

Drop Shipments and Sales Tax

Navigating Varying State Policies on Registrations and Exemptions

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

David Olivier, Founder and Managing Principal, **Olivier & Associates**, New York
Silvia Aguirre, President, **Tax Technology Services**, Raleigh, N.C.
Michael Keefe, Sales and Use Tax Supervisor, **United Technologies Corp.**, Farmington, Conn.

Wednesday, June 23, 2010

The conference begins at:

1 pm Eastern

12 pm Central

11 am Mountain

10 am Pacific

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Drop Shipments And Sales Tax Webinar

June 23, 2010

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Today's Program

Fundamental Drop Shipping Issues <i>(Dan Davis)</i>	Slides 6-11
Specific Drop Shipping Issues <i>(Silvia Aguirre)</i>	Slides 12-29
Compliance From Taxpayer's Perspective <i>(Michael Keefe)</i>	Slides 30-37
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Fundamental Drop Shipping Issues

Dan Davis, Associated Sales Tax Consultants

What Is A Drop Shipment?

Sale where merchandise is not already in retailer's inventory

Involves three parties: Retailer, retailer's vendor/supplier, and customer

Drop shipment

Subset of above transaction type, wherein vendor ships the merchandise directly to customer

Possible Scenarios

1. All three parties are situated in same state
2. Parties are in different states; retailer and supplier/drop shipper both have nexus in destination state
3. Parties are in different states; retailer has nexus in destination state but supplier does not
4. Parties are in different states; neither retailer nor supplier has nexus in destination state
5. **The problem scenario: The drop shipper has nexus, but the retailer does not**

Who Owes Tax In The Problem Scenario?

- The logical answer
- States that take the logical approach
- The other, less logical, states
- What if the *customer* will resell the merchandise or has exempt status?

Through The Looking Glass – The Drop Shipper’s Dilemma

The drop shipper as tax collector

From whom does the shipper collect?

What is the measure of the tax? Is it wholesale, retail or something else?

How is the “retail selling price” determined?

Questions To Be Considered

- Is the drop shipper registered in the destination state?
- Is the retailer registered in the destination state?
- If the problem scenario applies, what is the destination state's policy regarding drop shipments?
- Is the sale to the *customer* exempt, and if so, how will the exemption be documented?

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Specific Drop Shipping Issues

Silvia Aguirre, Tax Technology Services



Drop Shipment

When a **supplier** accepts an order from a **seller**, and the **supplier** delivers the goods to the **customer** on behalf of the **seller** in a state where the **supplier** has nexus

For purposes of above definition:

Supplier – Manufacturer/originator of goods

Seller – Wholesaler/distributor (middleman)
between supplier and customer

Customer – End user



Drop Shipment – Different Views

Common player thoughts regarding drop shipments

Customer: “If I buy it from an out-of-state wholesaler, I do not owe taxes.”

Concern: Are the items being purchased really tax-exempt?

Seller/Buyer: “Why am I being taxed? I am reselling, and the supplier and customer are in another state. This is unconstitutional!”

Concerns: Are you comfortable with your nexus exposure analysis? Do you really only operate in one state?

Do you understand your customer’s use of the items being sold?
Should you?

What do you know about your supplier? Are you applying the customer’s point of view?



Drop Shipment – Different Views (Cont.)

Common player thoughts regarding drop shipments (Cont.)

Supplier: “Why is the buyer short paying the tax? Don’t they understand?”

Concern: Do you have policies in place for your customer care personnel, tax department, or credit departments to address the concerns of the buyer?

Do you know which certificates to accept?

Can you contact your buyer’s customer for information?



