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## Features:

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### ■ AUDITS TRAP UNWARY

#### Drop-shipment survey finds new business models facing continuing challenges

**T**he following article references a massive research project conducted by SUTA editors. The results were compiled into a new CCH book, *Drop Shipments: Taxation, Compliance and Planning*, authored by Diane Yetter, of Yetter Consulting Services Inc. in Chicago.

Taxation of drop shipment transactions remains a thorny area for many sales tax managers. Like most sales and use tax issues, taxability, statutes and rules vary among states.

In the typical drop shipment scenario, the Manufacturer sells its product to a Distributor, but the Manufacturer ships the product directly to the Consumer. Most states regard this as a simple sale for resale, comprised of two separate transactions: The Manufacturer sells the product to the Distributor; the Distributor then sells the product to the Consumer.

However, problems may occur when the Consumer is located in a state where the Manufacturer is registered to collect sales tax but the Distributor is not. The Distributor is not registered because it does not have nexus in the Consumer's state, and therefore does not have a resale certificate for the delivery state to issue to the Manufacturer.

Some states, however, may view the drop shipment transactions differently, collapsing them into a single transaction for sales tax purposes. Still, states that recognize two transactions may require different documentation to prove a sale for resale transpired.

In some ways, *SUTA's* survey of the drop shipment taxation requirements of 45 states and the District of Columbia prove heartening to the sales tax manager, showing broad strokes of similarity between states;

- More than 70% of the states exempt the distributor's purchase as a purchase for resale.
- Of these states, the majority accept a resale exemption certificate from any state and only require proof that the product is being resold.
- In states that require the manufacturer to collect tax from the distributor, 75% allow the distributor to pass the consumer's exemption certificate to the manufacturer to be relieved of tax liability if the Consumer qualifies for an exemption.

"The majority of the states recognize that a drop shipment comprises two separate transactions and that the Manufacturer is selling for resale to the Distributor," says **Diane Yetter**, of **Yetter Consulting** in Chicago.

#### Differing views of transactions

Yet drop-shipping goods into states that do not follow these trends, without adequate research and

preparation, could result in assessments or nexus for your company.

"The devil is in the details," warns **Richard Prem**, director of global indirect taxes for **Amazon.com**.

Twelve states, plus the District of Columbia, require manufacturers to collect from distributors in the absence of the delivery state's resale certificate with the delivery state's registration number.

"Some of the states that are strict on this are not states we necessarily think of as aggressive," Yetter notes. "For example, Rhode Island is not overly aggressive or onerous otherwise but requires the Distributor to be registered in order to issue a valid Rhode Island resale certificate."

### **Basis of tax**

The survey shows that where there is a tax collection requirement, most states require that the tax be based upon the selling price from the Manufacturer to the Distributor. Fewer states require the price to the consumer be taxed. Nonetheless, while that price may not be known to the manufacturer, some states allow the price to the Distributor to be used when the price to the Consumer is unknown.

California, however, requires the Manufacturer to calculate tax using a 10% markup on the price to the Distributor.

Yetter was surprised when a few states responded that the Manufacturer is required to collect the tax directly from the Consumer if the Distributor is not registered in their state. Wisconsin is among a handful of states that put this onerous and almost impossible requirement on the Manufacturer.

Some states that require the Manufacturer to collect tax from the Distributor allow the charge for this tax to be passed on to the Consumer. However, only a few states allow this tax reimbursement to be separately stated on the Distributor's invoice to the Consumer and for this tax to reduce the Consumer's use tax obligation.

South Dakota, for instance, does not allow the tax to be separately stated on the invoice to the Consumer and will not allow the reimbursement to reduce the Consumer's use tax base. South Dakota views the tax paid to the Manufacturer as a cost of goods sold. Florida, though, allows the tax to be a separate line item on the invoice to the Consumer.

### **Agency nexus**

When drafting the questionnaire for this study, Yetter wanted to include questions regarding nexus creation based on fulfillment activities. Today, many drop-shipment transactions relate to new e-commerce relationships. Since drop-shipment issues are so closely tied to where the Distributor does not have nexus, she felt it was an important component of the study.

