STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
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April 3, 1998

Mr. C--- G---, CPA
Director of Taxes
A---, Division of
A--- M--- Incorporated
XXXX --- Road
P.O. Box XXXX
---, Ohio XXXXX

Re: SR --- XX-XXXXXX

Dear Mr. G---:

This is in response to your letter dated February 27, 1998 addressed to the Franchise Tax Board regarding the application of sales and use tax to drop shipments. Since it is the Board of Equalization that administers the California Sales and Use Tax Law, your letter has been referred to us for response. You state

> "Taxpayer is seeking an update of the state's requirement of proof of Resale Exemption required by transactions involving third party drop shipments.
>
> "Your written opinion received in 1993 did not accept out-of-state registration and/or a resale certificate issued by our customer for shipments to an unrelated third party in your state.
>
> "In view of recent law changes and court decisions such as "Steelcase, Inc. v. Crystal" and Federal Commerce clause, cases decided in the U. S. Supreme Court citing discrimination against interstate commerce, we would like a written opinion of your state's documentation [requirements.]
>
> "1. A sale delivered from our factory to our customer's customer in your state. Our factory and our customer are outside the destination state and our customer is a bonafide reseller in his sitused jurisdiction.

> "A. Is a 'properly completed' multi-state resale certificate given to A--- by our customer proof of resale that tax does not have to be applied to our wholesale price?
>
> "B. If the out-of-state registration is not valid, can further proof of the resale be obtained via letter or certificate that the in-state customer is also purchasing for resale, thus relieving A--- form tax collection from the out-of-state A--- customer?
>
> "C. If additional proof does not shift the burden, must our out-of-state customers become registered for sales tax in your state to claim a resale exemption?
>
> "2. In the same facts as in 1. above, if terms of the sale are FOB our factory, does the requirements in A., B., C. change (i.e., is the sale transaction by A--- considered to have occurred outside your state)?

Initially, I note that the case you cite is a state court decision interpreting another state's statute, and therefore is not applicable to California's rules pertaining to drop shipments. California's drop shipment rule has, however, been specifically considered by the California courts, and the rule, and this Board's interpretation of it, have been upheld. (*Lyon Metals, Inc. v. State Bd. of Equalization* (1997) 58 Cal.App.4th 906.) Accordingly, there has been no change in the application of the rule since our response to you in 1993. Below is a general discussion of the rule, and the answers to your specific questions.

When a sale is not defined as a retail sale, the sale is not subject to California's sales or use tax. (Rev. & Tax. Code §§ 6051, 6201; Reg. 1668.) Revenue and Taxation Code section 6007 defines "retail sale" for these purposes. The general rule is that a retail sale is a sale for any purpose other than resale in the regular course of business. The second paragraph of section 6007, however, redefines certain sales, which would otherwise be classified as sales for resale, to be retail sales. This provision is California's "drop shipment" rule.

The drop shipment rule is triggered *only* when the person who would otherwise be classified as the retailer without resort to the second paragraph of section 6007 (who, for purposes of this discussion, I will refer to as the "true retailer") is not engaged in business in this state within the meaning of Revenue and Taxation Code section 6203 (California's nexus status). If the true retailer has nexus with California, the drop shipment rules of section 6007 do not apply. On the other hand, if the true retailer does not have nexus with California and does not voluntarily register to collect California's use tax, we must look to the second paragraph of section 6007 to determine whether another person (e.g., the wholesaler) is redefined to be the retailer. If another person is redefined to be the retailer under the second paragraph of section

6007, that person owes sales tax, or must collect and remit use tax, and the measure of that tax is the retail price paid by the consumer to the true retailer.

Generally, it is possible for a person who does not hold a California seller's permit to issue a valid resale certificate by including an explanation of why it does not hold a California seller's permit. Such a certificate will not, however, protect a drop shipper from liability for tax or tax collection as the retailer. The reason for this is that drop shipper must establish not only that its sale is for resale under the general rules (which is generally the case in a drop shipment situation), but must also establish that its sale is not redefined to be a retail sale under the second paragraph of section 6007. It makes this latter showing by establishing that the true retailer is registered with this Board to collect California's use tax or is required to be so registered (i.e., that it is engaged in business in California). A resale certificate that indicates that the true retailer does not have a seller's permit because it is not engaged in business in California would not establish that a drop shipper's sale is a sale for resale. Rather, the drop shipper would still have the burden of establishing that the true retailer was actually engaged in business in California, contrary to the true retailer's position that it was not so engaged. To avoid this heavy burden, the drop shipper should treat its sale as a retail sale unless it obtains a timely and valid resale certificate which includes the true retailer's California seller's permit number.

Accordingly, in answer to your question 1.A., a "multi-state" resale certificate would have no effect on a drop shipper's liability for sales or use tax for drop shipments made to California consumers unless it included a valid California seller's permit number and otherwise conformed to applicable requirements. (See Reg. 1668, a copy of which is enclosed.) I note that in this question you refer to applying tax to your wholesale price. The measure of tax on these transactions is the price paid by the consumer to the true retailer, without regard to whether the drop shipment rules apply. If the true retailer is engaged in business in California, it is responsible for the tax, and if the true retailer is not engaged in business in California, the drop shipper is responsible for the tax. In either event, the amount tax owed by the applicable seller remains the same.

A drop shipper is reclassified to be the retailer only when drop shipping to a consumer. If the property is drop shipped to a person who will resell the property in the regular course of business prior to any use, the drop shipper is not recharacterized to be the retailer. The best way to establish this is to take a timely and valid resale certificate from the person to whom you drop ship the property. If you do not take such a timely and valid certificate, you would have the burden of establishing that the drop shipment was for resale by person receiving it. However, if you could make such a showing to the Board's satisfaction, you would be relieved of liability. Taking a timely and valid resale certificate is of course preferable to having to prove that a third party (the person you drop ship to) resold the property in the regular course of its business prior to any use.

In answer to your question 1.C., if your out-of-state customers were to register to collect California's use tax, then your drop shipments made pursuant to their retail sales would not result in your being recharacterized to be the retailer with respect to those drop shipments. Of course, your customers would then be required to collect California's use tax on *all* their sales to California consumers, not just with respect to your drop shipments. (See Reg. 1684, a copy of which is enclosed.)

In answer to your question 2, an F.O.B. provision would not change the analysis above. California's drop shipment rules are triggered by a drop shipment made by a person engaged in business in California to a California consumer on behalf of a retailer who is not engaged in business in California. Although whether the drop shipper's sale occurs in California or not is relevant to determining whether the applicable tax is sales or use tax, it is not relevant to the question of whether the drop shipper is recharacterized to be the retailer for purposes of California's Sales and Use Tax Law.

If you have further questions, feels free to write again.

Sincerely,

David H. Levine
Supervising Tax Counsel

DHL/cmm
Enclosures

cc: Out-of-State District Administrator (OH)
Chicago Area Branch Office (OHA)