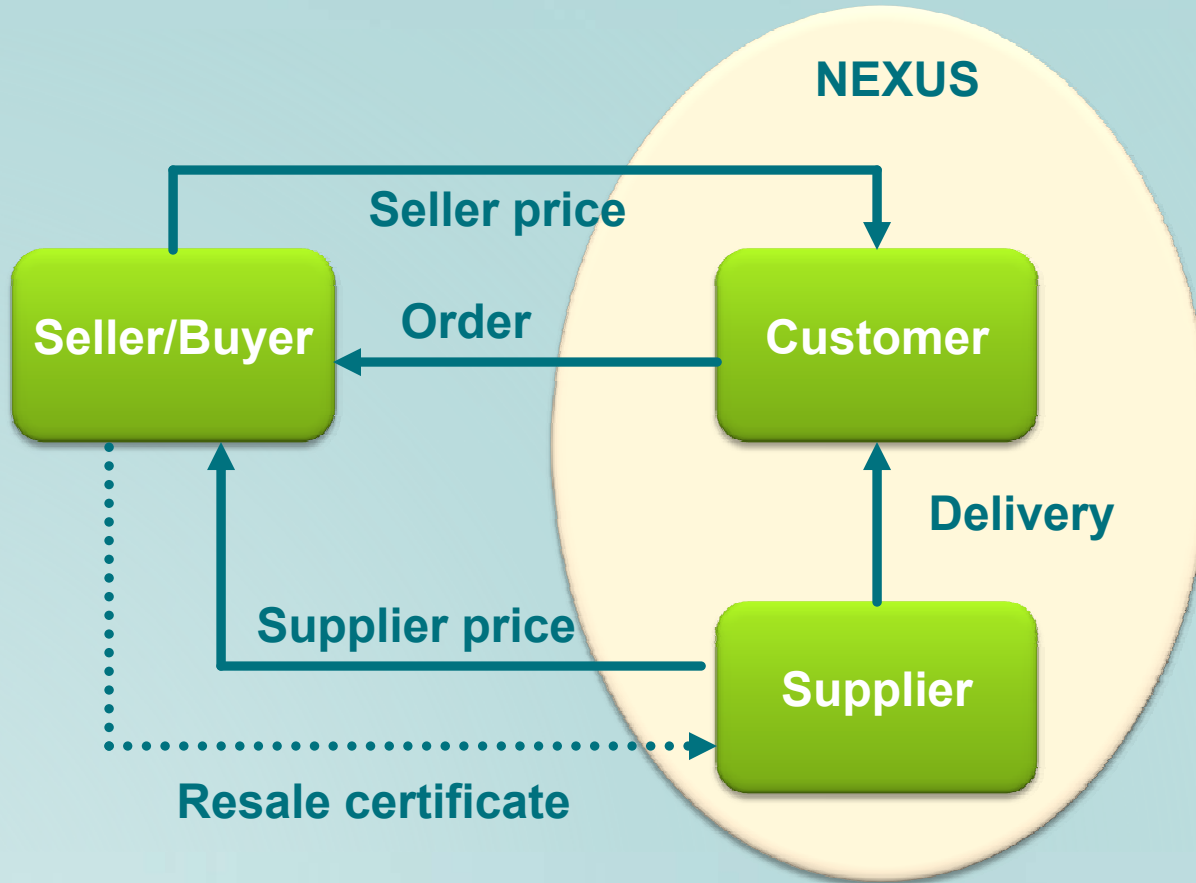
Drop Shipment Considerations

- Some states assume items are for resale, and the seller/buyer certificate is sufficient.
- Some states require the customer's exemption be included with the seller/buyer certificate to prove resale.
- Some states want you to retain shipping information to prove out-of-state origination.
- Some states tax the sales based on the seller's price, others based on the supplier's price.



Drop Shipment Common Approaches

Seller/buyer can issue resale certificate to supplier





Drop Shipment Common Approaches (Cont.)

States that fall under this category

Alabama

Arizona

Colorado

Georgia

Idaho

Illinois **

Indiana

Iowa

Kansas

Kentucky

Maine

Michigan

Minnesota

Missouri

Nebraska

New Jersey

New Mexico

New York

North Carolina

North Dakota

Ohio

Pennsylvania

Rhode Island

South Carolina

South Dakota

Texas

Utah

Vermont

Virginia

Washington

Wyoming

Nevada as of 10/1/2007

Wisconsin as of 10/1/2009

West Virginia as of 12/31/2007

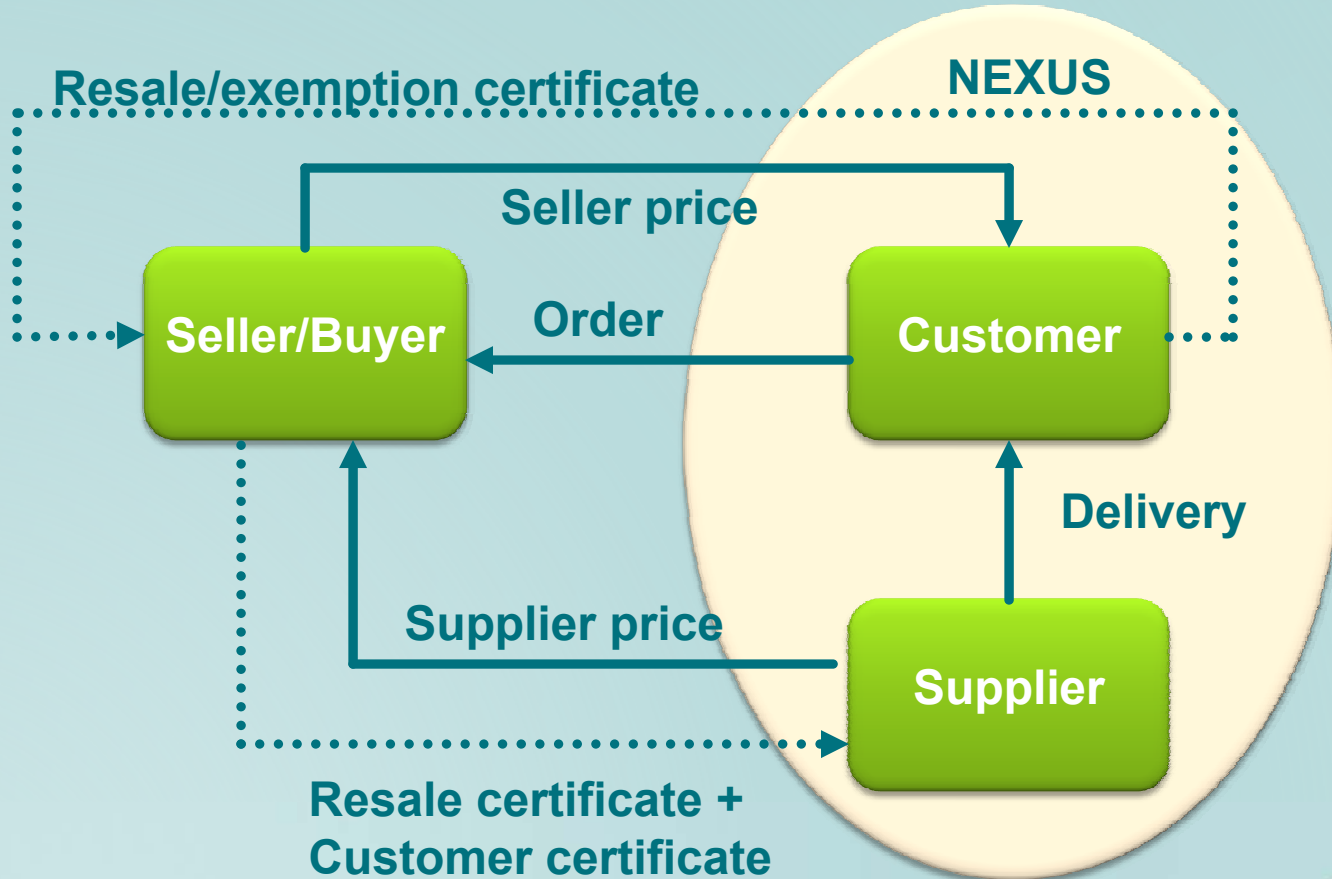
** Illinois – A resale number can be obtained without establishing nexus, and/or a written statement that buyer has no nexus should be sufficient.

http://12.43.67.2/commission/jcar/adm_incode/086/086001300B02250R.html



Drop Shipment Less Common Approaches

Pass-through: Customer could issue resale/exemption certificate to supplier via seller





