



The 5 W's Of Drop Shipping Tax Rules

What Ecommerce
Retailers Must Know



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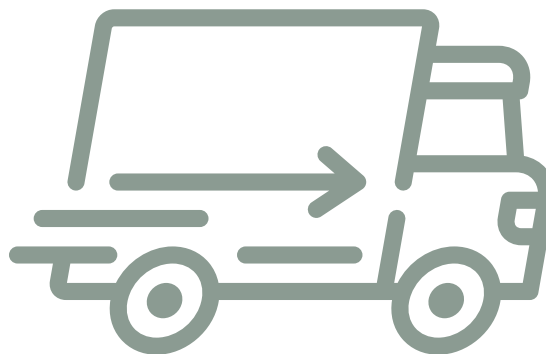
Ecommerce retailers feel increased pressure to offer both an expanded product line and rapid home delivery, driving many to increase their drop shipping programs. According to the Retail Systems Research report Retail Insight: *Moving Beyond Omnichannel*, 40% of retail respondents expect an increase in drop ship vendors in 2017, a trend echoed by logistics service providers catering to retail.

Drop shipping delivers significant benefits in lowering inventory and supply chain costs while driving increased sales. “Often merchants want to start, grow or fine-tune their product offering without the headaches of warehousing everything,” said George Heudorfer, Vice President, Digital Commerce at Logicbroker. “It’s a great way to tip-toe into new categories without taking on overhead.”

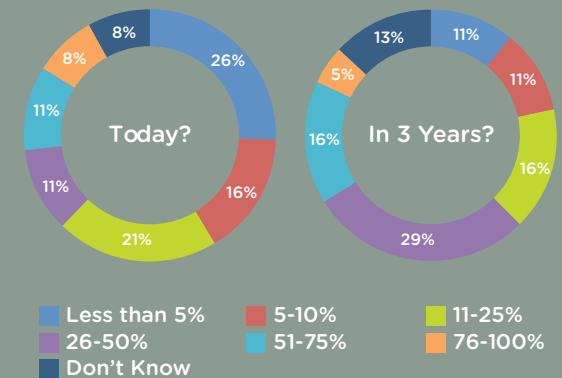
“ 40% of retailers expect an increase in drop ship vendors in 2017. ”
- Retail Systems Research

But engaging with a drop shipper can bring on new issues with nexus — laws governing whether companies have a physical presence that requires them to collect sales tax.

With more than 11,000 tax jurisdictions in the U.S., each with its own rates and requirements, the maze of nexus rules is truly Byzantine — and growing more so, as states losing sales tax revenue from brick and mortar retail seek a share of ecommerce sales. States are both modifying their nexus rules and stepping up enforcement. With significant penalties for non-compliance, it’s critical that ecommerce retailers establish systems and processes to ensure they’re getting it right.

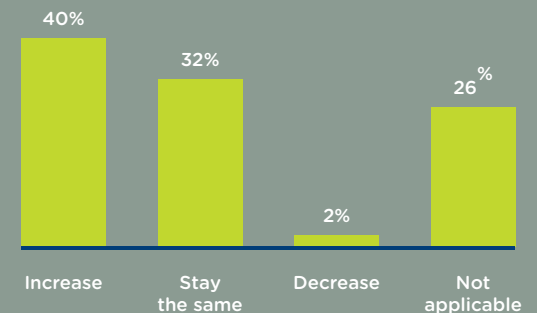


Percent of Logistics Service Provider (LSP) Sales From Drop Ship



Source: RSR Research, January 2017

How Will The Number Of Drop Ship Vendors Change In 2017?



Source: RSR Research, December 2016

“Retailers are increasingly interested in drop ship as a low-risk way of expanding their assortment as a hedge against uncertain consumer demand.”

- Retail Systems Research’s Retail Insight: *Moving Beyond Omnichannel*

The Lowdown On Sales Taxes

Many retailers don't initially realize that the benefits of expanded drop shipping programs bring added sales tax complexity.

