

**Statement of Reasons for the Proposed Amendments to  
Section 1706, *Drop Shipments*,  
in Title 18 of the California Code of Regulations**

The California Department of Tax and Fee Administration (Department) proposes to amend California Code of Regulations, title 18, section (Regulation) 1706, *Drop Shipments*, to clarify that marketplace sales are generally not drop shipment transactions and to provide more guidance about how a person can overcome the presumption they are a drop shipper.

**General Background**

Under the California Sales and Use Tax Law, sales tax is imposed on retailers, and applies to retailers' gross receipts from their retail sales of tangible personal property made in California, unless specifically exempted or excluded from the tax. When sales tax does not apply, use tax generally applies to the sales price of tangible personal property purchased from a retailer for storage, use, or other consumption in this state and stored, used, or otherwise consumed in the state. Use tax applies to taxable purchases of tangible personal property from retailers, whether, for example, the purchase is made by mail order, telephone, or internet; and the person storing, using, or otherwise consuming the property purchased from a retailer is liable for the tax. The state's sales tax and use tax are mutually exclusive, meaning either sales tax or use tax applies to a single transaction, but not both.

California consumers are generally required to report and pay the use tax on their taxable purchases to the state. However, pursuant to Revenue and Taxation Code (RTC) section 6203, a "retailer engaged in business in this state" is required to collect the use tax on its taxable sales to California consumers and give the consumers a receipt for the tax. The tax required to be collected by the retailer constitutes a debt owed to the state. Consumers remain liable for the use tax, unless they obtain a receipt from a retailer that holds a seller's permit or Certificate of Registration – Use Tax issued by the Department. (Reg. 1685, subd. (a).)

Every person engaged in the business of selling tangible personal property in this state of a kind the gross receipts from the retail sale of which are required to be included in the measure of the sales tax is generally required to register with the Department for a seller's permit for each of its places of business in this state. Regulation 1699, *Permits*, implements, interprets, and makes specific those registration requirements.

Also, retailers engaged in business in this state and selling tangible personal property for storage, use, or other consumption in this state are required to register with the Department. (Reg. 1684, subd. (a).) The Department requires such retailers to register for a Certificate of Registration – Use Tax unless they are also required to hold a seller's permit.

*Retailer Engaged in Business in This State*

RTC section 6203 provides that the term retailer engaged in business in this state "means any retailer that has substantial nexus with this state for purposes of the commerce clause of the United

States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty.” The term retailer engaged in business in this state includes, but is not limited to, a retailer that owns tangible personal property, such as inventory, or leases tangible personal property, such as a computer server, in California; a retailer that maintains or uses an office location in California; and a retailer having representatives in California for purposes of taking orders, making sales or deliveries, or installing or assembling tangible personal property. The term also includes, but is not limited to, any retailer that, in the preceding calendar year or current calendar year, has total combined sales of tangible personal property for delivery in this state by the retailer and all persons related to the retailer that exceed five hundred thousand dollars (\$500,000).

### *Assembly Bill 147*

On April 25, 2019, the Legislature enacted Assembly Bill No. (AB) 147 (Stats. 2019, ch. 5). AB 147 added the Marketplace Facilitator Act (MFA) to the RTC to address sales of tangible personal property through marketplaces. The MFA became operative October 1, 2019. (RTC, § 6049.5.) The MFA defines the terms “marketplace,” “marketplace facilitator,” and “marketplace seller.” (RTC, § 6041.) Amongst the key provisions, the MFA specifies that a marketplace facilitator is considered the seller and retailer for each sale facilitated through its marketplace for purposes of determining whether the marketplace facilitator is required to register with the Department for a seller’s permit or for a Certificate of Registration – Use Tax. (RTC, § 6042; Reg. 1684.5, subd. (b)(1).) The MFA provides that any marketplace facilitator that is registered or required to be registered with the Department and who facilitates a retail sale of tangible personal property on behalf of a marketplace seller is the retailer making the sale of the tangible personal property sold through its marketplace. (RTC, § 6043.) Such facilitators are required to pay any sales taxes and collect and remit any use taxes due, and the marketplace seller is not responsible for the tax, unless the facilitator qualifies for relief from liability pursuant to RTC section 6046. (Reg. 1684.5, subd. (c).)