About half of the states will allow the Manufacturer to pack and ship orders when the inventory is owned by the Manufacturer without creating nexus for the Distributor. However, there is a greater chance of nexus being created when the Manufacturer performs the same fulfillment activities on inventory owned by the Distributor. Almost every state deems significant fulfillment activities, such as order and payment processing and handling product returns, to create an agency relationship and therefore nexus for the Distributor. Although this solves the drop-shipment issue, the Distributor is now required to register and collect tax.

"Look at the contractual arrangement," Yetter says. "Determine whether you're establishing an agency or vendor-vendee relationship. When you establish an agency relationship, that's when you run into

problems."

### Other problems

Sometimes businesses experience difficulties not in complying with states' requirements for drop shipments but with others in the business community. Sophisticated taxpayers may face unnecessary demands from less savvy tax managers.

"A lot of manufacturers are leery about accepting home-state exemption certificates-they demand ship-to state certificates," Yetter notes

Or manufacturing companies may wrongly assume transactions are exempt because they deal more with use tax exemptions on purchases rather than exemptions on retail sales.

**Craig Combs**, director of sales and use tax for **Federated Department Stores Inc.** in Cincinnati, says drop shipments usually aren't a problem because Federated's retail stores, like Bloomingdales, and Internet entities are registered in many states. But problems may arise in a few states.

"When our vendor has nexus in a state where we are not registered, we have to pay out of our own pocket," he says. "We can't collect because we are not registered to collect.

### New face of drop shippers

Traditionally, drop shipments were largely considered the province of big mail-order companies. Now, however, many smaller companies are in the mix. Rarely do they even have an inventory.

"The unique thing is, there are tons of smaller sellers that have done the same thing," Prem says. "The Internet allows you to enter into these drop-ship scenarios. What's really changed is, it's not just the big guys."

But many of these small Internet companies are not likely to have the resources to stay on top of sales and use tax laws for all the states that levy such taxes.

"For small wholesalers or manufacturers, the biggest thing is lack of awareness of the issue," he adds. "It's a trap for the unwary-an assessment could put them out of business."

**Editor's note:** Prem can be reached at (206) 266-2708; Yetter at (312) 701-1800; Combs at (513) 579-7337; Compton at (770) 988-8382.

### DROP-SHIP CHECKLIST

When trying to determine the taxability of a drop shipment scenario, begin by completing a simple checklist.

- First look at the ship-to state and how it treats drop shipments, says **Diane Yetter**, of **Yetter Consulting Services Inc.** in Chicago. What documents are acceptable? What is the nature of the consumer-is the consumer exempt?
- Next, determine what exemption documentation you already have, perhaps a home-state certificate from a distributor that should be programmed into your computer system for all states where your company conducts business that will accept a home-state certificate.

- Take a look at what activities you perform in the ship-to state and what activities are being performed there on your behalf. Remember that certain fulfillment activities performed on your inventory by another can sometimes constitute agency status and thereby trigger nexus. Has nexus been triggered in states where your company has not registered?

"The best protection is to get an exemption from the destination state to avoid assessment and litigation," says **J. Whitney Compton**, of **Compton & Associates LLP** in Marietta, Ga. Failing that, get an exemption certificate from the wholesaler's home state.

**Richard Prem**, director of global indirect taxes for **Amazon.com**, says much of managing drop shipments involves having a good system in place to manage the resale certificates you receive from customers. Your system should cover these points:

- Make sure you get the certificate from each customer.
- Ensure you've got the appropriate certificate and it includes the necessary information to be valid along with a signature.
- Maintain a centralized archive of certificates so they don't get lost. Make sure other employees in your company know where to send certificates after they arrive in the mail.
- Regularly update your collection of certificates, since they expire after two or three years. Also, if a customer is acquired by another company, get certificates from the new company.

