1st Civil No. A104964

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION THREE

MASON SHOE MANUFACTURING COMPANY

Plaintiff-Appellant,

v.

STATE BOARD OF EQUALIZATION of the State of California

Defendant-Respondent.

Appeal from Judgment of the Superior Court of the State of California, City and County of San Francisco,
Case No.CGC-02-411873
The Honorable John J. Conway, Presiding

BRIEF OF *AMICUS CURIAE* NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS IN SUPPORT OF APPELLANT

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INTRODUCTION

This case involves, among other things, the constitutionality of the State Board of Equalization's ("SBE") application of California's drop shipment rule, where it seeks to impose California use tax payment responsibility on wholesalers making drop shipments from outside the state—but only where the wholesaler has sold its goods to an out-of-state retailer.[1] The SBE reaches this result in this case by first merging two sales—the sale between the wholesaler and the out-of-state retailer, and the sale between the out-of-state retailer and the California consumer—into a single, hypothetical sale between the wholesaler and the California consumer. The drop shipment rule then appoints the wholesaler as the "retailer" of this hypothetical "sale," thereby making the wholesaler responsible for remitting "drop shipment use tax."[2]

Several problems arise where a wholesaler is required to pay drop shipment use tax as a result of the hypothetical "sale" it was deemed to have made to an out-of-state retailer's customer. First, the drop shipment rule makes the wholesaler liable for drop shipment use tax even though the

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[1] The term "out-of-state retailer" refers to a retailer who is not engaged in business in California, but who sells goods to California consumers.

[2] This brief will refer to the "drop shipment use tax" in an effort to clarify the differences between the general use tax, which must be paid by the consumer or by a retailer engaged in business in the state and making an out-of-state retail sale, versus the use tax that the SBE is seeking from wholesalers making sales for resale and drop shipping that property into California from out-of-state.

A "drop shipment sales tax" is imposed on drop shipments made by wholesalers who deliver goods to California consumers from inside the state. However, the constitutionality of the drop shipment sales tax is not at issue in this case, and thus this brief will not address arguments regarding the constitutionality of that tax.

wholesaler lacks privity of contract with the California consumer and has no ready means of recouping the tax, either from the out-of-state retailer or the California consumer.

Second, because the wholesaler is not a party to the actual sale taking place between the out-of-state retailer and the California consumer, the wholesaler has no direct knowledge regarding the actual retail sales price. The regulations acknowledge this problem by allowing wholesalers to assume that the retail selling price is equal to the wholesale price plus a ten percent markup; however, if the actual retail markup is less than ten percent or the California consumer has purchased the goods for resale, the wholesaler will end up paying more drop shipment use tax than would have been due under the general use tax.

Third, if the wholesaler asks the out-of-state retailer for the retail sales price, and the retailer complies, the retailer will be disclosing confidential information regarding its profit margin to the wholesaler. If the out-of-state retailer refuses to provide this information, and the wholesaler seeks reimbursement of the tax from the consumer based on the wholesale price plus the ten percent mark-up, the consumer will learn the retailer's profit margin.

Fourth, the drop shipment rule creates the risk of multiple taxation because, even though the State may collect drop shipment use tax from the wholesaler, the California consumer is required by law also to remit use tax unless it has proof demonstrating that it paid sales tax reimbursement to a retailer engaged in business in this state. Moreover, the State also may seek to collect use tax from the out-of-state retailer.

The drop shipment use tax sought to be collected here must be paid only where the wholesaler sells to an out-of-state retailer. No drop shipment use tax applies at all when the wholesaler sells to a retailer engaged in business in California. Taxing a wholesaler for doing business

with a non-California retailer, while relieving the wholesaler from that tax if it does business with a California retailer, could not be a clearer example of discriminating against interstate commerce. The drop shipment rule thus is unconstitutional as applied to sales made by wholesalers shipping goods from outside of California, and must be struck down.

Moreover, the SBE should not be permitted to use the drop shipment rule to override the basic premise of the sales and use tax law that only retail sales and purchases are subject to tax, and not wholesale sales for resale. The SBE's own regulation expressly provides that a wholesaler will not be liable for the drop shipment use tax where the wholesaler has received a valid California resale certificate establishing that the sale is a non-taxable wholesale, rather than a taxable retail, sale. However, the SBE refuses to accept a valid resale certificate from another state. Because only California retailers holding a California seller's permit, and not out-of-state retailers, may issue a California resale certificate, the SBE is discriminating against the out-of-state retailers in this way as well.

I. STATUTORY BACKGROUND

A. California Sales and Use Tax Generally

California imposes sales tax on the gross receipts of every retailer for the privilege of making retail sales of tangible personal property in California. (See Rev. & Tax. Code § 6051.) A "retailer" is defined as "[e]very seller who makes any retail sale or sales of tangible personal property." (Rev. & Tax. Code § 6015, subd. (a)(1).) "Sales" are defined as "[a]ny transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for consideration," (Rev. & Tax. Code § 6006, subd. (a)), and are deemed to be "at retail" if they are made "for any purpose other than resale in the regular course of business," (Rev. & Tax. Code § 6007). Although

California imposes its sales tax on the retailer, the retailer has the right to seek reimbursement of the tax from the purchaser pursuant to an agreement of sale. (See Civ. Code § 1656.1; Cal. Code Regs., tit. 18, § 1700.)