Drop Shipment Pass-Through

States that fall under this category

California

Massachusetts

Mississippi

Tennessee

Nevada prior to 10/1/2007*

Wisconsin prior to 10/1/2009 *

If no certificate is received, tax will be calculated accordingly

Seller price

**California + 10% markup of
supplier price!**

Massachusetts

Wisconsin prior to 10/1/2009 *

Supplier price

Mississippi

Tennessee (seller considered an agent)

Nevada prior to 10/1/2007 *

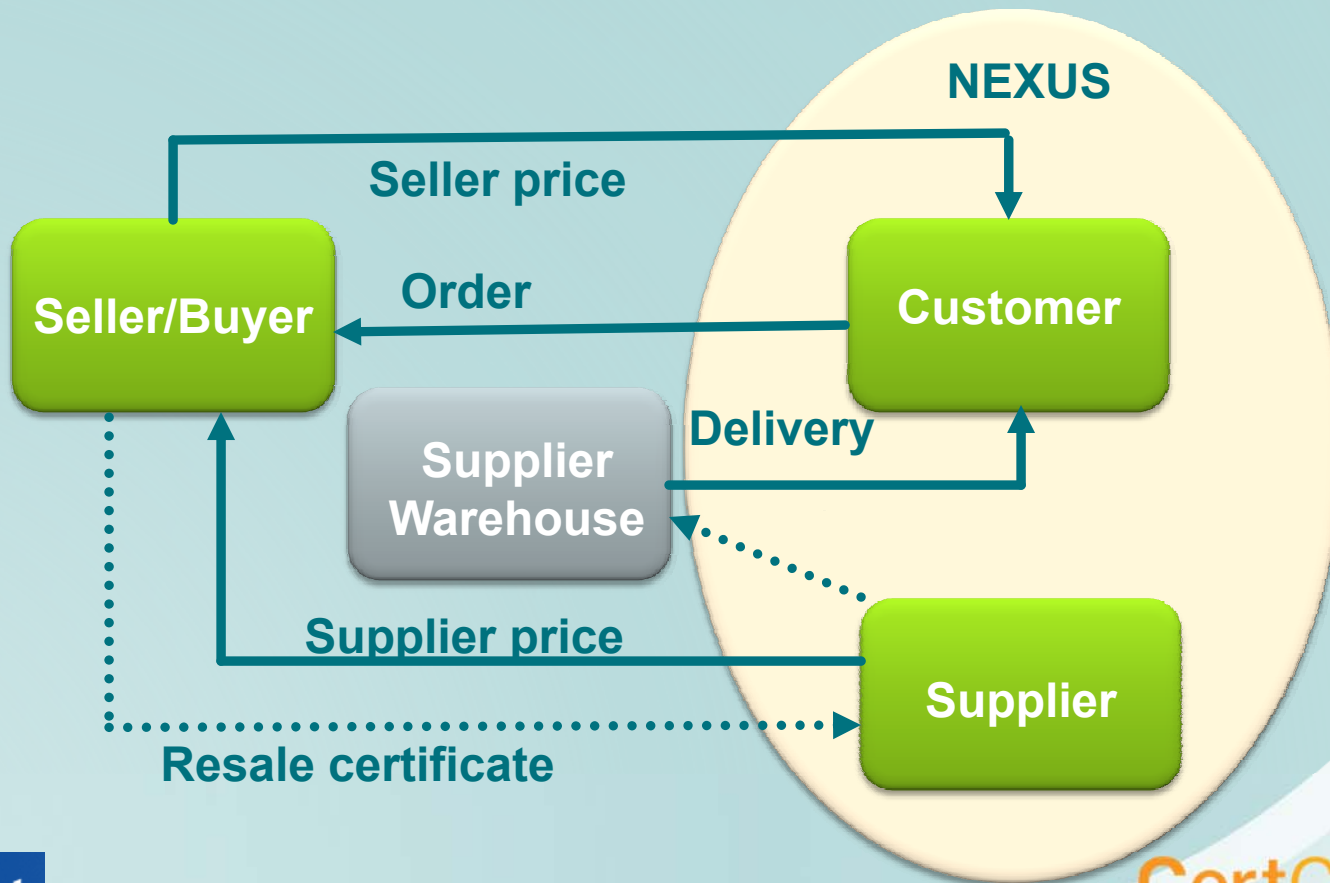
* Nevada note - http://tax.state.nv.us/documents/27026_TAX%20NOTES.pdf

* Wisconsin note - <http://www.revenue.wi.gov/taxpro/news/100119.html>



Drop Shipment – First On Board

- Sale occurred outside the nexus state
- Inventory shipped from outside the state
- Supplier can accept seller certificate





Drop Shipment – First On Board (Cont.)

States that fall under this category

Seller's certificate of exemption can be accepted

Connecticut

Florida

Louisiana

West Virginia prior to 12/31/2007**

Arkansas **

Oklahoma **

**** West Virginia note – West Virginia became a full member of SST 10/1/05. The regulations changed 12/31/07 to accept the drop shipment rules from SST.**

<http://www.legis.state.wv.us/WVCODE/Code.cfm?chap=11&art=15B#15B>

**** Arkansas note – Arkansas became a full member of SST 1/1/08; the regulations are conflicting. In SST, Arkansas should accept the resale certificate regardless of FOB, but the regulations still state that documentation should be retained to prove origin.**