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## States' drop-shipment policy weighs SSTP, litigation

While tax managers face the ongoing, daunting task of hacking their way through varying drop-shipment statutes, rules and guidelines in the states where their companies conduct business, time to observe general trends may be scarce.

**Richard Prem**, director of global indirect taxes for **Amazon.com**, offers a macrocosmic view of what state tax policy initiatives will impact drop shipment tax rules. First, an impact is to be felt by the Streamlined Sales Tax Project, which is pushing for participating states to phase out laws regarding drop shipments by the end of 2005.

"There's a recognition by state tax administrators that these complex drop-shipment tax rules place an onerous burden on small and mid-sized businesses," he adds.

So state legislators and tax policy makers are left to decide whether to pursue revenue from their drop shipment statutes or to get rid of them to make the SSTP successful in hopes of having Congress overturn Quill—which would eliminate the reason states enacted these statutes in the first place.

### Aggressive enforcement

Nonetheless, many states are zealously targeting drop shipment transactions in audits.

In fact, these transactions are much more aggressively audited than before, Prem adds. States are aware that there is more activity and revenue online. Many states enacted their drop shipment laws in the 1990s

and have only recently revised their audit manuals and training to get their field auditors up to speed on these laws and how to audit them.

"The states are much more on top of this in terms of training their auditors to look for it," he says.

### **Always reaching**

**J. Whitney Compton**, of **Compton & Associates LLP**, in Marietta, Ga., indicates that the past may be a guide for the future, especially regarding state revenue departments attempting to litigate drop-shipment assessments.

"The trend for states is to extend their reach until the U.S. Supreme Court tells them they can't," he says.

Usually, state supreme courts will turn down overly aggressive litigation by the revenue departments. But, say one state out of four will win. This encourages other states to try to stretch their reach every three or four years.

Another tactic states have used is to force registrations through resale certificate requirements.

"The game that a lot of states play is, if you can't give us our certificate, then you the manufacturer are liable for the tax," Compton says.

This was a roundabout method of trying to force wholesalers to register. Manufacturers under pressure of liability for the tax would insist that wholesalers get a certificate in the state in question. As many as 16 states have used this approach.

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### **■ HIGH-TECH CONTRACTS AFFECTED**

#### **Georgia, New Jersey target state contractor affiliates**

Georgia and New Jersey have joined a growing list of states that require out-of-state contractors and their affiliates to register to collect sales and use taxes.

Georgia's Act 499 (HB1457), effective May 13, 2004, requires any nongovernmental vendor, or its affiliates, bidding on a state agency contract that exceeds \$100,000 per year to register with the state and to collect and remit Georgia sales and use tax on all retail sales occurring in the state.

Under New Jersey's Chap. 57 (AB3130), effective Sept. 1, 2004, contractors, subcontractors and their affiliates entering into contracts with New Jersey agencies, colleges and universities, county colleges, local government units, boards of education, and certain municipal water and wastewater contractors must collect New Jersey use tax on all sales of tangible personal property delivered into the state.

**Michael Guariglia**, a partner at **McCarter & English LLP** in Newark, N.J., says out-of-state contractors will be hard pressed not to comply with New Jersey's new statute.

"It's purely contractual," he says. "I think it would be a tough constitutional argument."

He likens the new demands to other contractual requirements for doing business with the state, such as bidding specs and minimum bonding.

"It's a neat way to get around the Constitution," he notes. (*See the March 15, 2004 SUTA article "Register or no state contracts-an offer remote sellers can't refuse? Maybe not..."*)

Advice: See if there is any way to create separate and distinct entities that aren't captured by state contractor requirements. "It's going to depend upon the definition of affiliates," Guariglia says. "But if the state has buttoned down its definition, it's going to be difficult to work around."

Yet some out-of-state vendors may be forced to choose between registering to secure a government contract and walking away from the contract to keep private sector clients happy, notes **Ned A. Lenhart**, of **Sales Tax Advisors of Georgia PC in Atlanta**.

"Are you offending your customers by overturning a long-standing policy of not charging sales tax?" he asks.