California also imposes a complementary use tax on "the storage, use or other consumption in this state of tangible personal property purchased from any retailer," (Rev. & Tax. Code § 6201), unless sales tax already has been paid, or the transaction was otherwise exempt from sales tax (see Rev. & Tax. Code § 6401). Unlike the sales tax, the use tax is imposed on the purchaser based on the sales price of the property. (See Rev. & Tax. Code § 6201.) If the retailer is engaged in business in California and therefore holds a California seller's permit or "Certificate of Registration—Use Tax," and the retailer makes a sale outside of California to a California customer, the retailer must collect and remit the use tax to the State. (See Rev. & Tax. Code § 6202; Cal. Code Regs, tit. 18, § 1685, subd. (a)(1).) If the retailer is not engaged in business within California, the purchaser remains liable for the use tax and must report and pay the tax directly to the State. (See Rev. & Tax. Code §§ 6202, 6203; Cal. Code Regs., tit. 18, § 1685, subd. (a)(2).)

Only retail sales and purchases are subject to the sales and use taxes. California law provides a rebuttable presumption that all sales of tangible personal property within the state are retail sales, and are thus subject to sales tax, (see Rev. & Tax. Code § 6091), and that all tangible personal property sold for delivery in the state is sold for use, storage or consumption in the state, and is thus subject to use tax, (see Rev. & Tax. Code § 6241). However, the seller may rebut these presumptions, and establish that the sale is a non-taxable wholesale sale, by obtaining a resale certificate from the purchaser that the property is being purchased for resale. (See Rev. & Tax. Code §§ 6091, 6092, 6241, 6242; see also Cal. Code Regs., tit. 18, § 1668.)

B. The Drop Shipment Rule

The above provisions thus operate to ensure that all retail sales, or uses, of tangible personal property that take place within California will be subject to either California sales tax or use tax. Nevertheless, California's sales and use tax law also contains an additional provision that recharacterizes certain wholesale sales, or sales for resale, as taxable retail sales. (See Rev. & Tax. Code § 6007.) This rule is commonly referred to as the drop shipment rule.

The statute incorporating the drop shipment rule provides:

> When tangible personal property is delivered by an owner or former owner . . . to a consumer . . . pursuant to a retail sale made by a retailer not engaged in business in this state, the person making the delivery shall be deemed the retailer of that property. He or she shall include the retail selling price of the property in his or her gross receipts or sales price.

(Rev. & Tax. Code § 6007.) In other words, a wholesaler that makes such shipments on behalf of an out-of-state retailer will be "reclassified as the retailer and is liable for the tax." (Cal. Code Regs., tit. 18, § 1706, subd. (b).)

The wholesaler's tax liability is removed if the wholesaler secures a California resale certificate from the retailer. (Cal. Code Regs., tit. 18, § 1706, subd. (e).) However, the SBE will continue to impose this liability on the wholesaler if the resale certificate "does not include a valid California seller's permit number," (Cal. Code Regs., tit. 18, § 1706, subd. (e)(1)), which, of course, can only be obtained by a California retailer, (see Rev. & Tax. Code § 6066, subd. (a)).

In the absence of the drop shipment rule, a sale from a wholesaler to an out-of-state retailer would be exempt from California sales tax because the sale took place outside of the state and was a nontaxable sale for resale.

The sale from the out-of-state retailer to the California consumer would be exempt from California sales tax because this sale also took place outside of the state. However, the California consumer's use of the property within the state would be subject to California use tax (assuming that the California customer is not, in fact, a reseller), which the California consumer is required by law to report and remit. (See Rev. & Tax. Code §§ 6202, 6203; Cal. Code Regs., tit. 18, § 1685, subd. (a)(2).) Thus, California would be entitled to use tax revenues even if the drop shipment rule did not exist.

When the drop shipment rule is applied, the wholesaler is reclassified as a retailer making a retail sale to the California consumer. If the wholesaler originates the sale from outside of California, the sale would not be subject to drop shipment sales tax because the sale occurs outside of the state. The sale would, however, be subject to drop shipment use tax. As the deemed "retailer" in this transaction, the wholesaler would be responsible for reporting and remitting the drop shipment use tax to the State. Thus, the effect of the drop shipment rule is to transform certain wholesale sales made to out-of-state retailers into retail sales, and to impose responsibility for paying the drop shipment use tax upon the wholesaler.

C. Problems Created by the Drop Shipment Rule

Although it might appear that a wholesaler's responsibility to report and remit drop shipment use tax is similar to a retailer's responsibility to report and remit use tax generally, the burdens actually are quite different. If a retailer is responsible for reporting and remitting California use tax, it merely collects the tax from its customer at the time it invoices the sale, just as it would have collected a sales tax. In such cases, the retailer knows what the retail selling price is and has authority to demand the tax from the California consumer pursuant to section 6203 of the California Revenue and Taxation Code. The retailer then provides the California consumer

with a receipt documenting that the retailer collected this tax from the consumer, thereby relieving the consumer of the responsibility to remit use tax directly to the State.