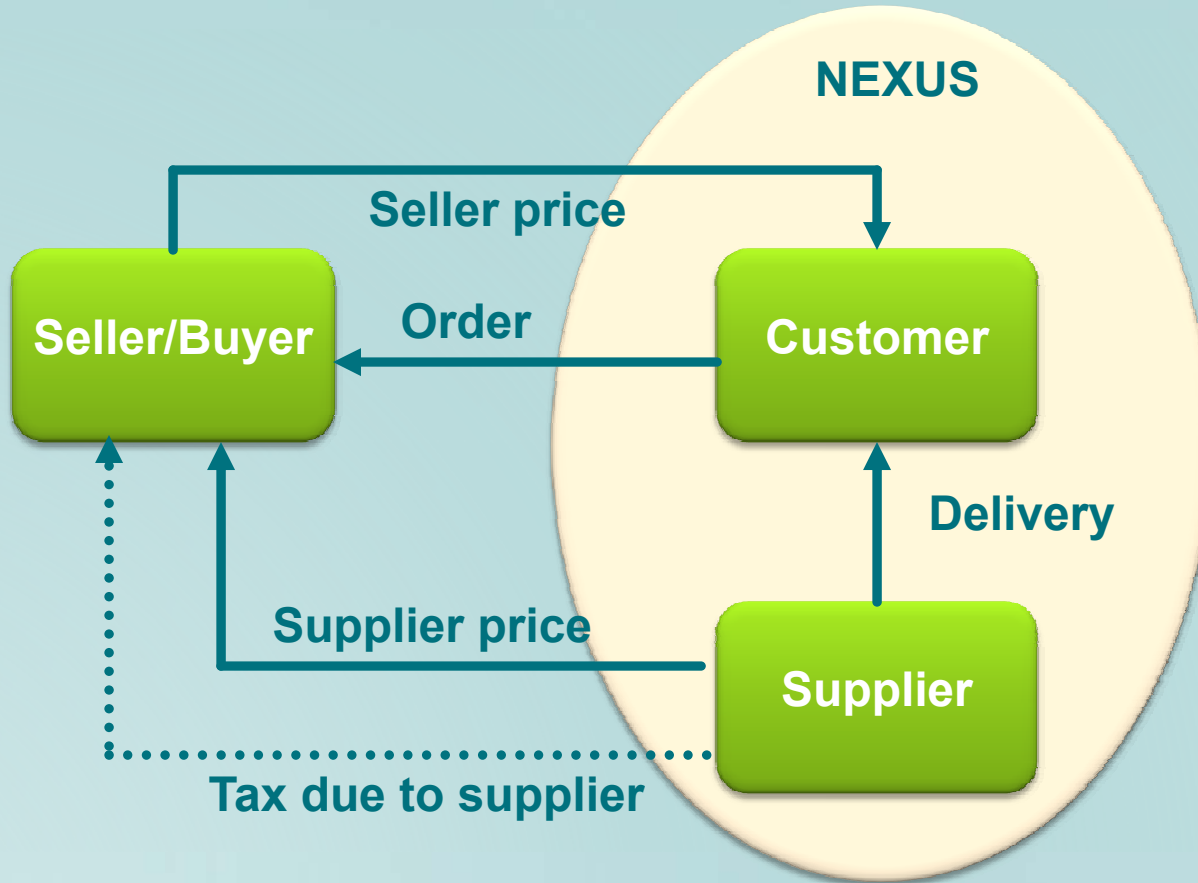
http://www.sos.arkansas.gov/elections/elections_pdfs/register/nov-dec_06/006.05.06-005.pdf

**** Oklahoma note – Oklahoma became a full member of SST 10/1/05; the regulations are conflicting. In SST, Oklahoma should accept the resale certificate regardless of FOB, but the regulations were just amended in February 2010 to include the language. http://www.oar.state.ok.us/register/Volume-27_Issue-10.htm#a30978**



Drop Shipment Taxable

Taxable transaction





Drop Shipment Taxable (Cont.)

States that fall under this category

District of Columbia

Hawaii

Maryland

- Maryland - <http://www.dsd.state.md.us/comar/comarhtml/03/03.06.01.14.htm>
<http://business.marylandtaxes.com/news/taxtips/business/bustip04.asp>
- Hawaii – <http://suiteswaikiki.com/SuitesWaikiki/Resources/GET.pdf>
- District of Columbia -
<http://weblinks.westlaw.com/result/default.aspx?cite=UUID%28N2266D14095%2DE311DB9BCF9%2DDAC28345A2A%29&db=1000869&findtype=VQ&fn=%5Ftop&ifm=NotSet&pbcc=4BF3FCBE&rlt=CLID%5FFQRLT8063617416166&rp=%2FSearch%2Fdefault%2Ewl&rs=WEBL10%2E06&service=Find&spa=DC C%2D1000&sr=TC&vr=2%2E0>



SST Drop Ship Rule

Sect. 317: Administration Of Exemptions

A. Each member state shall observe the following provisions when a purchaser claims an exemption:

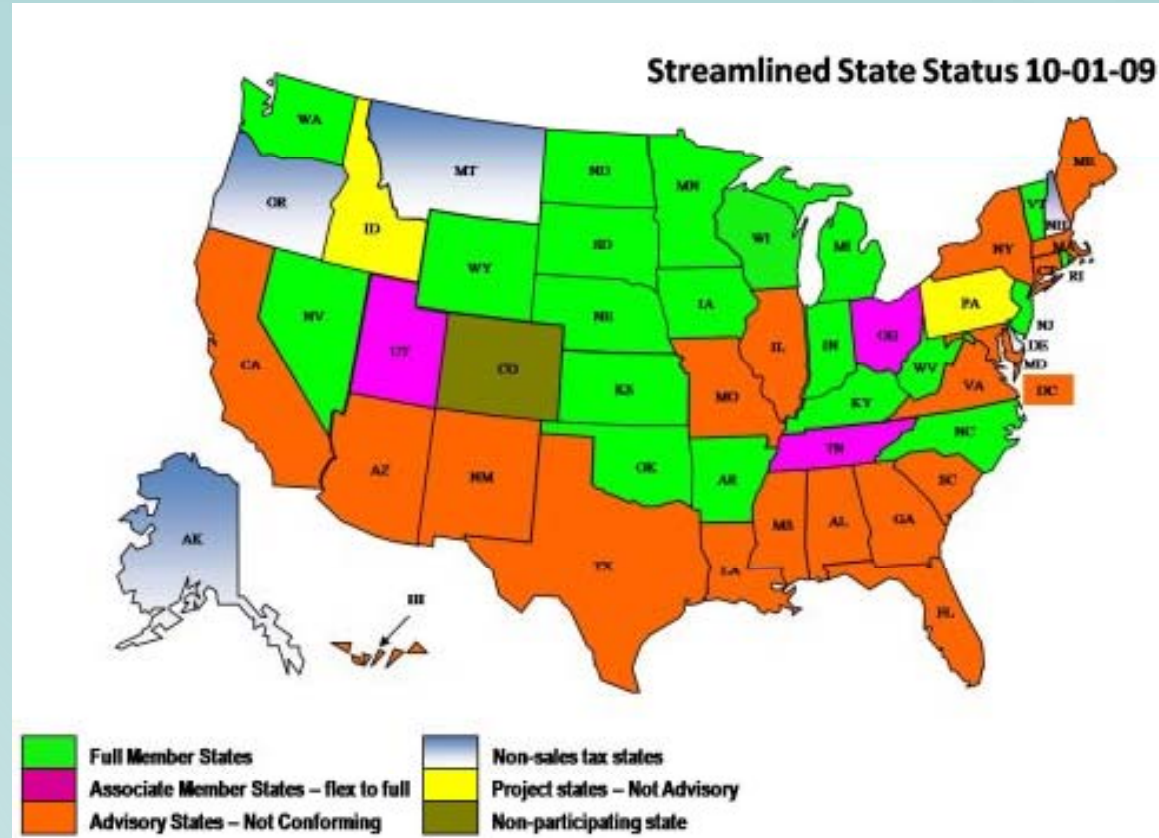
8. In the case of drop shipment sales, member states must allow a third party vendor (e.g., drop shipper) to claim a resale exemption based on an exemption certificate provided by its customer/re-seller or any other acceptable information available to the third party vendor evidencing qualification for a resale exemption, regardless of whether the customer/re-seller is registered to collect and remit sales and use tax in the state where the sale is sourced.