### **Online sales**

"Some other states have done this," says **Phil Embry**, director of the sales and use tax division of the **Georgia Dept. of Revenue**. "The revenue departments in a lot of states are frustrated with online sales."

In the past, the state relied on consumers to remit use tax, which may or may not occur, Embry says. The \$100,000 threshold relieves out-of-state mom-and-pop businesses that may not do that much business in the state anyway. State agency purchases affected might include things like vehicles, high-tech equipment and office furniture, he says.

### **High-tech targeted?**

Lenhart says computer and software systems purchases are probably targeted in particular by Georgia's law.

"My hunch is it may be more on the high-tech side," Lenhart says. "One hundred thousand dollars in high-tech isn't that much."

### **Reasons underlying the statute**

"A lot of legislation is retribution," Lenhart notes. Local vendors may become irritated after losing bids to out-of-state companies, then push for legislation.

**J. Whitney Compton**, of **Compton & Associates** in Marietta, Ga., says, "Affiliate nexus for sales tax purposes is another device to allow a state to force a vendor to collect tax, because the state isn't willing to go collect tax from the consumer, who clearly owes the tax."

"This may also be a device to limit the number of bidders."

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## **FORCED REGISTRATION FOR STATE CONTRACTS**

- California SB1009 (Chap. 718) of 2003
- Connecticut HB6802 (P.A. 03-1, §105) of 2003
- Georgia HB1457 (Act 499) of 2004

- Illinois SB874 (Act 93-25) of 2003
- Indiana HB1811 (P.L. 254) of 2003
- New Jersey AB3130 (Chap. 57) of 2004
- North Carolina N.C. Gen. Stat. §143-59.1
- South Dakota HB1261 of 2003 enacted requirement; HB1177 of 2004 repealed it.
- Virginia SB938 (Chap. 1006) of 2003

## Washington businesses dispute interpretive rules

The ability of the state Dept. of Revenue to issue rules interpretive in nature was upheld in a Court of Appeals decision recently rendered in *Association of Washington Business v. Dept. of Revenue*, Dkt. No. 29793-1-II.

The AWB challenged sales and use and business and occupation tax rules adopted by the DOR. The AWB case underscored the distinction between legislative rules and interpretive rules issued by the DOR. Interpretive rules do not have the force of law and are informational only, the AWB charged. The DOR had thereby misled the public by not explicitly stating the rules were informational only.

Three rules, not particularly onerous, were chosen simply to challenge the DOR's practice of issuing interpretive rules, says **Frank Dinces**, of **Dinces Law Firm** in Seattle.

"The AWB takes the view that the Dept. of Revenue does not have the authority to issue interpretive regulations," Dinces adds.

The ruling is fairly ambiguous as to whether the regulations have the force of law, he says. The results of an appeal filed with the state Supreme Court will be known this fall.

## Sales and Use Tax Incentives-Missouri

The following is excerpted from the *Business Incentives Guide*, a CCH book and online service detailing state-by-state business exemptions, incentives and credits. Unless otherwise indicated, all statutory references are to the Missouri Revised Statutes.

### MANUFACTURING (§144.030; 12 CSR 10-3.358 AND 12 CSR 10-111.010)

Materials, manufactured goods, machinery and parts that are used in manufacturing, processing, compounding, mining, producing or fabricating and that become a component or ingredient of new personal property to be sold for final use or consumption are exempt from sales and use tax. If a part of the material is intended to and becomes a component or ingredient of a finished product, the entire purchase is exempt. Sales of parts to manufacturers that sell components are not subject to tax. Replacement machinery and equipment, as well as parts, also qualify for exemption from sales and use tax. Equipment used to test manufactured products is also exempt. A regulation provides examples of equipment that qualifies for the exemption

Electrical energy used in the primary manufacture, processing, compounding, mining, or production of a product, or used in the secondary processing or fabrication of a product, in facilities owned or leased by the taxpayer, is exempt under certain circumstances. The total cost of such energy used must exceed 10% of the total cost of production excluding the cost of the electrical energy used. The exemption applies only to persons engaged in manufacturing. The exemption includes energy used in a material recovery processing plant if the raw materials used contain at least 25% recovered materials. Also, electrical energy or gas, whether natural, artificial, or propane, that is consumed in connection with the manufacture of

cellular glass products is exempt.