In contrast, many more problems are created when the wholesaler is required to remit drop shipment use tax. *First*, unlike the retailer, the wholesaler has no ready means for collecting the drop shipment use tax from the retailer's California consumer. Section 6203 of the Revenue and Taxation Code states that "every retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state . . . shall, at the time of making the sales . . . collect the tax from the purchaser . . . ." (Rev. & Tax. Code § 6203, subd. (a).) Although this language may authorize the wholesaler to collect drop shipment use tax directly from the California consumer, it does not authorize the wholesaler to collect it from the out-of-state retailer (who is the wholesaler's only customer) because the out-of-state retailer is not storing or using the property in the state.

The statute also does not authorize the out-of-state retailer to collect the tax from the California consumer, because the out-of-state retailer is not engaged in business within the state. Accordingly, the out-of-state retailer cannot collect the drop shipment use tax from the California consumer on behalf of the wholesaler. Moreover, even if the State authorized the out-of-state retailer to collect drop shipment use tax, because the out-of-state retailer lacks nexus with the State, the State (and thus the wholesaler) could not force the out-of-state retailer to collect this tax for remittance to the wholesaler, just as it could not force the out-of-state retailer to collect the general use tax for remittance to the State.

Given that the wholesaler cannot collect the drop shipment use tax from the out-of-state retailer—its real customer—the wholesaler's only alternative is to seek direct reimbursement from the California consumer.

However, this effort is more difficult than it might seem, because the "retail sale" between the wholesaler and the California consumer is only a hypothetical sale, the wholesaler does not actually bill the consumer for the cost of the product and has no privity of contract with the consumer. Indeed, in most cases, the wholesaler's involvement in the transaction is invisible to the consumer, who has dealt only with the out-of-state retailer. The wholesaler thus cannot just add the drop shipment use tax to a sales invoice, as it was not involved in invoicing to the consumer.

The wholesaler thus would be required to separately bill each and every one of the out-of-state retailer's California consumers for the drop shipment use tax, which imposes a significant administrative burden on the wholesaler. Moreover, it is unlikely to be successful because the California consumer (having purchased its property from the out-of-state retailer) typically has no idea who the wholesaler is and would be unlikely to pay its use tax obligation to the unknown wholesaler—who was not even a party to the sale between the out-of-state retailer and the California consumer.[3] Thus, even if the wholesaler were to separately bill each and every one of its out-of-state retailer's California consumers, if the California consumer refused to reimburse the wholesaler, the wholesaler would be left "holding the bag" for this liability.

Second, it will not always be clear how much drop shipment use tax the wholesaler should collect and remit to the State. The proper amount of drop shipment use tax is based on the "retail selling price of the property

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[3] This process is complicated even further by the fact that the wholesaler only has the California customer's shipping address, which may be different from the billing or purchasing address for large businesses with numerous locations, branches, or stores. Retailers generally are reluctant to provide wholesalers, who often are competitors, with detailed information such as this regarding their customers. In such cases, the wholesaler would not be able to remit the invoice to the proper location.

paid by the California consumer to the out-of-state retailer." (Cal. Code Regs., tit. 18, § 1706, subd. (c)(1).) However, because the wholesaler is not a party to the actual sale between the out-of-state retailer and the California consumer, the wholesaler is not privy to the actual amount for which the product was resold.

In acknowledgement of the fact that a wholesaler typically would not know the actual retail price charged by a retailer, the SBE, in its drop shipment regulations, permits the wholesaler to satisfy its drop shipment use tax liability by calculating the tax based on the wholesale price (i.e., the sales price paid by the out-of-state retailer) plus a ten percent markup. (Cal. Code Regs., tit. 18, § 1706, subd. (c)(1)-(2).) While this provision caps the wholesaler's presumed liability at a certain point, the wholesaler will nonetheless be held liable for more use tax than is truly due in cases where the out-of-state retailer's actual markup is less than ten percent. Moreover, if the California customer were to resell the goods, rather than storing, using or consuming them within the state, no general use tax liability would have been due. Nonetheless, the drop shipment rule would continue to hold the wholesaler liable for drop shipment use tax unless, by serendipity, the wholesaler learned of the resale and was able to obtain documents proving the resale—in reality, a near impossible burden.

Third, the SBE's proffered solution to these problems causes additional problems. For example, to solve the problem of the wholesaler not knowing what the true retail price is, the SBE advises that the wholesaler just "ask." (SBE's Brief at p. 18-19.) However, if the out-of-state retailer opts to disclose the retail sales price of the goods to the wholesaler, the out-of-state retailer will be providing the wholesaler (who is often a competitor) with confidential information regarding the retailer's profit margin. On the other hand, if the out-of-state retailer refuses to provide this information to the wholesaler, and the wholesaler seeks

reimbursement of the tax from the California consumer at the wholesale price plus a ten percent markup, the California customer will learn this confidential information regarding the out-of-state retailer's profit margin. No such burden is imposed on California retailers.

Fourth, the drop shipment rule potentially can cause a single transaction to be subject to double or even triple tax. Section 6007 of the California Revenue and Taxation Code imposes drop shipment use tax collection responsibilities on the wholesaler. Sections 6202(a) and 6203(a) of the California Revenue and Taxation Code, on the other hand, provide that the California consumer's use tax liability will not be extinguished unless it receives a receipt from a retailer engaged in business in the state. Because a California consumer generally would not receive a receipt in such transactions (and likely would not even be aware that a drop shipment occurred or whether there is a drop shipper liable for the drop shipment use tax under the statute), any law-abiding California consumer would remit California use tax to the state as well.[4] And, if the out-of-state retailer is later deemed to have been engaged in business in the state at the time the sale was made, the out-of-state retailer also could be held liable for California use tax. Consequently, it is possible that all three parties—the wholesaler, the out-of-state retailer, and the California consumer—would be held liable for the use tax on the drop shipment sale.[5]

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[4] Indeed, under the law, the only way the California consumer is relieved of its own use tax obligation would be to collect a receipt from the retailer (in this case, the wholesaler), which again necessarily involves revealing the out-of-state retailer's confidential profit margin information.

