

## **Business & Occupation Tax Reform, Part III**

*Part III in the B&O Tax Policy Note Series*

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### **Introduction**

Taxes play an integral part in commerce—businesses and consumers take into account the cost of taxation along with the other costs of any business or commercial transaction when determining their action. But taxes, and the way they are collected, also play a huge role when business owners decide where and how to set up a business.

In Washington state, there are three main taxes levied upon businesses:

- The retail sales tax is levied on every transaction where a tangible piece of property or service is sold to consumers or businesses.
- Property taxes are levied every year against property assets owned by both personal land owners or owners of a business.
- The Business and Occupation Tax (B&O)—an annual gross receipts tax that businesses pay during the daily activities, or transactions, of running a business.

Washington's B&O tax is the second largest tax source for the state. In fiscal year 2007, B&O tax collections totaled \$2.679 billion, which represented approximately 13 percent of state revenue sources within the general fund.<sup>1</sup> Almost all firms doing business in the state of Washington are subject to the state B&O tax, including corporations, partnerships, sole proprietors, and nonprofit organizations.

Part I of this series laid out general principles of a responsible business taxation system and found that the B&O tax system lacked several of the more important principles. Part II of the series focused on two specific problems inherent in the B&O tax system 1) pyramiding—the effect of multiple transactions to produce a single product increases the tax liability and 2) a lack of transparency—it is very difficult, if not impossible for consumers to find out how much the final price of the product is increased by the B&O tax.

Since gross receipt taxes were largely phased out in other states over the past 75 years, Washington policymakers have failed to produce a silver bullet reform that would alleviate much of the aggravation caused by the B&O tax. In fact, there is really no getting around the challenge of pyramiding or transparency. They are

<sup>1</sup> Tax Statistics 2007, Washington State Department of Revenue, January 2008, page 9, [http://dor.wa.gov/docs/reports/2007/tax\\_statistics\\_2007/tax\\_statistics\\_2007.pdf](http://dor.wa.gov/docs/reports/2007/tax_statistics_2007/tax_statistics_2007.pdf)

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inherent and systemic problems.

Indeed, as the author of “Gross Receipts Tax in State Government Finances: A Review of Their History and Performance” says,

“No sensible case can be made for imposing gross receipts taxes in the modern economic environment. The old turnover taxes, typically adopted as desperation measures in fiscal crisis, were replaced with taxes that created fewer economic problems. Gross receipts taxes should never be seen as an element of positive tax reform. They were abandoned for a good reason.”<sup>2</sup>

Washington policymakers should take this historical context into account in further discussions of our tax code. The bottom line is that Washington state government is relying upon revenue generated by an archaic system that was discarded by most other states within a few decades of its installment.

However, there do exist several proposals that may lessen the detrimental impact of the B&O tax upon smaller, newer or unprofitable businesses. This final part in the series will examine several of those proposals, gauge their merit and recommend further steps for action.

Whatever the course that policymakers pursue, they should ensure that any good tax idea is also a good business idea.

## **Examples of Gross Receipts Tax Reform in Other States**

### Texas

Texas is one of seven states, including Washington, which does not impose an income tax. The Texas state sales tax (6.25%) is comparable to Washington’s (6.5%).

Details of how Texas imposes its limited gross receipts tax (GRT):

- Requires businesses to pay a gross margins tax of 1 percent,
- Businesses can deduct the cost of goods purchased, or the cost of employee payroll and benefits,
- Retailers and wholesalers pay 0.5 percent. Sole proprietorships and general partnerships are exempt,
- Companies with less than \$300,000 total revenue a year are exempt.
- Companies with a tax liability of less than \$1,000 per year pay no tax.
- Discounts are available to reduce a small business’ tax liability, regardless of industry. These discounts benefit firms grossing up to \$900,000.

The Texas tax is not exactly an apples-to-apples comparison with Washington’s B&O tax. Texas’ margin tax stems from a statewide franchise tax and acts more like a Value-Added-Tax (VAT). A VAT is a system that taxes each stage of production, taking the increase in value of the output as compared to the value of the input. Washington’s B&O pyramiding taxes each stage of production based on the entire value of the product, not just the value added to each stage.