SST And Drop Shipments

SST full members

Arkansas
 Indiana
 Iowa
 Kansas
 Kentucky
 Michigan
 Minnesota
 Nebraska
 Nevada
 New Jersey
 North Carolina
 North Dakota
 Oklahoma
 Rhode Island
 South Dakota
 Vermont
 Washington
 Wisconsin
 West Virginia
 Wyoming





State Sales Tax Audits - General

- States are becoming more aggressive in audits.
- Nexus is being redefined in many states.
- Keep organized and track expirations
- Train your staff and keep aware of changing state regulations.
- Penalties are increasing.



Audits - Drop Shipment

Drop shipment audits, from different point of view

Customer – Use tax: Was tax accrued for the items being purchased from the seller if they were taxable?

It is very likely that the auditor will not audit the seller if no nexus is established. Having said that, the auditor will likely try to find out if the seller should be registered in their state.

Seller/buyer – Because the transaction is being scrutinized in two different instances, it might flag your company for audit based on evidence that you might have nexus.

Supplier – Sales tax: Exemption certificates were not correctly collected. Tax was not correctly charged. Do you have shipping documents to prove the items came from out of state?



Audits - Drop Shipment - Advanced

Double taxation

If the customer accrues tax, and the buyer pays tax to the supplier, then the state has been paid twice for the same items.

This information could be helpful if the customer is being audited, and the items purchased are determined to be taxable and no accrual was in place.

Regulation changes

For example, Wisconsin just passed legislation to comply with Streamlined Sales Tax drop shipment rules. This does not mean you are off the hook; the changes occurred effective Oct. 1, 2009, and the audits cover usually a four-year period. <http://www.revenue.wi.gov/taxpro/news/100119.html>

Auditors' education

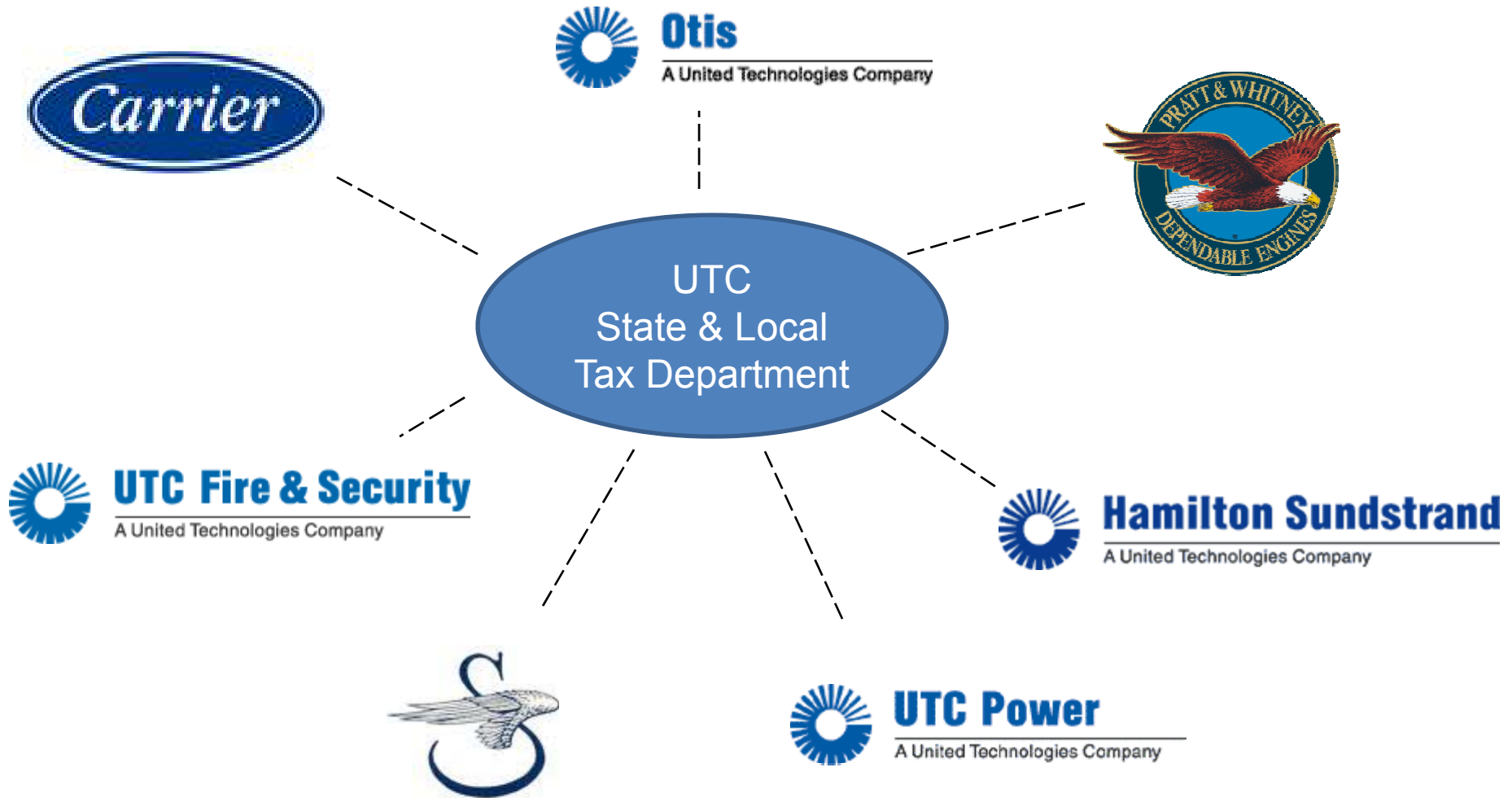
Sometimes, you know might know more than the auditor. For example, the states that recently joined SST have not spent enough time retraining their audit force, and they might be relying on non-SST information.