[5] While the SBE may assert that it tries to avoid this multiple taxing, in our experience, it always is up to the wholesaler, at significant cost, to show that the general use tax has been paid by one of the other parties.

The consequence of these problems is that wholesalers making drop shipments to California consumers will be inclined to discriminate against out-of-state retailers. For example, a wholesaler might refuse to drop ship goods directly into California on behalf of an out-of-state retailer to avoid these drop shipment use tax payment responsibilities. This would lead to inefficiencies and create higher shipping costs for the out-of-state retailer.

If the wholesaler did agree to drop ship goods to a California consumer on behalf of an out-of-state retailer, the wholesaler would have an incentive to charge the out-of-state retailer a higher sales price than the wholesaler would have charged a retailer who is engaged in business in California. The wholesaler also might refuse to sell to the out-of-state retailer unless the retailer remitted the tax, even though the wholesaler would have no right to do so. In either case, the wholesaler would be discriminating against the out-of-state retailer.

Ironically, in addition to levying a potentially duplicate tax, the drop shipment rule might cause the California consumer's use tax base to be greater than it should have been. Assuming the wholesaler simply charged a higher price to the retailer and the retailer passed its increased price through to its consumer, the California consumer's general use tax measure would also increase, creating a higher tax liability. Moreover, the California consumer would not receive a valid receipt indicating that the wholesaler had collected that tax from the consumer, and thus would not be relieved of this higher tax liability.[6]

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[6] The law only relieves a California consumer of its use tax obligation where it collects a receipt from a California retailer. (See Rev. & Tax. Code § 6202.)

II. CALIFORNIA'S DROP SHIPMENT RULE VIOLATES THE COMMERCE CLAUSE BECAUSE IT DISCRIMINATES AGAINST INTERSTATE COMMERCE[7]

The United States Constitution provides Congress with the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes . . . ." (U.S. Const., art. I, § 8, cl. 3.) "Though phrased as a grant of regulatory power to Congress, the [Commerce] Clause has long been understood to have a 'negative' aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce." (*Ceridian Corp. v. Franchise Tax Bd.* (2000) 85 Cal.App.4th 875, 882.) Thus, the Constitution "prohibits economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." (Ibid.; see also *Associated Indus. v. Loham* (1994) 511 U.S. 641, 647.) By doing so, the Constitution "create[s] an area of free trade" among the several States. (*Boston Stock Exch. v. State Tax Comm'n* (1977) 429 U.S. 318, 328.)

In determining whether a tax is discriminatory under the Commerce Clause, the Supreme Court has held that "the first step... is to determine whether it regulates evenhandedly with only 'incidental' effects against interstate commerce." (*Fulton Corp. v. Faulkner* (1996) 516 U.S. 325, 331.) Such discrimination will be found when a state "taxe[s] a transaction or incident more heavily when it crosses state lines than when it occurs entirely in the state." (Ibid.)

Discriminatory taxes are evaluated under the strictest scrutiny. (See *Camps Newfound/Owatonna v. Town of Harrison* (1997) 520 U.S. 564,

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[7] The trial court properly accorded the SBE little deference below. (See August 26, 2003 Statement of Decision "Trial Ct. Decision" at p. 3.) Indeed, because the SBE cannot hold a statute unconstitutional, (see Cal. Const., art. III, § 3.5(a)-(b)), the trial court could not have provided the SBE deference as to whether the drop shipment rule is unconstitutional.

582.) If a law discriminates against interstate commerce on its face, it is generally invalid per se, unless the state can "show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." (*Oregon Waste Sys., Inc. v. Dept. of Envtl. Quality* (1994) 511 U.S. 93, 100-101; see also *Ceridian Corp., supra*, 85 Cal.App.4th at p. 884 ("Absent a compelling justification . . . a [s]tate may not advance its legitimate goals by means that facially discriminate against [interstate] commerce").) It is not relevant whether the state intended for the tax to be discriminatory or the tax was merely discriminatory in effect; "[t]he [s]tate's burden of justification is so heavy that 'facial discrimination by itself may be a fatal defect.'" (*Oregon Waste, supra*, 511 U.S. at p. 101.)

Notably, a tax can be discriminatory even if the discrimination is not directed at the taxpayer itself. For example, in *Fulton*, the United States Supreme Court held that a state's intangibles tax discriminated against interstate commerce because it taxed in-state residents on their stock in a corporation to the extent that the corporation conducted business outside of the state. (See *Fulton, supra*, 516 U.S. at p. 327.) The Court noted that the tax had the effect of "favor[ing] domestic corporations over their foreign competitors in raising capital among [in-state] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce." (*Id.* at p. 333.) The California Court of Appeals similarly has found that deductions for dividends received by domestic corporations were discriminatory where the amount that was deductible hinged on whether and to what extent the corporation issuing the dividend was engaged in business within the state. (See, e.g., *Farmer Bros. Co. v. Franchise Tax Bd.* (2003) 108 Cal.App.4th 976, *cert. den.* 2004 U.S. LEXIS 1055; *Ceridian Corp., supra*, 85 Cal.App.4th 875.) In other words, the Commerce Clause

prohibits discrimination in cases where a tax penalizes the taxpayer for engaging in transactions with non-California businesses.

