cup is not paid by the New Jersey customers.

The Tax Court resolved the issue on the basis of the *Steelcase* holding and the fact that the Solo Cup sales to the wholesalers were exempt sales for resale. Like the *Steelcase* decision, the *Solo Cup* case is direct authority that a Drop Shipper is not required to collect sales or use tax from the retailer's customers, and also suggests that no nexus of the out-of-state retailer was established through the drop shipment arrangements.

Florida

Florida does not have a specific statutory provision addressing drop shipments. However, the Department of Revenue has addressed drop shipments in Technical Assistance Advisements. Most recently, the Florida Department of Revenue found that an out-of-state Drop Shipper registered with Florida to collect sales tax is not obligated to collect sales or use tax on sales to an out-of state dealer where the product is shipped to Florida via common carrier.[26] The Department reached this conclusion because the transaction was not a Florida sale since both the Drop Shipper and dealer are located outside Florida.

Two other Florida advisements also discuss drop shipments. In Technical Assistance Advisement No. 85A-020,[27] Company A, which is located outside of Florida and not registered to collect Florida sales tax, sold merchandise to Company B, which is also located outside of Florida and not registered to collect Florida sales tax. Company A, however, shipped the merchandise directly to Company B's customer located in Florida. The ruling found that Company A was not required to collect Florida sales tax because it was not making a sale in Florida. The sale in Florida was made by Company B; however, Company B was not required to collect and remit sales tax if there is insufficient nexus.[28]

Idaho

Idaho has an administrative regulation that addresses drop shipments.[29] The regulation describes a drop shipment in this manner:

> [A] manufacturer produces Product X. The Retailer is a distributor of Product X. * * * The Customer places a purchase order with the Retailer. The Retailer, having no inventory in stock, places an order with the Manufacturer. The Retailer directs the Manufacturer to ship the product directly to the customer in Idaho. The Manufacturer,

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[26] *Technical Assistance Advisement* No. 07A-008 (March 29, 2007).

[27] (June 18, 1985).

[28] *See also Technical Assistance Advisement* No. 86A-029 (December 22, 1986).

[29] Idaho Admin. Code § 35.01.02.022.

> however, bills the Retailer for the product and receives payment from the Retailer. The Retailer bills and receives payment from the customer. The Manufacturer holds an Idaho seller's permit.

Subsection .02 of the regulation states, "[s]ince there is not privity of contract between the Manufacturer and the Customer, the Manufacturer will not be required to collect and remit sales tax on the purchase by the Customer." Likewise, subsection .03(b) states "[i]f the Retailer has no nexus with the state of Idaho it can accrue no sales tax liability and the sale between the Manufacturer and the Retailer is not subject to the jurisdiction of the Idaho State Tax Commission." However, if the Retailer holds an Idaho seller's permit, the Retailer must provide the Manufacturer with a resale certificate.[30]

Illinois

Ill. Admin. Code tit. 86, § 130.605(a) states:

> Where tangible personal property is located in [Illinois] at the time of its sale . . ., and then delivered in Illinois to the purchaser, the seller is taxable if the sale is at retail.

Pursuant to this section, "assuming delivery in Illinois, an Illinois retailer is anyone who either accepts purchase orders in Illinois or who sells items of tangible personal property . . . located in Illinois at the time of the sale."[31]

A drop shipper that accepts a valid resale certificate from its customer will not be required to collect and remit sales tax.[32] If the out-of-state retailer does not have nexus with the state, "it cannot be required to act as a use tax collector" on its sales of tangible personal property to Illinois residents which are effected through drop shipments.[33]

Iowa

Iowa also has an administrative regulation that addresses drop shipments.[34] This regulation states:

> A "drop shipment sale" occurs when the consumer places an order for the purchase of tangible personal property with the out-of-state retailer. The retailer does not own the property ordered at the same time the consumer's order is placed.

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[30] Idaho Admin. Code § 35.01.01.022.03(a).

[31] Priv. Ltr. Rul. ST-00-0176 (Ill. Dep't of Revenue Aug. 25, 2000).

[32] Priv. Ltr. Rul. ST-01-0212 (Ill. Dep't Revenue Oct. 17, 2001).

[33] See Priv. Ltr. Rul. 95-0464 (Ill. Dep't of Revenue Nov. 16, 1995).

[34] Iowa Admin. Code § 701-18.55.

> The retailer then purchases the property from the supplier. The supplier in turn ships the property directly to the consumer in Iowa. Under Iowa law the supplier in a drop shipment sale cannot be required to collect tax (either sales or use) from the consumer, even if the requisite nexus to require collection exists. . . . The supplier transfers possession of the goods to the consumer; however, transfer of possession alone has never been held to be a sale for purposes of Iowa sales and use tax law (citations omitted).

No cases or rulings have been found to expound on this provision.

Michigan

Under Michigan law a drop shipment sale is excluded from the gross proceeds used for the computation of sales and/or use tax of a person subject to tax if a resale or exemption certificate is obtained.[35] For purposes of both sales tax and use tax, Michigan statutes define a drop shipment as:

> (T)he direct delivery of tangible personal property to a purchaser in Michigan by a person who has sold the property to another person not licensed under this act but possessing a resale or exemption certificate or other written evidence of exemption authorized by another state, for resale to the Michigan purchaser.[36]

There are no cases examining these statutory sections. Drop shipments are, however, addressed in Revenue Administrative Bulletin 1988-34. Example three details the following transaction. Company A = out-of-state company. Company B = out-of-state seller. Person C = Michigan purchaser/consumer. Company B takes the order, collects the money and has Company A drop ship to Person C. If Company B is not registered in Michigan for sales and use tax collection, person C is responsible for the use tax on the purchase.

Conclusion

Before making drop shipments vendors should proceed cautiously in order to avoid unexpected sales tax collection obligations. Failure to do so could result in a substantial sales tax assessment that the vendor may be unable to collect from its customers.■

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[35] Mich. Comp. Laws Ann. §§ 205.54(k) and 205.94(i).

[36] *Id*.

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