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November 12, 1992

X-----

Dear X-----:

This is in response to your letter dated September 16, 1992 regarding the sales and use tax consequences of certain drop shipments. Some of your clients drop ship property to California consumers under several scenarios, but always by common carrier. You note that you are aware of SB 1608 which, at the time of your letter, had been passed by the Legislature and which has now been signed by the Governor. You ask our opinion regarding the scenarios set forth below for periods before the operative date of SB 1608 and after. Each of your four scenarios is quoted below, followed by our analysis.

"1. Retailer, an out-of-state company not engaged in business in California, takes an order from a California consumer. It orders the property from Manufacturer, an out-of-state company which is engaged in business in California. Retailer instructs Manufacturer to ship the property directly to the consumer in California. Manufacturer bills Retailer for the wholesale price of the property. Retailer, in turn, invoices the consumer for a marked up price. What is the responsibility for collection of use tax as to Manufacturer and/or Retailer?"

I assume that the property in question is shipped from the out-of-state manufacturer's out-of-state location. The current version of the second paragraph of Revenue and Taxation Code section 6007 redefines certain sales occurring in California, which would otherwise be regarded as sales for resale, to be retail sales. Under the facts in your letter and the assumption made above, the sale from the out-of-state manufacturer is not a sale in California. Since the manufacturer's sale is not a sale in California, the current version of the second paragraph of section 6007 does not apply and the manufacturer's sale for resale is not redefined to be a retail sale by the manufacturer. The manufacturer is therefore not required to collect use tax. The California consumer is of course liable for use tax, but since the retailer is not engaged in business in this state, California cannot require it to collect that use tax (if it wished to do so, the retailer could voluntarily register to collect the tax).

SB 1608 becomes operative on January 1, 1993. On and after that date, the second paragraph of section 6007 redefines a sale which would otherwise be regarded as a sale for resale to be a retail sale when a person who is a retailer engaged in business in this state drop ships' property, or has property drop shipped, to a California consumer pursuant to a retail sale made by a retailer not engaged in business in California. That is, beginning January 1, 1993, the second paragraph of section 6007 will also apply to situations in which the sale occurs outside California. In your first scenario, under the amended version of section 6007, the person drop shipping the property (i.e., the manufacturer) will be regarded as the retailer of that property for purposes of the California Sales and Use Tax Law. That person will be required to collect the applicable use tax from the purchaser and pay it to this state. The measure of that tax will be the retail selling price, that is, the marked up price paid by the consumer.

"2. Retailer, again, is an out-of-state firm not engaged in business in California. It receives an order from a California consumer and orders the property from a California sales office of Manufacturer, which has its principal manufacturing facilities, warehouses, and sales offices located in California. However, in this instance, Manufacturer ships the property by common carrier from one of its out-of-state warehouses directly to the consumer in California. The terms of sale are F.O.B. shipping point. Manufacturer bills Retailer who marks it up and bills the consumer. Are the tax consequences different from those of scenario #1, above?"

The tax consequences are the same as discussed above. Currently, although the consumer would owe use tax, the California seller would not be responsible for collecting it since the sale occurs outside California. Beginning January 1, 1993, the California seller would be responsible for collecting use tax measured by the marked up price paid by the consumer.

"3. Retailer, once more, is an out-of-state firm not engaged in business in California. It receives an order from a California consumer and orders the property from Wholesaler, a California company. Wholesaler, in turn, places an order with Manufacturer, which is located outside the state and not engaged in business in California. Manufacturer ships the property directly to the consumer in California by common carrier, F.O.B. shipping point. Manufacturer bills Wholesaler who bills Retailer who bills the consumer, each party adding a markup to its billed price. Does any party have a responsibility to report the use tax other than the consumer?"

Under current law, no. However, on and after January 1, 1993, the sale by the wholesaler will be redefined under section 6007 to be a retail sale and the wholesaler will be responsible for collecting use tax measured by the marked up price paid by the California consumer (this is explained further below).

"4. All facts are the same as scenario #3 except that Manufacturer is engaged in business in California. Does that affect the answers given for #3?"

The answers remain the same, and this factual scenario is a useful model for the explanation of our conclusion. When responding to inquiries on the subject of drop shipments,

we have often emphasized that a California seller who drop ships to a California consumer pursuant to a retail sale by another person could not avoid the application of the second paragraph of section 6007 by accepting a resale certificate which does not include a valid California seller's permit number. Such a certificate indicates that the out-of-state retailer is not engaged in business in California. The acceptance of such a certificate would not relieve the California seller of liability for sales tax under the second paragraph of section 6007. Rather, the California seller would still have to prove that the out-of-state seller was, in fact, engaged in business in California.

The corollary to the rule mentioned above is that a person who drop ships property to a California consumer, or who has property drop shipped, and who accepts in good faith a valid and timely resale certificate that includes the purchaser's valid California seller's permit number, is not liable for sales or use tax on the sale. This is consistent with the relevant statutes and regulation. (See Rev. & Tax. Code §§ 6091, 6241, Reg. 1668.) We would not require that seller to further document that the person who issued the certificate was reselling directly to the consumer, or instead to another person who may or may not be engaged in business in California and who would make the actual retail sale. Needless to say, the person in the best position to ascertain whether the actual retailer is engaged in business in California, and to otherwise protect itself if not, is the person contracting with that retailer. In your example, the manufacturer would not be liable for tax if it obtained a timely resale certificate from the wholesaler.

Since the timely acceptance of such a certificate in good faith relieves the manufacturer of liability for tax, and since the drop shipment is pursuant to a retail sale made by a retailer not engaged in business in California, the wholesaler, who issued the resale certificate is redefined by section 6007 as the retailer. Consistent with this conclusion, even if the manufacturer did not obtain a resale certificate, it would not be liable for tax if it established that the wholesaler resold the property and that the wholesaler is engaged in business in California. Rather, the wholesaler would be liable for the tax. The measure of that tax would be the sales price paid by the consumer.

Applying this analysis to your fourth scenario, the manufacturer would not be liable for collection of use tax if it accepted a timely and valid resale certificate which included the wholesaler's California seller's permit number. If the manufacturer failed to accept a timely and valid resale certificate, then it would, of course, have the burden of proving that its sale was a sale for resale. If it did so and also established that the wholesaler is engaged in business in California, the manufacturer would have satisfied its burden. (On the other hand, if neither the wholesaler nor the retailer were engaged in business in California, the manufacturer would be regarded as the retailer under the second paragraph of section 6007.)

I hope this answers your questions. If not, feel free to write again.

Sincerely,

David H. Levine
Senior Tax Counsel

DHL:cl

bc: Out-of-State District Administrator
Sacramento District Administrator
Mr. Glenn Bystrom
Ms. Shirley Johnson
Mr. Donald Fillman

Please annotate. The annotation should replace current 495.0880. If not, that annotation should be corrected as noted in my memorandum to Gary Jugum dated August 21, 1992, and this one should be placed directly below it with the relevant dates of application added to each annotation. I suggest the following wording:

Under the second paragraph of section 6007, a seller engaged in business in California owes sales tax, or must collect use tax, when it makes a wholesale sale of property and makes a delivery of that property to a California consumer pursuant to a retail sale made by a person not engaged in business in California. The California wholesaler is redefined to be the retailer under section 6007 even if it, in turn, purchases the property from another supplier who actually delivers, on the wholesaler's behalf, the property to the California consumer. The supplier would be liable for tax under section 6007 only if neither the retailer nor the wholesaler were engaged in business in California.