



Looking Out for Out-of-State Taxes: Key tax considerations when doing business outside your home state



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It's exciting to consider the possibilities of selling your products outside the state of Washington. An increased sales force beyond your state borders means greater exposure for your products and the opportunity for more sales.

As exciting as that sounds for your business, it's just as exciting for other states to have you selling to their residents and businesses. Because each sale – and the mere presence of one of your sales people within their borders – means the potential of added revenue to their state coffers in the form of numerous taxes. These include:

- Business activity taxes such as state income or franchise taxes
- Transaction or indirect taxes, such as sales and use taxes
- Taxes associated with deploying your labor force, such as payroll taxes and personal income tax withholding
- Property tax

To determine which of these taxes apply to your company, you'll have to determine which of three categories you fit into.

1. If you are a Washington-based company that is selling goods outside the state, but you don't have a deployed sales force:

Your business becomes subject to another state's taxes when you establish what's known in the state tax world as "nexus." Nexus standards vary on a tax measured by net income and a sales tax.

You won't have to pay state net income taxes if your only activity in another state is asking for orders and the orders are filled from an inventory outside the taxing state. However, companies often do more than just ask for orders. For example, the U.S. Supreme Court – in a

case involving Wrigley gum – determined that the gum salesman crossed the line of merely asking for orders and caused Wrigley’s to be subject to the Wisconsin income tax when he carried merchandise to replace stale product, handled credit application issues with customers, and restocked store displays. The court determined that was more than simply asking for orders. If your company steps over the line of simply asking for orders, you’ll be subject to state income tax. It’s important to understand where the line is and make a business decision on whether you want to cross it. This only applies to products (not services), and you have to ship the products from outside the state where they are being sold.

All services – including warranty, installation, consulting, and training services – are subject to income tax. This involves services that go beyond simply educating a customer about the attribute of a product – if a person is actually providing the service in person in the state, rather than over the phone from outside the state.

For sales taxes, companies with nexus in the state where their products are sold are responsible for collecting, reporting, and remitting taxes on taxable sales. States will hold the company responsible for taxes they don’t collect, so it’s important to understand individual state sales tax rules. If everything you sell is subject to sales tax, and you have sales tax nexus everywhere you sell your products, you’re going to have to collect sales tax and remit it to each state where your products are sold. To establish nexus for sales tax, you must have a physical presence in the state where you are selling products. Having a physical presence includes having employees or independent contractors, and can extend beyond the obvious.

For example, recent laws passed in New York, Rhode Island and North Carolina make internet retailers liable for collecting the states’ sales taxes if they have “associates” in the state. Associate programs are used by internet retailers as a form of advertising. Associates place a link to the retailer on their website, and every time a customer uses the link to access the retailer’s website and buys a product, the associate receives a fee. The law in these states creates a presumption that the associate is doing more than advertising for the retailer and imposes sales tax collection responsibility on the retailer. The legal standard for having a physical presence in a state includes not only employees in the taxing state but also using representatives who promote sales. This broad definition of physical presence may also include various forms of collaborative marketing agreements with marketing partners. The key is to understand these types of arrangements up front so you don’t face a large tax liability later on.

How do you know if the goods that you are selling are subject to tax? You’ll have to consult each state’s laws to determine what is taxable and whether any exemptions are available. However, in general, manufacturers often sell to distributors who resell their product. A sale for resale is not subject to sales tax, meaning sales to distributors for resale are not subject to sales tax. Sales to end users are generally taxable.

All states presume that sales of personal property and taxable services are subject to sales tax unless the seller can prove the sale is exempt. To meet this burden of proof, the seller will often need exemption documentation, which in the case of a sale to a distributor, is a resale

certificate signed by the distributor verifying the product is not being sold directly to the end user.

Exemptions can apply to the type of product sold, such as food in many states. An exemption may also extend to sales to a type of entity, such as certain non-profit organizations. A third type of exemption is based on how something is used. For example, machinery and equipment used in manufacturing operations is frequently exempt. Proper documentation is required to prove the exempt nature of these sales.

2. If you are a Washington-based company with employees in another state:

Employing people in other states raises state tax issues for the company and its employees. Like the state of Washington, other states impose taxes on employers related to the employment relationship. A company with employees based outside Washington should expect to pay state unemployment and workers compensation insurance premiums to the states where the employees are assigned. If the state where the employee is located imposes a personal income tax, then the company will also be required to withhold income tax from the employee's wages.

Washington companies that have employees who live in one state, but travel on business to other states may have a duty to withhold the other states' personal income tax from the employees' wages and remit the tax to the destination state. Income earned by employees while working in a state that imposes a personal income tax is usually taxable and the employer is required to withhold and remit the tax. The employees are then required to file nonresident income tax returns in the states where they travel to perform work. This is an issue even if employees are only in the state for a few days a year. Companies with employees that travel on business are advised to seek tax advice to determine how best to deal with balancing the burden of technical compliance with the potential exposure to tax, penalties and interest for failing to comply.

3. If you are a Washington-based company that is selling product through offices in several states – how do you determine how much tax you owe in each jurisdiction where you're doing business?

This question involves taxes that are imposed on the level of business activity conducted in a state, such as net income taxes. Dividing net income, or another applicable tax base, among the states where business is done is called "apportionment." Apportionment is a concept that attempts to measure the economic presence of a business within the taxing state. Most states use a formula that averages three factors – property, payroll and sales. When looking at sales of widgets, it's easy to determine. But when looking at sales of financial services, telecommunications or digital technology services, it gets complicated. Manufacturers would look at where the company has people (payroll), property, and sales, and determine what percent of each of those is based in each state. The average of these factors is used to determine how much of the company's net income should be taxed. Sales receipts are based on where the customer takes delivery of the goods. Property is based on its physical location and payroll is assigned to the state where the employees normally work. In general, since states

prefer to tax out-of-state businesses more heavily than in-state businesses, they often weight the sales factor more heavily than the others.

Also, note that Washington manufacturers pay manufacturing Business and Occupation tax on the value of the products they manufacture in Washington, regardless of where the products are sold. If products are sold in Washington State, companies must also compute a selling tax, but will get a credit for it. No credit is allowed against the B&O tax for income taxes paid to other states on income earned from the sale of products manufactured in Washington.

Doing business out of state can be exciting and prosperous. And the states think that too. That's why it's imperative that companies doing business out of state know all the taxes that apply to them. Also, manufacturers considering expanding into another state can seek tax incentives from those states that are anxious to attract new businesses and family-wage jobs. It's important to understand what kinds of discretionary and statutory incentives are available and take appropriate steps to secure them. It is often advisable to seek professional assistance when negotiating with state or local governments for discretionary incentives.

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