The MFA also states that a marketplace seller shall register with the Department for a seller’s permit or Certificate of Registration – Use Tax, as required, for retail sales made on its own behalf and not facilitated through a registered marketplace facilitator. (RTC, § 6045; Reg. 1684.5, subd. (b)(2).) Therefore, a marketplace seller is not required to register with the Department for a seller’s permit or Certificate of Registration – Use Tax if it does not make any sales of tangible personal property in this state or for storage, use, or other consumption in this state, except for sales facilitated by marketplace facilitators who are the sellers and retailers for purposes of those sales. (Reg. 1684.5, subd. (b)(2).)

### *Regulation 1668, Sales for Resale*

As stated above, sales tax applies to gross receipts from the “retail sale” of tangible personal property. A “retail sale” or “sale at retail” is generally defined as a sale of tangible personal property for any purpose other than resale in the regular course of business. (RTC, § 6007, subd. (a)(1).) Additionally, use tax applies to the sales price of tangible personal property purchased for “storage, use, or other consumption” in this state, which does not include the keeping or retention of property for resale or the resale of property in the regular course of business. (RTC, §§ 6008, 6009.) Therefore, neither sales nor use tax generally applies when tangible personal property is sold for resale in the regular course of business.

Subdivision (a) of Regulation 1668, *Sales for Resale*, provides that the burden of proving that a sale of tangible personal property is not at retail is upon the seller unless the seller timely takes in good faith a certificate from the purchaser that the property is purchased for resale. If timely taken in proper form and in good faith from a person who is engaged in the business of selling tangible personal property and who holds a California seller's permit as required by Regulation 1699, the certificate relieves the seller from the liability for the sales tax and the duty of collecting the use tax. A certificate is considered timely if it is taken any time before the purchaser is billed, within the seller's normal billing and payment cycle, or prior to delivery of the property to the purchaser.

Regulation 1668, subdivision (b)(1) states that any document, such as a letter or purchase order, timely provided by the purchaser to the seller will be regarded as a resale certificate with respect to the sale of the property described in the document if it contains all the following essential elements:

- The signature of the purchaser, purchaser's employee, or purchaser's authorized representative.
- The name and address of the purchaser.
- The number of the seller's permit held by the purchaser if required by Regulation 1699. If the purchaser is not required to hold a seller's permit because the purchaser sells only property of a kind the retail sale of which is not taxable or because the purchaser makes no sales in this state, the purchaser must include on the certificate a sufficient explanation as to the reason the purchaser is not required to hold a California seller's permit in lieu of a seller's permit number.
- A statement that the property described in the document is purchased for resale.
- Date of execution of the document.

Subdivision (c) of Regulation 1668 also provides that in the absence of evidence to the contrary, a seller will be presumed to have taken a resale certificate in good faith if the certificate contains all the essential elements described above and otherwise appears to be valid on its face.

#### *Regulation 1706, Drop Shipments*

RTC section 6007, subdivision (a)(2), specifies that 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 is deemed the retailer of that property and is liable for the tax due. Regulation 1706 implements the provisions of RTC section 6007, subdivision (a)(2).

Subdivision (a) of Regulation 1706 provides the following definitions. A "drop shipment" means and includes a delivery of tangible personal property by an owner or former owner thereof, or factor or agent of that owner or former owner, to a California consumer pursuant to the instructions of a true retailer. A "true retailer" means and includes a retailer who is not a retailer engaged in business in this state and who makes a sale of tangible personal property to a consumer in California. A "retailer engaged in business in this state" means and includes any person who would be so defined by RTC section 6203 if the person were a retailer. Lastly, a "drop shipper" means and includes an

owner or former owner thereof, or factor or agent of that owner or former owner, who makes a drop shipment of tangible personal property.