A. California's Drop Shipment Rule Discriminates Against Interstate Commerce on Its Face and in Effect

California's drop shipment rule discriminates against interstate commerce on its face and in effect, in two ways. Accordingly, for either one of these reasons, this Court should strike down the application of the rule here.

1. The Drop Shipment Rule Only Applies to Sales Made to Out-of-State Retailers

First, the drop shipment rule only applies "[w]hen tangible personal property is delivered by an owner or former owner . . . to a consumer . . . *pursuant to a retail sale made by a retailer not engaged in business in this state* . . . ." (Rev. & Tax. Code § 6007.) As the SBE clearly acknowledges in its brief, "The drop shipment rule is triggered only when the . . . 'retailer' . . . is not engaged in business in this state . . . ." (July 9, 2004 Brief of Respondent State Board of Equalization "SBE's Brief" at p. 13.) Thus, a wholesaler would not be subject to the drop shipment use tax if the sale was made to a retailer who was engaged in business in the state, but would be subject to the tax if the exact same sale was made to an out-of-state retailer. It is hard to imagine a clearer form of discrimination against interstate commerce.

2. The SBE Only Accepts Resale Certificates from California Retailers

Second, although the wholesaler generally is allowed to rebut the presumption that a sale is a taxable retail sale by obtaining a resale certificate from its customer, the SBE refuses to recognize certificates from retailers without "a valid *California* seller's permit number." (Cal. Code

Regs., tit. 18, § 1706, subd. (e)(1), emphasis added.) Indeed the trial court below stated that "[t]o overcome the presumption, plaintiff needed to have produced a California resale certificate bearing the names Wissota Trader and B.A. Mason." (Trial Ct. Decision at p. 6.) Even though the trial court acknowledged that it was undisputed that those two non-California retailers "had Wisconsin resale certificates in effect during the relevant taxation period, and that Mason Shoe received those Wisconsin resale certificates" when making the wholesale sales at issue to the out-of-state retailers, it nonetheless found that "plaintiff has failed to rebut the presumption that the sales were retail sales . . . ." (*Id.* at pp. 6-7.)

Importantly, the effect of this practice, created by the SBE's regulation, is to discriminate against out-of-state retailers. The SBE only grants valid California seller's permits to retailers who are engaged in business in California. Consequently, wholesalers can accept resale certificates, and rebut the retail sale presumption, only when making a sale to a California retailer. By refusing to accept valid non-California resale certificates, and thus refusing to acknowledge that such sales being made to out-of-state retailers are likewise non-taxable sales for resale, the SBE discriminates against interstate commerce by penalizing the wholesaler for doing business with out-of-state retailers. This clearly "favors domestic corporations over their foreign competitors" and "tends, at least, to discourage domestic corporations from plying their trades in interstate commerce," (see *Fulton*, *supra*, 516 U.S. at p. 333), and therefore is unconstitutional.

B. The Drop Shipment Rule Fails to Advance a Legitimate Purpose That Could Not Otherwise Be Achieved by Non-Discriminating Means

The drop shipment rule thus discriminates against interstate commerce on its face and in effect and must be evaluated under the strict

scrutiny standard. This standard requires the State to prove that the tax "advances a legitimate local purpose" and that this purpose cannot be achieved by "reasonable nondiscriminatory alternatives," (see *Oregon Waste, supra,* 511 U.S. at p. 101), otherwise the tax must be struck down.[8]

The drop shipment rule creates the responsibility for reporting and remitting use tax on wholesalers making drop shipments of goods into the state on behalf of out-of-state retailers. However, the State already has enacted laws requiring California consumers to report and remit the general use tax on those same goods. (See Rev. & Tax. Code §§ 6202, 6203; Cal. Code Regs., tit. 18, § 1685, subd. (a)(2).) Moreover, it is no easier—in fact it is much more problematic—for the wholesaler to undertake this effort. The State should not be permitted to burden interstate commerce by creating a hypothetical sale and a hypothetical selling price, and imposing a tax liability on otherwise exempt wholesale sale for resale, just for the state's own administrative convenience.

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[8] Although a discriminatory tax may nevertheless be upheld if the tax can satisfy the compensatory tax defense, (see *Fulton, supra,* 516 U.S. at p. 331), the compensatory tax defense is not applicable here.

The compensatory tax defense requires (1) the state to identify the intrastate tax burden for which the state is attempting to compensate, (2) the tax on interstate commerce to roughly approximate, but not to exceed, the tax on intrastate commerce, and (3) the interstate and intrastate taxes to be imposed on substantially equivalent events that are "sufficiently similar in substance to serve as mutually exclusive proxies for each other." (*Id.* at pp. 332-333.)

The compensatory tax defense does not apply in this case because the constitutionality of California's sales and use tax law is only being contested to the extent that it imposes a drop shipment use tax on wholesalers making sales to out-of-state retailers. As discussed above, this tax is not compensatory for an equal sales tax; rather, it is in addition to the general use tax that would be imposed on a California consumer's purchase of goods from an out-of-state retailer.