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Compliance From Taxpayer's Perspective

Michael Keefe, United Technologies Corp.

Corporate Organizational Structure



Standard Work

- Establish a standard process
- Provide basic information, such as states that the business is registered in for sales/use tax
- Explain what a drop shipment is; give some easy-to-follow examples

Hamilton Sundstrand Exemption Certificate Process – Standard Work

Sales Tax Exemption Certificates

Hamilton Sundstrand must have a valid exemption certificate on file to substantiate each tax exempt transaction. It is the requirement of the Hamilton group to ensure that this requirement is met by collecting the certificate(s) from the customer. The following paragraphs outline some important exemption certificate requirements.

Which State's Exemption Certificate is Required?

In determining which exemption certificate is needed from a customer, look to the "ship-to" location – not the "sold-to" location. An exemption certificate must be collected from the customer for the state in which Hamilton is shipping in to. Please see *Appendix D* and *Appendix E* for more information regarding exemption certificates applicable to the states in which Hamilton is registered to collect sales & use tax.

Drop Shipments: The same guidelines should be followed in regard to drop shipments. That is, if the customer, who is located in State A, directs Hamilton to ship to a third-party customer located in State B, Hamilton will need to meet the exemption certificate requirements of State B, even though the customer is located in State A. For more detailed information regarding drop shipments, please see *Appendix B*.

Multi-jurisdictional Sales & Use Tax Certificate

38 states currently accept the "Uniform Sales & Use Tax Certificate – Multi-jurisdiction." A business may issue this as a "blanket" certificate to cover multiple states. The actual states that allow for the use of this certificate are listed on the certificate. A customer must insert its state tax identification number into the space next to the state in order for it to be acceptable in that state. Please see *Appendix C* for a copy of this certificate.

Blanket Certificate vs. Single-Use Certificate

- **Blanket:** Applies to all future purchases by the issuer of the certificate (within the expiration period of the certificate).
- **Single-Use:** Certificate is valid only for the purchase that it is issued for.

Pratt & Whitney Exemption Certificate Collection Process – Standard Work

Pratt & Whitney must have a valid exemption certificate on file to substantiate each tax exempt sale. It is Pratt's responsibility to ensure that this requirement is met by collecting the certificate(s) from the customer at the time of sale. The following paragraphs outline some important exemption certificate requirements.

Which State's Exemption Certificate is Required?

In determining which state's exemption certificate is needed from a customer, look to where the product is being shipped. Only in states where Pratt is registered to collect sales tax must an exemption certificate must be collected from the customer (see example below). Pratt & Whitney is currently registered to collect sales tax in the following states:

Alabama	Iowa	Ohio
Arizona	Kansas	Oklahoma
Arkansas	Kentucky	Rhode Island
California	Louisiana	South Carolina
Colorado	Maine	Tennessee
Connecticut	Maryland	Texas
Delaware	Michigan	Utah
Florida	Minnesota	Vermont
Georgia	Missouri	West Virginia
Idaho	Nevada	Wisconsin
Illinois	New Jersey	Wyoming
Indiana	New York	

Example: Pratt ships to a customer in Arizona, New Jersey, and Pennsylvania. Both an Arizona and New Jersey exemption certificate must be collected from the customer, since Pratt is registered in these states. However, since Pratt is not registered to collect sales tax in Pennsylvania, it is not required to collect a Pennsylvania exemption certificate from the customer.