Subdivision (b) of Regulation 1706 explains that a drop shipment generally involves two separate sales. The true retailer contracts to sell tangible personal property to a consumer. The true retailer then contracts to purchase that property from a supplier and instructs the supplier to ship the property directly to the consumer. The supplier is a drop shipper. A drop shipper that is a retailer engaged in business in this state is reclassified as the retailer and is liable for tax. When more than two separate sales are involved, the person liable for the applicable tax as the drop shipper is the first person who is a retailer engaged in business in this state in the series of transactions beginning with the purchase by the true retailer.

Regulation 1706, subdivision (c) provides that a drop shipper making a drop shipment must report and pay tax measured by the retail selling price of the property paid by the California consumer to the true retailer, unless the sale and use of the property are otherwise exempt. It provides that a drop shipper may also calculate the retail selling price of their drop shipments of property based on their selling price of the property to the true retailer plus a mark-up of 10 percent and a drop shipper may use a mark-up percentage lower than 10 percent if the drop shipper can document that the lower mark-up percentage accurately reflects the retail selling price charged by the true retailer to the California consumer. It further provides that if a mark-up percentage lower than 10 percent is developed in an audit of the drop shipper, the drop shipper may use that percentage for the subsequent reporting periods provided the drop shipper has not had a significant change in business operations. However, the mark-up provisions do not apply to drop shipments of vehicles, vessels, and aircraft.

Examples illustrating how subdivisions (b) and (c) of Regulation 1706 apply to specific factual situations are included in subdivision (d). As relevant here, the example in subdivision (d)(5) illustrates that a drop shipper who only sold computer hardware during a prior audit period and now makes considerable sales of software during the current period cannot use a mark-up percentage lower than 10 percent developed during the audit of the prior audit period to calculate the retail selling price of their drop shipments during the current period because there was a significant change in the drop shipper's business operations between the two periods.

Also, subdivision (e) of Regulation 1706 states that an owner or former owner of tangible personal property, or a factor or agent of that owner or former owner, who, upon the instructions of that person's customer, delivers property to a California consumer is presumed to be a drop shipper liable for the applicable tax as the retailer. A person may overcome this presumption by accepting a timely resale certificate from the person's customer that includes a valid California seller's permit number. Acceptance of a resale certificate that does not include a valid California seller's permit number will not overcome the presumption. A person otherwise qualifying as a drop shipper may also overcome the presumption that the delivery is to a consumer by accepting a timely and valid resale certificate in good faith from the person in California to whom the property is delivered.

## Discussion of Proposed Amendments

### *Marketplace Sales*

A marketplace facilitator that is registered with the Department or required to register with the Department for a seller's permit or Certificate of Registration – Use Tax that facilitates a retail sale of tangible personal property by a marketplace seller on or after October 1, 2019, is the retailer selling or making the sale of the tangible personal property sold through its marketplace under RTC section 6043. When a marketplace facilitator is the retailer for a retail sale of tangible personal property to a California consumer by a marketplace seller under RTC section 6043, the marketplace facilitator is not a true retailer. As such, if the marketplace seller contracts to purchase the property from a supplier and instructs the supplier to deliver the property directly to the consumer, the supplier is not a drop shipper because it is not delivering the property pursuant to a retail sale by a true retailer.

Therefore, the Department proposes adding new subdivision (c) to Regulation 1706 titled “Marketplace sales” to clarify that these marketplace sales are not drop shipments. The Department also proposes adding a new example to Regulation 1706 illustrating a marketplace sale that is not a drop shipment. The Department has determined that these amendments are necessary to prevent these marketplace sales from being taxed as drop shipments.

The Department also proposes that new subdivision (c) refer readers to Regulation 1684.5, *Marketplace Sales*, for more information about determining who the retailer is for purposes of a marketplace sale. The Department has determined that this cross reference is necessary because Regulation 1684.5 explains when a marketplace seller is still the retailer for purposes of a retail sale to a California consumer facilitated by a marketplace facilitator, in which case the sale may still be a drop shipment.