Here are the 5 W's (and 1 H) on what they need to know:

Why?

Most retailers have a handle on tax rules where they maintain stores, offices, or distribution operations. They register with state tax authorities, receive a resale certificate, and charge sales tax according to state and local rules. If the retailer sells into a state where it does not have nexus, the retailer doesn't have to charge sales tax — instead, the customer is expected to pay a use tax.

But it gets more complicated when a drop shipper gets involved. In drop shipping, there are really two transactions:

- **Retailer to customer**
- **Retailer and the drop shipper (usually a manufacturer or distributor)**

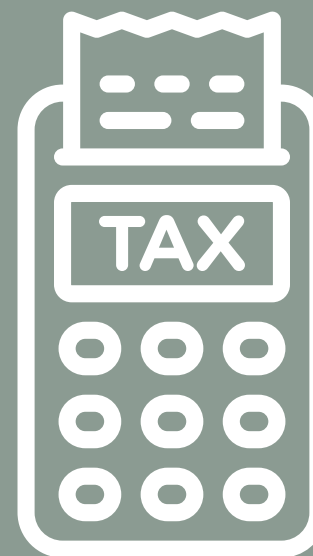
Case in point: A customer places an order in a state where the retailer has nexus but the drop

shipper does not. The order is for a drop ship item, so it's really going right from the drop shipper to the end customer. Usually the retailer can share its resale certificate with the drop shipper, then charge the correct sales tax to the customer.

"But if the drop shipper has nexus or is registered in the state where the retailer does not have nexus, it gets complicated," said Pete Bunio, Tax Research and Support Lead at Vertex. Many states will accept the retailer's resale certificate from another state — those that are members of the Streamlined Sales and Use Tax Agreement, for example, use an SST-certified exemption certificate for that purpose. However, "there are handful of states that don't accept an out-of-state certificate," Bunio said. "They're very rigid and will only accept their own." That forces the drop shipper to charge sales tax to the end customer.

Calculating that tax is tricky. Sales tax is a percentage of the sale, *but which sale* — the sale between the retailer and end customer, or the retailer and the drop shipper (the wholesale price)? Drop shippers usually don't know the retail price. States deal with that situation differently. In California, if the retail price is unknown, the drop shipper is expected to base the tax on the wholesale price plus 10%.

“ Sales tax is a percentage of the sale, but which sale — the sale between the retailer and end customer, or the retailer and the drop shipper (the wholesale price)? ”



In addition, many drop shippers aren't equipped to bill the customer separately for tax, and retailers find going back to the customer to recoup a tax balance unwieldy or unwise. "It's a rabbit hole that you don't want to go down," Bunio said. Jurisdictions might even disagree with how the basis — wholesale or retail price — is determined.

Calculating the correct sales tax also means the retailer must know which drop ship facility the inventory will ship from, instantly. Ideally, "you calculate tax immediately in the cart and you charge the appropriate tax immediately," said Michael Sonier, Senior Director, Product Management, Magento Commerce. "That requires a pretty complex orchestration of your order management system, one that knows where you're going to source that order from immediately at the time you take that order, and a tax solution that knows exactly where that's going to come from and tells you the right tax. That's the best-case scenario." Without that, retailers are forced to guess, and make up any difference from margin to avoid compliance penalties. "You want to have the most accurate information up front so you limit your liability and deliver the best consumer experience," Sonier said.

Customers are unaware of all this, of course. They simply want the retailer to calculate and display the correct sales tax so they can hit the "submit order" button.

“ Calculating the correct sales tax means the retailer must know which drop ship facility the inventory will ship from, instantly. ”



Who?

The 11,000 U.S. tax jurisdictions include states, counties, cities, and districts, each with its own continuously changing regulations and documentation requirements. “Districts can be anything from an economic development zone to a transit, library, or police jurisdiction,” Bunio said.

