

Module 3.10: State Considerations

Most states tax at least some types of business income derived from the state. As a rule, the details of how income from a specific business is taxed depend in part on the business's legal form. In most states, corporations are subject to a corporate income tax, while income from pass-through entities such as S corporations, limited liability companies (LLCs), partnerships, and sole proprietorships is subject to a state's tax on personal income. Tax rates for both corporate income and personal income vary widely among states. Corporate rates, which most often are flat regardless of the amount of income, generally range from roughly 4% to 10% at the state level. Personal rates, which generally vary depending on the amount of income, can range from 0% (for small amounts of taxable income) to around 9% or more in some states.

Currently, six states – Nevada, Ohio, South Dakota, Texas, Washington, and Wyoming – do not have a corporate income tax. However, four of those states – Nevada, Ohio, Texas, and Washington – do have some form of gross receipts tax on corporations. Moreover, five of those states – Nevada, South Dakota, Texas, Washington, and Wyoming – as well as Alaska and Florida currently have no personal income tax. Individuals in New Hampshire and Tennessee are only taxed on interest and dividend income.

Apart from taxing business income through a corporate income tax or a personal income tax, many states impose a separate tax on at least some businesses, sometimes called a franchise tax or privilege tax. This is frequently justified as a tax simply for the privilege of doing business in the state. As with state taxes on business income, the specifics of a state's franchise tax often depend in part on the legal form of the business. Franchise taxes are generally either a flat fee or an amount based on a business's net worth.

But it is not just income taxes that you have to take into consideration. So, I wanted to take a few minutes to run through some of the most common state taxes that you may have to address:

Sales Tax

Small businesses are not responsible for paying sales tax directly on the merchandise or services sold in the course of operating their business. However, if the state in which you operate has a state sales tax, then these businesses are required to set up a system to collect the sales tax from their customers and then pass that tax along to the state. Complying with the obligation to pay sales tax can be tricky. There are often many taxing localities involved, each with the own tax rate and list of taxable products and services. In states that have city or county sales taxes, sometimes they are collected by the state and sometimes you have to file separate returns.

There are two ways you can handle sales tax in your accounting. If the business uses a flat-pricing model where sales tax is built into the cost of items and is thus reflected in total revenue, then the amount of sales tax paid to the state is totaled and deducted from total gross receipts on the tax return. If, however, a business calculates sales tax as a separate item and records sales tax separately from other revenue, then there is not a deduction on the income tax return because the tax is not included in the income reported.

In other states, there are some professions that do not have to collect sales tax. One of the most common is the construction industry. They are generally companies that manufacture or create products for sale and some service industries.

There are six main steps that a business owner needs to take to comply with sales tax obligations:

1. Determine whether sales tax must be collected in the state and local area (county/city) in which the business will operate.
2. Register with each taxing authority.
 - Businesses operating in more than one state many need to register in each state.
 - Once registered, the state taxing authority should be able to provide information on what products and services are taxable.
3. Determine the sales tax rate or rates that must be charged.
 - Thirty-eight states presently have local sales tax.
 - Within those states, there are many local taxing authorities as well.
 - Business owners need to do careful research to ensure compliance with their sales tax obligations.
4. Set up the processes to collect sales tax from customers.
 - There are a lot of digital solutions available to business owners to assist with this.
 - Careful research is needed to find a solution that assures compliance and can be easily updated since sales tax laws often change.
5. Develop business accounting practices that organize records in a way that illustrates that sales tax has been collected. It is recommended that businesses implement a quality assurance program to ensure these practices are followed.
6. Send report to each taxing authority as required, and pay the tax to each authority as required, to avoid financial and other penalties.

States with no sales tax:

They are Alaska, Delaware, Montana, New Hampshire, and Oregon. However, Alaska and Montana do allow localities to charge local sales tax with one exception. If they do business in states with a sales tax, then they must meet their sales tax obligation in those states.

How about online sales?

Business owners may be liable for sales tax on items sold online. Many states are now requiring collection of sales tax for specific types of sellers. It is imperative that business owners understand the tax laws of each state in which they will sell their products, as well as each state's requirements for online sales, which may require other fees and registrations.

One example of this is [amazon.com](https://www.amazon.com). When they first started, they did not collect sales tax on their online sales. But most states now have laws that say if you have a physical location in the state, then you have to pay sales tax on those items sold in that state. Since Amazon now has warehouses and offices in all 50 states, they have to collect sales tax in all states that charge it.

Property Tax

If a business owns real property (real estate), such as a building, it will pay property tax to the local taxing authority. This is usually the city or county where the property is located.