Furthermore, the Department proposes to incorporate the MFA's definitions of “marketplace,” “marketplace facilitator,” and “marketplace seller” into subdivision (a) of Regulation 1706 by reference and to renumber the current definitions in subdivision (a) so that all the definitions are in alphabetical order. The Department also proposes to renumber current subdivisions (c), (d), and (e), as subdivisions (d), (e), and (f) due to the addition of proposed new subdivision (c) to Regulation 1706.

### *Reformatted Section References*

The Department proposes to reformat the RTC section references in renumbered subdivision (d)(3) to be consistent with how the RTC section references are formatted elsewhere in the regulation.

### *Examples*

The Department proposes amending the example in renumbered subdivision (e)(5) to refer to sales of furniture and appliances instead of computer hardware and software. The Department has determined that the amendment is necessary because the application of tax to computer software is

complex and it is likely that a retailer of computer hardware also sells computer software as part of its regular business operations.

The Department also proposes adding new subdivision (e)(6) to provide the new example illustrating a marketplace sale that is not a drop shipment, as discussed above.

### *Burden of Proof*

Current subdivision (e)(1) of Regulation 1706 states that a person may overcome the presumption that they are a drop shipper liable for the tax only if they accept a timely resale certificate that includes a valid seller's permit number. It further states that acceptance of a resale certificate that does not contain a valid seller's permit number will not overcome the presumption.

RTC section 6007, subdivision (a)(2), does not apply to a supplier that delivers property to a California consumer pursuant to a retail sale made by a retailer that is engaged in business in this state. Accordingly, a retailer engaged in business in this state is not a "true retailer" as defined in Regulation 1706. There are many retailers engaged in business in this state that are registered with the Department for a Certificate of Registration – Use Tax that are not required to register with the Department for a seller's permit. Pursuant to Regulation 1668, subdivision (b)(1), such retailers can generally issue a valid resale certificate to their supplier when purchasing tangible personal property for resale in the regular course of business if the certificate contains a sufficient explanation as to the reason the retailer is not required to hold a California seller's permit in lieu of a seller's permit number.

In addition, as stated above, when a marketplace facilitator is the retailer for a retail sale of tangible personal property to a California consumer by a marketplace seller under RTC section 6043, the marketplace facilitator is not a true retailer. As such, if the marketplace seller contracts to purchase the property from a supplier and instructs the supplier to deliver the property directly to the consumer, the supplier is not a drop shipper because it is not delivering the property pursuant to a retail sale by a true retailer. A marketplace seller that is not required to register for a seller's permit under Regulation 1699 can generally issue a valid resale certificate to their supplier if the certificate contains a sufficient explanation as to the reason the marketplace seller is not required to hold a California seller's permit in lieu of a seller's permit number.

Therefore, the Department proposes to amend renumbered subdivision (f)(1) to provide that a person can overcome the presumption that they are a drop shipper if they accept a timely resale certificate in good faith from their customer that contains all the essential elements as provided by Regulation 1668, including, where appropriate, an explanation as to the reason why the customer is not required to hold a California seller's permit. The Department proposes to add subdivision (f)(1)(B) to provide that the explanation must be accompanied by: (1) a statement that the customer is registered with the Department for a Certificate of Registration – Use Tax and the customer's valid account number; or (2) a statement that the customer is a marketplace seller and purchasing the property pursuant to a sale facilitated by a registered marketplace facilitator that is the retailer for purposes of the sale and the marketplace facilitator's name and valid seller's permit number or account number. The Department has determined that the amendments to renumbered subdivision (f)(1) are necessary to stop suppliers that are following Regulation 1706 from incorrectly treating

certain sales for resale as taxable drop shipments. These include sales for resale to retailers that are registered with the Department for a Certificate of Registration – Use Tax and sales to unregistered marketplace sellers purchasing the property pursuant to retail sales facilitated by registered marketplace facilitators.

Furthermore, a supplier is not a drop shipper when it sells tangible personal property to a customer that is a retailer engaged in business in this state at the time of the sale or to a customer that is a marketplace seller purchasing the property pursuant to its sale facilitated by a marketplace facilitator that was the retailer for purposes of the sale under RTC section 6043.