The SBE's Brief asserts that a wholesaler is able to collect use tax on drop shipment just as easily as a retailer is able to collect sales or use tax on retail sales:

> If the out-of-state retailer does not have a California seller's permit, the wholesaler can ask the retailer how much use tax to collect from the consumer when the delivery in California is ordered. Finally, the wholesaler can add to its price to the retailer the amount of tax that it will owe the State arising from the drop-shipment sale.
>
> Indeed, in this case it is even easier, because Mason Shoe's officers and employees are the same people who preside over, and operate, B.A. Mason and Wissota Trader. Therefore, Mason Shoe knows who the California customers are, and can easily collect the California tax from them.

(SBE's Brief at pp. 18-19.) However, the burden of collecting drop shipment use tax on a hypothetical sale is far different from the burden of having a retailer who is engaged in business in the state collect the general sales and use taxes. California's sales and use tax law provides retailers with the authority to collect general sales and use tax from their customers. Retailers are able to easily do this by adding the sales or use tax to their customers' invoice, thus collecting the tax at the time of the sale.

In contrast, as discussed in greater detail above, California law does not authorize a wholesaler to collect drop shipment use tax from an out-of-state retailer, nor does it authorize the out-of-state retailer to collect that tax from its California customer. (See Rev. & Tax. Code § 6203.) Moreover, unlike the retailer, the wholesaler cannot simply include the drop shipment use tax on its invoice to its customer, the out-of-state retailer, at the time of the sale; rather, it must individually bill each and every one of the out-of-state retailer's California consumers to collect that tax. This effort is

further complicated by the fact that, in most cases, the California consumer will have no idea who the wholesaler is or that a drop shipment was actually made, making such consumers reluctant to just pay over this asserted tax liability, particularly since the California consumer normally would be required to self-assess that use tax and remit it directly to the State. Thus, wholesalers are faced with the dual burden of having to collect that tax from each individual consumer, at a substantial administrative cost, and then being left "holding the bag" when the consumer refuses to pay.

The SBE also suggests that no problems arise from the fact that the wholesaler is not a party to the sale between the out-of-state retailer and the California consumer, and thus is unaware of the retail sales price, claiming that the wholesaler may just "ask." (SBE's Brief at pp. 18-19.)[9] As discussed above, it is not so simple. Retailers are likely to be reluctant to provide this information to the wholesaler from whom they purchased the goods, since wholesalers may be competitors, and may use this proprietary information regarding the retailer's profit margin when negotiating future sales. Indeed, the SBE's suggestion, rather than solving the problem, creates further discrimination, because only out-of-state retailers, but not California retailers, would be forced to disclose their confidential pricing information.

Furthermore, it is also unsatisfactory to rely on the ten percent drop shipment markup proposed by the drop shipment regulations. If this

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[9] The SBE suggests that the drop shipment use tax is not constitutionally impaired because, in the present case, Mason Shoe can easily find out the retail sales price from B.A. Mason and Wissota Trader. While this may be true in the present case, in most cases, the wholesaler and the out-of-state retailer are unrelated third parties. Accordingly, even if the Court were to find that the drop shipment use tax is not constitutionally infirm as applied to Mason Shoe, the Court should limit its holding to situations in which the wholesaler and the out-of-state retailer are related parties.

markup is greater than the actual markup or if the California customer resells the goods, the wholesaler will have remitted more drop shipment use tax than the general use tax that was actually due. Moreover, if the drop shipment use tax is based on the wholesale price plus a ten percent markup and the wholesaler provides this information to the California customer (which is what the SBE suggests to avoid double tax), the out-of-state retailer again will be disadvantaged, because this would disclose proprietary information regarding its profit margin to the California consumer.

Finally, the SBE has not acknowledged the real and significant risk of multiple taxation. As discussed above, drop shipment sales are potentially subject to double or triple taxation, first upon the wholesaler making the drop shipment, next upon the out-of-state retailer, if that retailer is later found to have been engaged in business in the state, and last on the California consumer — because unless the wholesaler opted to go through the significant administrative exercise of trying to separately invoice each customer and then actually collect that tax directly from the California consumer, the consumer would not receive a receipt relieving it of its use tax obligation. Sales made to California retailers are not subject to this risk of multiple taxation, which further discriminates against interstate commerce.

As discussed above, the drop shipment rule provides a disincentive for wholesalers to engage in business with out-of-state retailers. Whether wholesalers are inclined not to make drop shipments on behalf of out-of-state retailers; refuse to sell to such retailers unless the retailer reimburses the wholesaler for drop shipment use tax (even though the retailer cannot demand reimbursement of that tax from its California consumer); or increase the sales price of goods made to out-of-state retailers to indirectly

recover the tax, the end result is that the drop shipment rule has the effect of discriminating against interstate commerce in significant ways.

In light of the fact that the drop shipment rule fails to close any "gap" between the sales and use taxes, this discrimination is particularly egregious. California consumers already are required by law to remit the general use tax to the State when purchasing goods from out-of-state retailers; the drop shipment rule thus only operates to add liability for drop shipment use tax upon the wholesaler. However, business consumers certainly are capable of remitting use tax to the State, and individual consumers can easily remit use tax to the State on their personal income tax returns. (See Cal. Resident Income Tax Return 2003, Form 540, line 51.) The State should not assume that all California consumers receiving drop shipments are scofflaws, and in any event, the State should hold California consumers liable for their use tax obligations, and not add another tax upon the wholesaler who was in the unfortunate position of shipping goods into California on behalf of an out-of-state retailer.

