

Drop-Shipping Gets More Complicated

The Supreme Court Wayfair decision last June that allows states to collect sales tax on online purchases from out-of-state retailers was widely hailed by brick-and-mortar retailers for eliminating an unfair pricing advantage and “leveling the playing field.” The logic and fairness of the Court’s reasoning was clear-cut and hard to argue with: With their apps and cookies resident on phones, computers, and tablets, online retailers unquestionably had a “nexus” or presence in remote states. However, efforts to put the ruling into practice have lacked the same clarity. Now that nearly all m.i. retailers do some online business, they are faced with major administrative challenges in complying with the filing requirements of the nation’s 12,000 taxing districts. The ruling has also added a new level of complexity to the longstanding industry practice of drop-shipping.

Say you’re a brick-and-mortar retailer and you’ve just sold a \$3,500 keyboard to a customer who happens to be in another state. It’s not an item you normally stock, but fortunately your main supplier has one in the warehouse that they can ship tomorrow. You could have them ship it to your store and then re-ship it to the customer, but the \$400 to \$500 in UPS charges, plus insurance costs, would wipe out your gross profit. So instead, you ask the manufacturer to ship the instrument directly to the customer, halving the shipping costs and eliminating a lot of hassle.

Since the keyboard is being purchased for resale, it’s not legally subject to sales tax, and in the pre-Wayfair era, this commonplace two-step transaction wouldn’t draw any scrutiny. Now that states can collect sales tax on out-of-state transactions, though, auditors are taking a much more critical look. According to Mike Fleming, a widely quoted sales tax consultant, “Auditors now view all cross-border sales as ‘low hanging fruit.’ They aggressively pursue them and will levy the sales tax in any case where there is insufficient documentation.”

The experience of numerous industry suppliers and retailers bears out this warning. With increasing frequency, we’re hearing stories about newly inquisitive sales tax collectors demanding records on all out-of-state transactions. The retailers and suppliers who have undergone these audits say it’s a “brutal process,” and absent proper contemporaneous documentation, there is no alternative but to pay whatever taxes the auditors demand.

Given that drop-shipping has become increasingly prevalent with the rise of the internet and online sales, document-

ing the tax status of every transaction has taken on a new urgency. In just about every product category—audio, frets, keyboards, wind instruments—retailers routinely ask their suppliers to ship directly to remote customers, thus incurring the risk of an audit. So how to avoid an unfortunate run-in with the tax collector?

We’re not tax experts, and the rules are changing as we write this—to date only 36 states have established clear guidelines for out-of-state collection of sales tax. However, there are a few basics that every retailer and supplier should be aware of. First and foremost is to have valid resale certificate for every state you ship to. These documents are the only way to prove that a transaction between retailer and supplier was for resale and not subject to sales tax. The Streamlined Sales and Use Tax Agreement (SST) offers a unified resale certificate that is accepted by the 17 participating states. The Multi-State Tax Commission (mtc.gov) also offers resale certificates valid in numerous states. Other states don’t make it so easy. California and Hawaii only recognize their own resale certificates. Of equal importance is



ensuring that the terms of any transaction are precisely documented between retailer and drop-shipper to address who pays for shipping and how taxes will be handled.

Complying with the multitude of sales tax rules was never going to be easy. How about just calculating the proper tax? It’s based on a percentage of the

sale, but which sale—the sale between the retailer and the end-customer, or between the retailer and the drop-shipper (the wholesale price)? Fortunately, though, a number of software services have emerged to help with the task. Avalara offers a one-stop solution for calculating and remitting sales tax and currently boasts more than 20,000 users, including both single-store and large chain operations. Avalara software can also be readily migrated onto a retailer’s website so sales tax charges automatically show up in the shopping cart. Taxcloud.com and Taxjar.com offer similar services. Given that this compliance challenge isn’t going away anytime soon, expect other solutions to emerge.

We doubt that many of the brick-and-mortar retailers who lobbied for an internet sales tax anticipated they would simultaneously be assuming a significant administrative burden. It’s worth remembering that tax laws change continuously, but the law of unintended consequences is eternal.

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