Therefore, the Department proposes to add new subdivision (f)(2) to Regulation 1706 to clarify that a person who does not timely obtain a resale certificate from the person's customer that satisfies the requirements of subdivision (f)(1) can overcome the presumption that they are a drop shipper by establishing that the person's customer was a retailer engaged in business in this state at the time of the sale or the person's customer was a marketplace seller and purchased the property pursuant to its sale facilitated by a marketplace facilitator that was the retailer for purposes of the sale. The Department has determined that the amendments to renumbered subdivisions (f)(1) and new subdivision (f)(2) are necessary to clarify that sales for resale to retailers that are engaged in business in this state, but not registered for a seller's permit, and unregistered marketplace sellers purchasing the property pursuant to retail sales facilitated by registered marketplace facilitators are not taxable drop shipments.

The Department also proposes to renumber current subdivision (f)(2) as subdivision (f)(3) and make the phrasing of subdivision (f)(3) more consistent with the phrasing in subdivisions (f)(1) and (f)(2).

### *References to the Board*

Regulation 1706 was originally adopted by the State Board of Equalization (Board) and it contains references to the Board because it has not been amended since July 1, 2017, when the Department began administering the Sales and Use Tax Law, instead of the Board. These references to the Board are deemed to refer to the Department under Government Code section 15570.24. Therefore, the Department also proposes to replace the references to the "Board" with references to the "Department" throughout Regulation 1706.

### *Interested Parties Meeting and Comments*

The Department distributed a discussion paper explaining the proposed amendments on August 25, 2020, and held an interested parties meeting to obtain public input on September 15, 2020. The Department received a letter dated October 13, 2020, from Ms. Joan Armenta-Roberts, Technical Tax Consultant, for the California Taxpayers Association (CalTax), with CalTax's comments regarding the amendments. Based on the comments received during the meeting and in the letter, the interested parties were generally supportive of the proposed amendments. Specifically, Ms. Armenta-Roberts stated that CalTax believes the proposed amendments do an excellent job of incorporating provisions relating to drop shipments that involve a marketplace or marketplace facilitator.

The discussion paper also discussed prospective amendments to the mark-up provisions in renumbered subdivision (d). However, CalTax did not agree with the proposed amendments to the mark-up provisions and the Department is not proposing those amendments at this time.

### **Economic Impact Assessment**

The proposed amendments to Regulation 1706 impact suppliers that make sales to third-party retailers for delivery to California consumers, which may include some small businesses. There are no comparable Federal regulations. In the absence of Federal regulation, state regulation is needed and the Department is the state agency responsible for administering state, local, and district sales and use tax. The Department considered whether to begin the formal rulemaking process to adopt the proposed amendments at this time or, alternatively, whether to take no action at this time. No additional alternatives were considered.

The amendments are needed due to the passage of AB 147 and to make the regulation consistent with RTC section 6007, subdivision (a)(2), discussed above. The benefits of the regulatory change are the result of goals developed by the agency based on broad statutory authority. Although the statewide dollar costs and benefits from this regulation are unknown, the amendments provide clarification and guidance that specified sales are not taxable drop shipments, which will assist in ensuring that such sales are not taxed. The amendments are also consistent with statutory requirements. As such, the Department anticipates that the proposed amendments will have little to no economic impact on businesses. The Department anticipates:

- The estimated impact is below \$10 million.
- No businesses or jobs will be created or eliminated as a result of the regulatory change.
- The regulatory change will not affect the ability of California businesses to compete with other states by making it more costly to produce goods or services here.
- The regulatory change will not directly impact housing costs.
- There are no other benefits of the regulatory change, including, but not limited to, benefits to the health, safety, and welfare of California residents, worker safety, and the state's environment and quality of life, identified by the Department.

Additionally, there is no estimated change of investment in the state; no incentive for innovation in products, materials, or processes; and no fiscal impact. The regulation does not mandate specific technologies or equipment. The regulatory change does not affect any local entity or program and does not affect any federally funded state agency or program. The Department will update the version of Regulation 1706 on its website and incorporate the amendments into industry guidance. The workload associated with these changes is considered routine. Any corresponding cost would be absorbed within the Department's existing budget.