The tax is based on assessed value, as is personal-use real property, like your personal residence. When selling business property, there are special considerations for paying property taxes and these are handled differently in various geographic areas, so be sure to consult a tax professional for your area.

If a portion of the real property is rented to others, generally, it would not be considered income from the normal course of business. Instead it would be treated as rental income, and the portion of the expenses relating to that income would be deducted from the rental income. Rental income and expenses are recorded on Schedule E (Form 1040) for sole proprietors, Form 8825 for partnerships and S corporations. C corporations report rental income directly in the income section of Form 1120, *U.S. Corporation Tax Return*.

Personal Property Tax

Many states and/or localities also have personal property taxes for businesses. Personal property is defined as assets that are not real property like real estate. Like machinery or office equipment. These are typically assessed based on the value of the personal property. Localities have varying reporting requirements and auditors to periodically evaluate the accuracy of the reporting. Inaccuracies can result in fines and penalties. It is important for a new business owner to understand their obligations regarding personal property taxes in your area.

Excise Tax

Excise taxes are paid by businesses for certain types of use and consumption (fuels, for example) and other activities, such as transportation and communication. Business owners that sell a product or service that is subject to excise taxes are responsible for collecting and paying the excise taxes to the appropriate federal, state, and local taxing authorities.

Federal excise taxes are applied to products and services in one of two ways: as a fixed dollar amount or as a percentage of the cost of the product or service. The products and services that are generally subject to excise tax include:

- Alcohol, tobacco, and firearms.
- Products that are manufactured, produced, or imported, such as fuel.
- Services, like travel by airplane or cruise line and hotels.

At the federal level, businesses are required to register with the IRS using Form 637, *Application for Registration (For Certain Excise Tax Activities)*, before beginning certain excise tax activities. This may include the purchase, manufacture, or sale of products and services subject to excise tax. If approved, the IRS will send a Letter of Registration.

Excise tax on some other products and services must be paid quarterly to the IRS on April 30th, July 31st, October 31st and January 31st, by filing Form 720, Quarterly Federal Excise Tax Return. Filing late or failure to file and/or pay when the taxes are due will result in penalties. To find out if you are subject to federal excise taxes, go to [irs.gov](https://www.irs.gov) and search for Publication 510, *Excise Taxes*.

Gross Receipts Tax

Some states impose a gross receipts tax on businesses instead of a state income tax. In these states, the gross receipts of the business are taxed. Some states allow a deduction for this and certain businesses are exempt.

Legislation varies greatly from state to state. Some states impose gross receipts tax based on business type. A partnership may be treated differently than a S corporation for these types of taxes.

Gross receipts taxes are applied to a company's gross receipts, that is gross receipts without deductions for the business' expenses. States that currently levy gross receipts tax include Delaware, Ohio, Oregon, Nevada, Tennessee, Texas, and Washington.

Franchise Tax

Some states charge franchise taxes to businesses based on the value of the company. Franchise tax is sometimes called a “privilege tax,” as it gives the business the right to operate within a state.

Some entities may be exempt from franchise taxes in a state. Examples include fraternal organizations, nonprofits, and some limited liability corporations. Franchise taxes are typically paid in addition to federal and state income taxes.

Estimated Taxes

As we discussed throughout these modules, one of the first requirements business owners need to understand is payment of estimated taxes. Both the IRS and state departments of revenue require that business owners pay taxes as income is earned. As such, it may be necessary to make estimated tax payments each quarter. Estimated taxes allow business owners to send in enough in tax payments to cover both income tax and self-employment tax. This is the equivalent of withholding on wages of employees.

To avoid a federal penalty, it is necessary for business owners expecting to owe \$1,000 or more, after subtracting withholding and refundable credits, to make estimated payments. There are also special rules for farmers, fishers, certain household employers, and certain higher income taxpayers.

C corporations are generally required to make federal estimated tax payments, if they expect their tax to be \$500 or more.

Form 1040-ES, *Estimated Tax for Individuals*, which includes quarterly payment vouchers, is used by individual taxpayers to submit estimated tax payments. Most small businesses are pass-through entities, so estimated payments are part of the business owner’s personal tax return. For corporations, Form 1120-W, *Estimated Tax for Corporations*, is used to submit estimated tax payments. For state requirements, you will need to check out the rules at your State of Revenue’s website, which is listed in the Bonus section.

Wrapping Up

Other deductible employment-related expenses include other state employment-related taxes that vary considerably from state to state. While the last thing on a small business person mind in starting a business is tax responsibilities, they can actually affect whether your business survives. You have to figure these expenses into your cost of doing business, so you to get the pricing right to make a profit. Not only that, but late filing and late remittance of the tax can result in significant penalties, including potential closure of the business.