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Streamlined Sales Tax Project Drop Shipments Issue Paper

In discussions with the public regarding exemption processing recommendations, the question was raised as to how states would deal with drop shipments since not all the states treat them the same for sales and use tax purposes. The following is a discussion of drop shipments with a recommendation as to how they should be treated in light of public comments and recommendations for exemption processing.

What is a drop shipment?

A drop shipment is a sale in which the seller accepts an order from a customer, places the order with a third party (such as a manufacturer or wholesaler), and directs the third party to deliver the item directly to the customer. The third party may deliver the item in its own truck, arrange for delivery by common or contract carrier, or have the customer pick up the item at the third party's location.

What is the problem?

If the seller has nexus or is voluntarily registered in the state where the sale occurs, generally there is no problem. The seller collects sales or use tax on the sale of the item to the customer, unless an exemption applies. The seller purchases the item from the third party without sales or use tax because it is for resale.

If the seller **and** the third party drop shipper do not have nexus and are not voluntarily registered in the state where the sale occurs, generally there is no problem. The seller and the third party drop shipper can not be required to collect sales or use tax on the retail sale. The customer is subject to use tax on the purchase of the item, unless an exemption applies.

If the seller does not have nexus and is not voluntarily registered in the state where the sale occurs, but the third party drop shipper does have nexus or is voluntarily registered in the state where the sale occurs, there is a conflict between some states laws and the exemption processing recommendations.

Conflict with Exemption Processing Recommendations

The exemption processing recommendations would allow a seller to issue a resale certificate to the third party drop shipper, regardless of whether or not the seller is registered to collect sales or use tax in the state where the sale occurs. The customer would report use tax on the sale, unless an exemption applies. The third party drop shipper would not be liable for tax as long as a resale certificate was received from the seller. This is the common treatment by most states.

By law, states handle drop shipments differently. The primary variations are summarized as follows (complete state summary attached):

1. The majority of states (33 out of 46) follow the exemption processing recommendation, allowing the seller to issue a resale certificate to the drop shipper, even though the seller is not registered in the state where the sale takes place. The seller is not responsible for the tax; the customer is subject to use tax.

Example

- Seller C does not have nexus in Washington and is not registered to collect Washington sales or use tax.
- Seller C receives an order from Washington Customer X for construction equipment.
- Seller C's retail selling price of the equipment is \$50,000.
- Seller C places an order to buy this equipment for \$45,000 with Third Party J, a manufacturer that has nexus in Washington and is registered to collect Washington sales tax.
- Seller C directs Third Party J to drop ship the equipment to Customer X's Washington location where the sale occurs.

The sale by Third Party J to Seller C is not subject to Washington sales or use tax because it is for resale. Customer X is subject to use tax on the \$50,000 purchase price, unless an exemption applies.

2. Thirteen states deem the third-party drop shipper the retailer of the item and require the third party drop shipper to collect sales tax on the sale to the customer or seller. Of these states, six require tax on the amount of the seller's selling price to the customer. The remaining seven states require the drop shipper to report on the wholesale price to the seller.

None of the thirteen states allow the drop shipper to accept a resale certificate from the seller unless the seller is registered in the state where the sale occurs. However, most of the states do allow the drop shipper to accept an exemption certificate if the customer can claim an exemption.

Example

- Company C does not have nexus in Wisconsin and is not registered to collect Wisconsin sales or use tax.
- Company C receives an order from Wisconsin Customer X for construction equipment.
- Company C's retail selling price of the equipment is \$50,000.
- Company C places an order to buy this equipment for \$45,000 with Third Party J, a manufacturer that has nexus in Wisconsin and is registered to collect Wisconsin sales tax.
- Company C directs Third Party J to drop ship the equipment to Customer X's Wisconsin location.

For Wisconsin (and CA, CT, HI, MA, RI), Third Party J is liable for sales tax on \$50,000 (Company C's selling price). Third Party J may not exempt the sale based on the receipt of a resale certificate from Seller C. Customer X may, if applicable, give an exemption certificate to Third Party J to exempt the sale.

For the other states (DC, FL, LA, MD, NE, NV, TN), Third Party J is required to collect sales tax from Seller C on the \$45,000 wholesale selling price. Third Party J may not exempt the sale based on the receipt of a resale certificate from Seller C's home state. In the majority of these states, Customer X may, if applicable, give an exemption certificate to Third Party J to exempt the sale.

Recommendation:

In the case of drop shipment sales, member states must allow the third party supplier to accept a resale exemption certificate from the seller regardless of whether the seller is registered to collect and remit sales and use tax in the state where the sale is made. The customer is subject to use tax if the seller does not collect the appropriate sales tax due on the sale unless the customer can claim an exemption.

If all sellers were to voluntarily register under the streamlined system, there would be no problem with drop shipments since the seller would collect tax on the retail sale to the customer and could give a resale certificate to the third party drop shipper to purchase the item without tax. Realizing that all sellers will not voluntarily register in a state where they have customers, the Work Group recommends that all states laws or regulations, whether in defining retailer, nexus, etc., be revised as a part of this project to reflect the treatment described above. It is presumed that states could identify purchasers subject to use tax based on resale exemption data received from the drop shipper, identifying those sales that are drop shipped on behalf of unregistered sellers.

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Drop Shipment Summary

(Information taken from 2000 CCH Drop Shipments Chart and 2001 SSTP Survey)

State	Resale Allowed		Tax due on customer's price	Tax due on seller's price	
	Yes	No			
Alabama	X				
Arizona	X				
Arkansas	X				
California		X	X		
Colorado	X				
Connecticut		X	X		
District of Columbia		X		X	
Florida		X		X	
Georgia	X				
Hawaii		X	X		
Idaho	X				
Illinois	X				
Indiana	X				
Iowa	X				
Kansas	X				
Kentucky	X				
Louisiana		X		X	
Maine	X				
Maryland		X		X	
Massachusetts		X	X		
Michigan	X				
Minnesota	X				
Mississippi	X				
Missouri	X				
Nebraska		X		X	
Nevada		X		X	
New Jersey	X				
New Mexico	X				
New York	X				
North Carolina	X				
North Dakota	X				
Ohio	X				
Oklahoma	X				
Pennsylvania	X				
Rhode Island		X	X		
South Carolina	X				
South Dakota	X				
Tennessee		X		X	
Texas	X				
Utah	X				
Vermont	X				
Virginia	X				
Washington	X				
West Virginia	X				
Wisconsin		X	X		
Wyoming	X				
Totals	46 states	33	13	6	7

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