Retailers must be able to quickly verify which tax rules and rates apply to the customer’s location and correctly calculate the state + city + county + district tax.

PwC predicts an uptick in legislation to expand nexus standards, limit exemptions and loopholes, and impose taxes on products/services that were traditionally exempt. “Moreover, federal and state legislation will impact how states treat out-of-state taxpayers, specifically around expanded nexus provisions and market-based sourcing implementation,” according to the **Tax Function of the Future** report.

“Federal and state legislation will impact how states treat out-of-state taxpayers.”

- Price Waterhouse Cooper

States are starting to declare that drop shippers create nexus for the retailer. They’re viewing the drop shipper as an extension of the retailer, and since the drop shipper has a physical presence in the state, the retailer has to register and collect sales tax in that state.

That won’t just mean for drop ship customers. “The retailer would then have to charge every customer from that state sales tax, whether or not they received the item via drop ship,” Bunio explained.

States also are becoming more restrictive in accepting out-of-state resale certificates. That introduces the problem of demanding drop shippers collect taxes and determining whether those taxes are based on the wholesale or retail price.



Where?

Laws are transforming everywhere, but many experts cite California, New York, Texas, Florida, and Indiana as among the dozen or so states where sales tax is seeing the most legislative pressure. For example:

- **Use of “cookies” now constitutes a physical presence in Massachusetts. In April 2017, the state announced that Internet vendors with more than \$500K in sales and 100+ transactions in the prior taxable year will be required to collect sales tax.**
- **Retailers who use Fulfillment by Amazon to ship from a California warehouse are required to collect sales tax there.**

States also differ on whether shipping charges are taxable. Some states always exempt separately stated shipping charges, and others always tax these charges. However, in most states the taxability of separately stated shipping charges will follow the taxability of the product.

A growing number of retailers are expanding their drop shipping programs internationally — using a non-U.S. company to fulfill orders in the U.S., or drop shipping items from the U.S. or other countries to international destinations. Those transactions add complexity, such as the

widely varying thresholds where transaction costs or types of items trigger collection of duties across countries.

According to 2017 survey data by Temando, 80% of U.S. enterprise retailers struggle with getting an accurate cost of shipping, including taxes and duties, when trying to ship internationally. And yet 42% of U.S. consumers won't shop with a retailer again if they had to pay tax and duties to have their items released from Customs. In comparison, when consumers encountered a positive shipping experience, 73% stated they'd shop with the retailer again. Accuracy is critical to avoid losing the customer or taking a big, margin-eating hit on the transaction.

“There's a fairly big piece of friction there that needs to be removed for the consumer to have a seamless experience,” said Carl Hartmann, Co-Founder and CEO at Temando. “Consumers understand that tax exists. It's when their expectations aren't managed that there's a potential issue.”

“ 80% of U.S. enterprise retailers struggle with getting an accurate cost of shipping when trying to ship internationally. ”

- Temando



When?

Sales tax rules also can be time-based. Governments periodically hold sales tax holidays, eliminating or reducing taxes for some period. Retailers must implement and document these events.

Taxable items and exemption rules also vary. “Clothing may be tax exempt — except for some items that are not,” Bunio said. “It’s on the retailer to correctly identify those items.” And some customers are exempt because they are non-profits or part of government, such as teachers purchasing school supplies. As with resale certificates, some states will accept other states’ tax exemption certificates, and others will not. These laws, too, vary widely and are under pressure as jurisdictions seek to replace declining revenue.

Small- to mid-sized and fast-growing companies in particular are in a double bind regarding sales tax nexus: they’re sizable and busy enough to find themselves in the increasingly broad sights of local tax officials, but they typically lack the expertise and means to minimize their tax liability and audit exposure, according to **Diane Yetter and Sales Tax Institute**.

“SMBs and fast-growing companies are in a double bind regarding sales tax nexus.”

