Insights: Publications

6 Key Takeaways | Drop Shipments and Use Tax Accrual

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Kilpatrick's **David Hughes** recently spoke at the **Sales Tax Institute's "Basics" of Sales and Use Tax Conference** in Chicago. David discussed drop shipments and use tax accrual.

David's key takeaways from the presentation include:

1. Resale documentation drives the tax result
In a drop shipment, the retail sale is between the seller/distributor and the customer, while the sale from the shipper/wholesaler to the seller/distributor is generally treated as a resale transaction, so the main compliance issue becomes whether the seller can provide acceptable exemption documentation. States differ significantly on what they will accept, with some allowing alternate certificates or pass-through exemptions and others requiring an in-state registration number before a valid resale certificate can be issued.

2. Nexus and registration create practical tension
Although a state generally cannot require an out-of-state seller to register unless nexus exists, the shipper/wholesaler may still insist on exemption documentation that effectively forces the seller/distributor to register or else pay tax on the wholesale invoice. This means drop shipment compliance is often shaped not just by legal nexus standards, but also by the documentation demands of suppliers trying to protect themselves from audit exposure.

3. State-specific rules can materially change outcomes
States such as California, Massachusetts, and Tennessee have adopted specific rules or exceptions for drop shipments, including special marketplace seller rules, notarized statements, and broader acceptance of out-of-state resale certificates. These examples show that businesses cannot rely on a single national rule and instead must review each delivery state's requirements for registration, documentation, tax base, and whether tax can be passed through to the customer.

4. Use tax compliance is an enterprise-wide process
Use tax is not just a tax department function. Requisition, purchasing, receiving, accounts payable, and general accounting all play roles in identifying how property will be used and whether use tax is due. A business is more likely to determine tax correctly when tax considerations are built into the procurement process from the start rather than addressed only after invoices are paid.

5. Accurate accrual depends on strong systems and documentation
Accounts payable often serves as the control point for use tax review, but the process works best when invoices

separately track tax charged, use tax accruals are clearly marked, and verification procedures exist for taxability, rate, and jurisdiction. Transactions outside the normal payables flow—such as inventory withdrawals, intercompany transfers, and bulk distributions—seed detailed backup to prevent under accruals or audit adjustments.

6. The tax base and sourcing rules are highly nuanced
Use tax is generally measured by purchase price, but the correct measure may vary depending on prior tax paid, temporary storage rules, direct pay authority, exemptions, local sourcing rules, and whether self-consumed property is valued at material cost, manufactured cost, or fair market value. Because states differ on reciprocity, credits, depreciation, and the treatment of property moved between jurisdictions, companies need state-by-state analysis rather than broad assumptions when accruing use tax.

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