In sum, the only argument in favor of the drop shipment use tax is that it eases the State's collection burden. This reason is not a compelling justification for a rule that discriminates against interstate commerce—if it were, then the State could require any retailer, including those with no presence in California, to collect the use tax on the State's behalf. (See, e.g., *Quill Corp. v. North Dakota* (1992) 504 U.S. 298 (holding that a retailer who lacked a physical presence in the state could not be subjected to the state's use tax collection responsibilities).) California should not be permitted to place the burden of reporting and remitting drop shipment use tax on wholesalers simply because it cannot require the out-of-state retailer to act as the State's collection agency for the general use tax. Requiring, as the law already does, California consumers to self-assess and remit use tax

to the State thus provides a "reasonable nondiscriminatory alternative" to the drop shipment rule's clearly discriminatory effect.

C. The Trial Court Erred in Relying upon the Decision in *Lyon Metal*

The trial court below, and the SBE in its brief, erroneously cite the California Court of Appeal's decision in *Lyon Metal Products, Inc. v. State Board of Equalization* (1997) 58 Cal.App.4th 906, in support of their assertion that the drop shipment rule as applied in this case is constitutional. To the contrary, the *Lyon* court made it clear that its decision only applied to transactions where the goods transferred were always wholly within this state (i.e., transactions subject to the drop shipment sales tax).[10]

Indeed, the *Lyon* court made a point of distinguishing its facts, which only addressed the drop shipment sales tax on goods sold within the state, from *Steelcase, Inc. v. Crystal* (1996) 238 Conn. 571, which, as here, involved goods shipped from outside of the state:

> The *Crystal* decision indicates that a drop shipment rule, as applied to goods shipped from a warehouse inside the state and delivered to consumers inside the state, would be valid. Because the goods in *Crystal* were shipped from outside Connecticut and delivered to Connecticut consumers outside Connecticut, and in Michigan, the Connecticut drop shipment rule could not be applied in that case. The *Crystal* decision, therefore, does not support the trial court's ruling in this case; it vitiates it. *The*

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[10] For example, the *Lyon* court defined "drop shipment" as the "direct delivery of goods to a consumer thereof within this state from a warehouse within this state." (*Id.* at p. 909.) The court also expressly observed that the drop shipment rule as originally enacted was intended to impose sales tax liability where "goods inside California are first sold at wholesale to an out-of-state retailer, then resold to a consumer inside California, and then shipped directly from the California warehouse of the wholesaler to the California consumer." (*Id.* at p. 910.)

> *goods in the case at bench were warehoused in California, shipped from California, and delivered to retail consumers in California, so the California drop shipment rule as stated in section 6007 could properly be applied.*

(*Lyon Metal Products, supra,* 58 Cal.App.4th at p. 911; emphasis added.) The *Lyon* decision thus indicates that a different result would be appropriate if the goods were shipped from outside of the state and thus subject to a drop shipment use tax, which is consistent with constitutional jurisprudence permitting more latitude in taxing a wholly-intrastate transaction, as compared to one crossing state lines. (See *Fulton*, *supra*, 516 U.S. at p. 331.)[11]

Moreover, the *Lyon* court's analysis as to why the drop shipment sales tax was constitutional focused primarily on the relative measure of the sales tax and drop shipment sales tax; it did not focus on the practical difficulties that arise when a wholesaler is required to collect a drop shipment use tax, other than to say that the wholesaler only had to ask the out-of-state retailer for the retail sales price. Indeed, the *Lyon* court based its conclusions regarding discrimination upon the facts of that case, which involved wholly intrastate shipments, and the law in effect at that time, which did not provide for a ten percent markup, as do the current regulations.

The facts and law here, however, are different. This case involves a wholesaler's sale of goods to an out-of-state retailer, and its shipment of those goods to the retailer's California consumer on the retailer's behalf, thus causing those goods to cross state lines. Moreover, in light of the fact that the wholesaler's tax is based upon a ten percent markup when a

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[11] Indeed, the *Lyon* decision can be squared within this constitutional jurisprudence only by limiting the *Lyon* holding to its facts involving wholly intrastate transfers of goods.

wholesaler is unable to determine the out-of-state retailer's retail sales price, the wholesaler's drop shipment use tax obligation will rarely be the same amount as the general use tax obligation, unless the out-of-state retailer's markup happens to be exactly ten percent.

Finally, the *Lyon* court made it clear that it was not confronted with a situation where the wholesaler was attempting to prove that the sale was not a retail sale by the use of a valid non-California resale certificate. Indeed, the *Lyon* court expressly distinguished its facts from *Siemens Energy & Automation, Inc. v. New Mexico Taxation & Revenue Dept.* (1994) 119 N.M. 316, reasoning that *Siemens* "did not involve the legal issue presented here of whether a drop shipment could be made subject to sales tax; *Siemens instead dealt with New Mexico's unlawful refusal to accept a resale exemption certificate from another state, an issue not present here*." (*Id.* at p. 911; emphasis added; see also *id.* at p. 912 (stating that "Lyon does not contend its purchasers certified the goods sold were purchased for resale.").) Here, in contrast, the wholesaler did accept valid Wisconsin resale certificates in its efforts to prove that its sale was an exempt sale for resale, rendering the conclusion of the *Lyon* court inapposite.