### **COMPUTER SOFTWARE (12 CSR 10-3.588)**

Custom software is not subject to sales and use tax because it is intangible personal property.

### **ADVERTISING (§144.034)**

Sales of advertising by legal newspapers, advertising agencies, and broadcast stations, and standardized outdoor billboard advertising are nontaxable services.

### **PACKAGING (12 CSR 10-3.196 AND 10-3.200)**

Nonreturnable containers sold to persons for use in packaging property that will be sold are considered to be sales for resale and exempt from tax. Sales tax is not imposed on the sale of bags, boxes, paper, twine, and similar items to persons for use in packaging property for sale.

### **POLLUTION CONTROL EQUIPMENT (§144.030)**

The purchase or lease of machinery, equipment, appliances and devices used solely for preventing, abating or monitoring air or water pollution are exempt. Also exempt are materials and supplies required for installation, construction or reconstruction of such machinery, equipment, appliances and devices.

### **DELIVERY/INSTALLATION CHARGES (12 CSR 10-3.066 AND 10-4.634)**

Delivery costs, including postage and transportation costs, are not taxable if the parties do not intend for delivery to be part of the sale. Factors relevant to the determination of the parties' intent include:

- when title passes to the purchaser;
- whether delivery charges are separately stated on the sales invoice;
- whether the method of delivery is entirely up to the purchaser;
- whether the purchaser has the option to take the tangible personal property, hire a carrier, or use a carrier selected by the seller;
- whether the seller derives any financial benefit from the delivery and undertakes any risk for damage or loss during delivery; and
- whether there is a written agreement between the parties.

### **AGRICULTURE (§§144.010(4), 144.030(1), (7), (22), (29), (32), (34), AND 144.045.1; 12 CSR 10-3.272, 10-3.274, 10-3.278, 10-3.282, 10-3.284, 10-3.286, 10-3.290, 10-3.336, AND 10-3.866)**

All feed, feed additives, medications or vaccines sold for the production of livestock and poultry are exempt. Grain for conversion into foodstuffs that will be sold in processed form at retail is exempt. Sales of grain bins for storage of grain for resale are also exempt.

Seed, limestone and fertilizer are exempt if the harvested crops will be sold at retail or fed to livestock or poultry that will be sold in processed form at retail. Pesticides and herbicides used in the production of crops, aquaculture, livestock, or poultry are exempt. "Pesticides" includes adjuvants such as crop oils, surfactants, wetting agents and other assorted pesticide carriers used to improve or enhance the effect of a pesticide, and the foam used to mark the application of pesticides and herbicides for the production of crops, livestock, or poultry. An exemption is also provided for sales of registered economic poisons used on crops, including fruit trees and orchards, which when harvested will be sold at retail or converted into foodstuffs to be sold in processed form at retail.

Propane, natural gas, electricity, or diesel fuel sold for use in drying crops are exempt. Purchases of electricity through a single meter, or propane and diesel fuel in a single tank, for use exclusively in drying crops, may be made tax-free with the use of exemption certificates.

Farm tractors and other farm machinery and equipment, their repair and replacement parts, and lubricants used exclusively for such machinery and equipment, is exempt. Also exempt is 50% of diesel fuel used exclusively for agricultural purposes.

## **DROP SHIPMENTS GUIDE**

Until now, tax practitioners have had little in the way of published reliable guidance on drop shipments. *Drop Shipments: Taxation, Compliance and Planning* brings together in one resource each state's rules with references to the statutes and regulations defining drop-shipment taxation. This new book also summarizes rules and requirements in states with large populations or unusual drop-shipment rules. Pages: 256. Price: \$149. Significant volume discounts. Call (800) 248-3248.

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