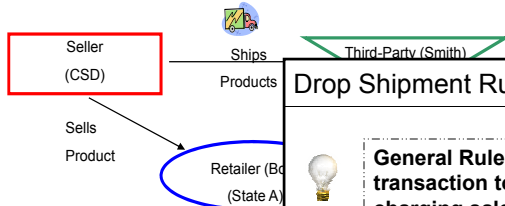
Guidance Material

Drop Shipment Transactions					
Scenario: Seller sells materials (no installation) to customer ("A") and delivers to customer's customer ("B") via common carrier to state where A is not registered.					
State of Delivery	If Customer ("A") cannot provide state's resale certificate, will state recognize Customer's out-of-state certificate	If yes, what documentation will state accept?	If no, will state accept ship-to customer's ("B") in-state certificate?	Comments	Cite/Authority
Alaska	Not applicable (no state sales/use tax imposed)				
Alabama	Yes	Home state resale certificate, Multijurisdiction Uniform Certificate, or other documentation of resale			
Arizona	Yes	Arizona resale certificate indicating registration not required; home state resale certificate, or Multijurisdiction Uniform Certificate is acceptable			
Arkansas	Yes, if FOB origin AND shipment does not originate from Arkansas	Home state resale certificate, Multijurisdiction Uniform Certificate, SST Exemption Certificate			http://www.sos.arkansas.gov/elections/elections_pdfs/register/nov-dec_06/006.05.06-005.pdf
California	No		Yes	If the California company "B" will resell the products or is otherwise exempt, seller can exempt sale through receipt of B's valid California certificate. If no exemption applies, tax is due on the retail selling price (price charged by A to B), which if unknown can be reputedly presumed by regulation to be based on an assumed 10% mark-up.	Cal. Code Regs. § 1706(c)(1); Cal. Code Regs. § 1706(c)(2); Cal. Code Regs. § 1706(d)(1)
Colorado	Yes	Home state resale certificate or Multijurisdiction Uniform Certificate			
Connecticut	Yes, if FOB origin AND shipment does not originate from Connecticut	Sale is deemed to occur outside Connecticut provided inventory shipped from outside Connecticut via common carrier. Documentation should be retained to prove non-Connecticut resale, along with buyer's home state or Multijurisdiction Uniform Certificate		The Dept of Revenue is bound by Connecticut Supreme Court precedent that Connecticut tax does not apply if ownership transfers outside Connecticut, but is strict in enforcing the requirements.	
Delaware	Not applicable (no state sales/use tax imposed)				
District of Columbia	No		No	With respect to goods drop-shipped into the District by Seller on behalf of "A," the Seller must collect the D.C. sales or use tax from "A" and report the tax to the District unless "A" provides Seller with a valid D.C. certificate of resale by the date of sale. "A" cannot use a resale certificate from its home state or "B's" resale or exemption certificate to exempt the sale.	D.C. Code Ann. § 47-2010; Letter to CCH, Audit Div. Dept. of Finance and Revenue (Sept. 1990)
Florida	Yes, if FOB origin AND shipment does not originate from Florida	Sale is deemed to occur outside Florida provided inventory shipped from outside Florida via common carrier and not COD. Documentation should be retained to prove non-Florida resale, along with buyer's home state or Multijurisdiction Uniform Certificate			

Training

Drop Shipments

- **Drop-Ship Transaction:** CSD sells to customer A, but ships the product to B, at customer A's direction.
- These are treated like any other transaction when all parties are located in the same state. CSD's customer would simply have to provide that state's resale certificate to CSD. However, sales tax problems may arise in these transactions when the ***sold-to customer is located in a different state than the ship-to customer.***
 - **Example:** Bob's Furnaces is located in State A. Bob sells a furnace to his customer John Smith, who is located in State B. To fulfill the order, Bob purchases the furnace from CSD. However, instead of having CSD ship the furnace to Bob in State A, Bob instructs CSD to ship the furnace directly to John Smith in State B.
 - In essence, CSD's sale to Bob is simply a sale for resale. However, since the furnace is being shipped by CSD to State B, and Bob is located in State A, which state's resale certificate does CSD need to collect from Bob?



Drop Shipment Rules (by State)

State	Rule	Option 1 or Option 2
Georgia	CSD may accept from its customer either a Georgia resale certificate or its customer's out-of-state exemption certificate, if the customer is not registered in Georgia.	Option 1
Kentucky	If CSD's customer is not registered in Kentucky, it can submit a resale certificate in a drop ship transaction if it makes a notation on the face of the certificate to the effect that it is a nonresident purchaser who is not required to register in Kentucky.	Option 1 (variation)
North Carolina	CSD may accept from its customer either a North Carolina resale certificate or its customer's out-of-state exemption certificate if the customer is not registered in North Carolina.	Option 1
South Carolina	CSD may accept from its customer either a South Carolina resale certificate or its customer's out-of-state exemption certificate if the customer is not registered in South Carolina.	Option 1
Tennessee	CSD may accept from its customer either a TN resale certificate or its customer's out-of-state exemption certificate if the customer is not registered in Tennessee, then CSD can accept a resale certificate from the customer, if applicable.	Option 2
Virginia	CSD may accept from its customer either a Virginia resale certificate or its customer's out-of-state exemption certificate, if the customer is not registered in Virginia.	Option 1

Drop Shipment Rules Vary from State to State

General Rule: Always look to the ship-to state's rules in a drop shipment transaction to determine which certificate is needed in order to validate not charging sales tax. The ship-to state is where the tax liability will arise.