D. Other Courts Have Refused to Apply Their State's Drop Shipment Rule to Interstate Commerce

Although *Lyon* held that California's drop shipment rule was constitutional where the goods were shipped entirely intrastate, other courts interpreting their states' drop shipment rules have determined that the drop shipment rule is inappropriate where the goods are shipped between states.[12] For example, in *Steelcase, Inc. v. Crystal*, *supra*, 238 Conn. at p.

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[12] Indeed, other states have not applied their drop shipment rules where, as with *Lyon*, the goods were shipped intrastate. For example, in *VSA, Inc. v. Faulkner* (1997) 126 N.C.App. 421, the court held that the

575, Connecticut's drop shipment rule, which is virtually identical to California's rule, stated that a "retail sale" included the delivery in the state of property by an owner or former owner, where the delivery was made pursuant to a retail sale made by an out-of-state retailer. The Supreme Court of Connecticut held that a wholesaler drop shipping goods from outside of the state was not subject to this rule on the grounds that the wholesaler was not delivering goods in Connecticut because the wholesaler transferred possession of the goods to a common carrier in Michigan. (*Id.* at p. 584.) Because the court was able to resolve the case on this issue, it was not required to reach the wholesaler's Commerce Clause argument. (*Id.* at p. 576, n.5.)

The Tax Court of New Jersey also concluded that New Jersey's drop shipment rule was inapplicable to a wholesaler drop shipping goods from out-of-state warehouses. (See *Steelcase, Inc. v. Director, Div. of Taxation* (1993) 13 N.J. Tax 182; see also *Solo Cup Co. v. Director, Div. of Taxation*, 1993 N.J. Tax LEXIS 13.) Like the SBE here, New Jersey had attempted to collect tax on such sales by preventing a wholesaler from establishing that its sales to out-of-state retailers were sales for resale, by only accepting New Jersey resale certificates. (See *Steelcase, supra*, 13 N.J. Tax at p. 187.) The court reasoned that the intent of the sales and use tax was to impose tax on the retail consumer at the point of final consumption and avoid pyramiding the tax, and stated that:

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wholesaler's evidence established that "the [wholesaler's] out-of-state purchasers resold the products 'outside this state' to its customers in North Carolina and the [wholesaler's] 'drop shipment' of the products [to consumers within the state] did not operate to transform what would otherwise be a sale outside of the [s]tate into a sale within the [s]tate." (*Id.* at p. 425.)

> By seeking to impose a tax at the wholesale level, Director, in an effort to require others to collect tax for the State, departs from the legislative intent to impose tax at the retail level and exposes the flow from the [wholesaler] to market place to multiple taxation.
>
> Additionally, Director seeks to force collection of tax from an out-of-state [retailer] having no nexus with New Jersey or, in the alternative, to force the out-of-state [retailer] to register in New Jersey in order to be able to provide the [wholesaler] with a New Jersey exemption certificate. Registration appears to carry with it the obligation to collect tax for New Jersey and be subject to audit by New Jersey. Thus, Director seeks indirectly to compel an out-of-state [retailer] with no New Jersey nexus to collect New Jersey tax, contrary to *Quill*. Further, [wholesalers] with no nexus with New Jersey are given a competitive advantage because they can drop ship to New Jersey customers [on behalf of out-of-state retailers] without obligation to collect New Jersey tax. This raises Commerce Clause questions and smacks of discrimination against interstate commerce.

(*Id.* at p. 194; footnotes omitted.) The court then concluded that because the Legislature intended to tax retail sales, the wholesaler could provide the Division with evidence other than a New Jersey resale certificate to establish that the wholesaler's sale was a sale for resale. (*Id.* at p. 195.)[13]

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[13] Similarly, in *In the Matter of the Petition of Steelcase, Inc.*, 1988 N.Y. Tax LEXIS 327, the court held that the wholesaler could use a resale certificate from another state to rebut the general presumption that all sales were taxable, even though the statute required the out-of-state retailer to provide "the number of his registration certificate." The court noted that although the wholesaler's certificates were not "in strict compliance" with the statutory and regulatory requirements to provide a New York resale certificate, such "affidavits and resale certificates contained such

CONCLUSION

The drop shipment rule is intended to impose responsibility for paying drop shipment use tax upon wholesalers who make otherwise valid, nontaxable sales for resale to out-of-state retailers. However, because this tax is only imposed when the wholesaler makes a sale to an out-of-state retailer, and not to an in-state retailer, and because the SBE does not impose the tax where the wholesaler receives a California resale certificate, but does imposes the tax even where a valid non-California resale certificate is obtained, the drop shipment rule as applied in this case discriminates against interstate commerce, both on its face and in effect, in violation of the U.S. Constitution. Accordingly, the application of the drop shipment rule to the facts presented in this case must be struck down.

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information as to sufficiently enable [the wholesaler] to sustain its burden of proof that each of its sales herein were sales for resale . . . ." (*Id.* at *9-*10.)

For all the reasons stated above, *Amicus Curiae* NAW respectfully requests for this Court to hold that California's drop shipment rule is unconstitutional as applied to wholesalers making sales from outside this state to out-of-state retailers.

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