- Sales Tax Institute



What?

Ensuring sales tax compliance for a drop ship sale entails two big challenges.

First is quickly and accurately calculating the correct tax rate to display in the cart. That is growing increasingly critical as consumers demand choices when it comes to shipping — next day or even same day; locker; click and collect, work, or home address; evening or Saturday delivery; and so on. Shoppers are also comparing fully-landed costs with competitors' offers.

To fulfill the order, retailers may source differently depending on the time frame selected, using different DCs, suppliers, drop shippers, or carriers. They must be able to calculate the full cost of each of these options — including taxes — accurately and nearly instantaneously to display the right data, noted Temando's Hartmann. "Consumers will wait up to about one second in the shopping cart before loading time lag starts to impact abandonment, so having the ability to dynamically display full shipping cost at checkout is paramount."

The second big challenge is proper documentation to support the remittance of taxes due and to successfully complete an audit.

"Every state a retailer adds via drop ship multiplies the documentation burden," according to Bunio. For each one, retailers must:

- **Carefully track state, city, county, and district rates, laws and tax calendars;**
- **Understand which items are taxable;**
- **Collect and maintain exemption certificates for tax-exempt customers;**
- **Comply with the correct filing calendars — monthly, quarterly, semi-annually, or annually according to revenue;**
- **Complete documentation requirements;**
- **Monitor for changes and instill them into internal systems and processes; and**
- **Ensure the terms of trade are properly set up between retailer and drop shipper to address who pays for shipping and how taxes are handled.**

Often retailers begin trying to manage their newly expanded drop shipping programs in-house, said Magento's Sonier, only to quickly find issues including sales tax too complex to manage.

“Every state a retailer adds via drop ship multiplies the documentation burden.”

- Pete Bunio, Vertex



How?

With expanded drop shipping programs, accounting departments must now configure and maintain internal accounting and ERP systems to reflect a sharply increased volume of tax regulations. They must ensure all certifications are current and stay on top of nexus requirements related to new drop ship partners.

“Some retailers outsource sales tax compliance, but often such companies specialize in general accounting or back office processing, not sales tax,” Bunio said. Others rely on the simple tax tables incorporated into some ecommerce solutions. Both put retailers at risk of compliance errors just as tax jurisdictions are stepping up scrutiny.

To cope with the growing complexity, the PwC report recommends organizations “implement a comprehensive approach to address these increased demands by streamlining internal processes around data and technology.”

A cloud-based sales tax management solution is emerging as the best practice to cope with the increasingly complex sales tax landscape.

An actively-managed cloud solution is backed by experts dedicated to researching sales tax laws, removing that growing task from retailer accounting staff. A well-crafted solution:

- **Tracks product taxability across 11,000 tax jurisdictions;**
- **Maintains customer exemption certificates;**
- **Ensures continuous compliance with sales tax laws;**
- **Calculates sales tax down to granular levels, including district taxes;**
- **Seamlessly integrates with ecommerce software such as Magento to quickly and accurately calculate sales tax for display in the customer’s cart;**
- **Automates compliance documentation and filing; and**
- **Frees up a retailer’s internal accounting staff for other tasks.**

“Many times retailers don’t know that they have to do this and that there is a solution that can solve it,” said Magento’s Sonier.

“A well-crafted tax management solution calculates sales tax down to granular levels, including district taxes.”



Managing The Tax Implications Of Drop Shipping

Drop shipping is emerging as a smart, go-to strategy for retailers looking to capture and retain customer attention. But along with increased revenue and customer satisfaction come new concerns, including sales tax compliance. The good news is that outsourcing this task to a well-qualified partner can take away this obstacle to the benefits of drop shipping.

“Not all retailers do sales tax correctly,” said Logicbroker’s Heudorfer. When expanding the business through drop ship, “it’s great to have someone with expertise to take over this function, like Vertex.”



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