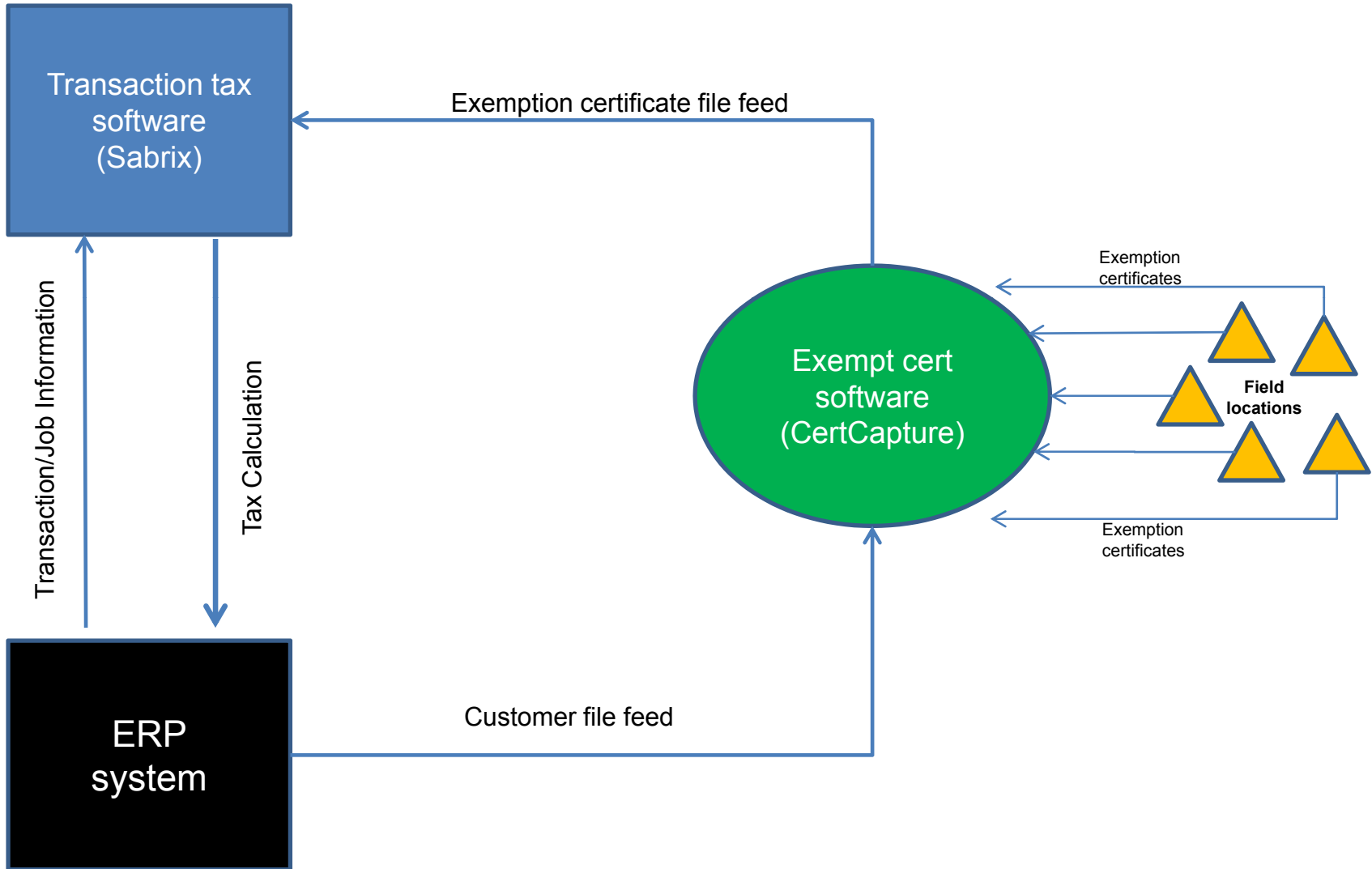
States Generally Take One of Two Approaches:

- **Option #1**
 - The ship-to state will allow the seller (CSD) to accept either the customer's out-of-state resale certificate or its own home-state certificate.
 - **Application to our example:** If State B (the ship-to-state) followed this rule, then CSD can accept from Bob either: (1) Bob's State B resale certificate (if he has one); or (2) Bob's State A resale certificate.
- **Option #2**
 - The ship-to state will only allow its own resale certificate to be accepted by the seller (CSD) from its customer.
 - **Application to our example:** If State B (the ship-to-state) followed this rule, then CSD can only accept State B's resale certificate from Bob. Since Bob is located in State A, he may not be registered in State B, and thus cannot issue a State A resale certificate. If this is the case, then CSD must charge Bob sales tax on the transaction (even though it is clearly a resale).

Certain Scenarios Not Covered In Standard Work/Processes

1. Customer wants your business to drop-ship on its behalf but cannot provide an appropriate exemption certificate, and refuses to pay sales tax. The ship-to state does not accept out-of-state certificates.
 - No easy answers
 - Honest conveyance of existing law, potential exposure, and/or options to mitigate exposure
 - Remains a business decision
2. You are not the supplier but instead the distributor. You are not registered in the state to which you are directing the supplier to ship. The supplier is registered in that state, and the state does not accept out-of-state certificates.
 - Options:
 - Pay the sales tax
 - Have items shipped to a different state
 - Register for sales tax in the ship-to state
 - Weigh the pros and cons of each option
 - Make the decision best suited to the business in each particular case

Technology Improvements/Automation



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Relevant State Case Law

David Olivier, Olivier & Associates

State Case Law – Drop Shipment Implications

1. Constitutional issues

- Nexus
- State requiring state resale certificates - is that constitutional? Double taxation potential

2. State case law

- *Steelcase Inc. v. Director, Div. of Taxation*
- Successfully litigated in Conn., NJ and NY



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Ongoing Compliance Demands

David Olivier, Olivier & Associates

Ongoing Compliance Demands

- I. Dealing with multiple states' documentation requirements
- II. Policy on internal preservation of certificate copies
- III. What kind of invoice should be given to the customer?
- IV. Recordkeeping on transactions for the seller and drop shipper

Dealing With Multiple States' Documentation Requirements

A. Resale certificates/exemption certificates

- Does the state allow acceptance of resale certificates to relieve drop shipper of liability?

B. In-state vs. out-of-state resale certificates

- Does the state accept out-of-state certificates?
 - California requires in-state certificates

C. Multi-state and SST exemption certificates

- Blanket certificates



Policy On Internal Preservation Of Certificates

- A. Maintaining exemption certificates on file
 - Associate specific certificate with sales invoice

- B. Examining exemption certificates for validity
 - Received in good faith
 - Timely issued (i.e. 60 to 90 days)
 - Properly completed (all required entries)
 - Corrected (valid if corrected within a reasonable time)

What Kind Of Invoice Should Be Given To The Customer?

- A. Drop shipper's invoice to out-of-state seller
- B. Drop shipper's invoice to end consumer
- C. Out-of-state seller's invoice to end consumer
- D. Calculating selling price

Recordkeeping On Transactions For The Seller And Drop Shipper

Seller's perspective

- State's certificate
- Multi-state certificates
- Blanket certificates
- Affidavit or letter

Drop shipper's perspective

- Keep and obtain resale certificates
- Obtain and store any end consumer exemption certificates
- Keep invoices on file
- Keep shipping documents on file

Q&A

- ▣ Prevent a problem and avoid the need to fix a problem!!!
- ▣ Ask your most pressing questions in this Q&A session.

Closing Comments

This presentation is NOT intended to be tax advice or specific recommendations.

- ▣ The previous discussion is intended to provide a general overview of sales and use tax drop shipment issues. There are many nuances that can affect the application of sales and use taxes.
- ▣ Olivier & Associates LLC, is a boutique tax consulting firm that only provides sales, use, and transaction tax advice. Our clients are businesses and fellow professionals.

FOR MORE INFO...

Please call or email us with your questions or comments.