However, it is important to note that Texas’ approach to taxing margins includes

<sup>2</sup> John L. Mikesall, “Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance,” Tax Foundation and Council on State Taxation, January 2007.

only two tax rates and has a large exemption threshold—\$300,000—when compared to Washington’s \$28,000 tax reporting threshold.

**Pros and Cons:** The merits of Texas’ gross margin tax follow very closely to Washington’s own B&O tax. Specifically, on the pro side, it is fair because of its near-universal applicability (only two rates) and its simplicity.

The gross margin tax also takes into account a business’ expenses during production of a product, including employee compensation (up to \$300,000 per employee). This provides an incentive for businesses to hire and expand operations. Currently, Washington’s B&O tax does not allow businesses to deduct the cost of doing business – such as payments for raw materials or wages paid to employees.

From a Texas business’ standpoint, the new gross margin tax could lead to higher business costs because of increased compliance costs due to the fact it is a new system. Washington-based businesses are already dealing with a gross tax system, so implementation of a few of the Texas-style reforms could marginalize increased compliance costs.

The Texas gross margin tax also suffers from a lack of transparency for the consumer, as the end product will reflect the added cost of the taxation system, but consumers will not see that breakdown.

Recent studies highlight the problem of savings realized through property tax rate reductions being dwarfed by the rising cost of the gross margin tax.<sup>3</sup>

### New Mexico

Similar to Washington, New Mexico instituted a gross receipts tax during the Great Depression, in large part because property tax revenues dried up. The gross receipts tax is described: “the gross receipts tax is imposed on the ‘seller’ on their gross receipts for the privilege of doing business in NM, even if the seller doesn’t pass the tax on to the buyer.”<sup>4</sup>

Similarly to Washington, New Mexico’s GRT taxable amount is determined by the gross amount – not net after business expenses. The gross amount also includes all reimbursed expenses billed to the customer such as meals, travel, hotels, shipping, handling, postage, etc.<sup>5</sup>

Unlike Washington state, however, New Mexico’s businesses can deduct the cost of business-to-business raw material transactions that go into the production of goods before applying the tax. The service industry does not get similar relief.

In 2005, then-Governor Bill Richardson pushed for, and the New Mexico legislature passed, a 15% deduction on a business’ gross receipts taxes on business-to-business transactions. The measure is estimated to save businesses approximately \$4.5 million per year.<sup>6</sup>

**Pros and Cons:** This 15% proposal from New Mexico is a fairly small reform,

<sup>3</sup> “Texas Business Tax Coalition seeks legislative relief on small business taxes,” *San Antonio Business Journal*, May 19, 2008.

<sup>4</sup> “Historical Overview of the New Mexico Tax System,” Fred O’Cheskey, <http://www.nmtri.org/associations/3740/files/Overview%20of%20New%20Mexico’s%20Tax%20System%20-%20Fred%20O’Cheskey%20-%20May%202003.pdf>

<sup>5</sup> Paul J. Gressing and Harry Messenheimer, PhD, “New Mexico’s Harmful Gross Receipts Tax: A Warning to Other States,” Rio Grande Foundation Policy Brief, January 29, 2007, pgs1-2.

<sup>6</sup> House Bill 582, 47<sup>th</sup> Legislature, State of New Mexico, First Session, 2005.

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but one of the positive ideas behind the legislation is that of broad-based tax relief. New Mexico lawmakers recognized the competitiveness problems that excessive tax pyramiding caused to their state's business community and took steps to alleviate some of the problem. One supporter of the proposal said that "pyramiding hurts small businesses because they often have to buy professional services, such as legal or accounting assistance, that larger companies get from their in-house staffs."<sup>7</sup>

## Proposed Gross Tax Receipt Reform in Washington State

### New business B&O exemption plus sliding scale

House Bill 1516, introduced in 2007, would provide a new business an exemption from paying business and occupation taxes during its first 12 months of operation.

It would also provide a new small business with fewer than 25 permanent, full-time employees an exemption from paying the B&O taxes during its first 24 months of operations and a reduced B&O tax liability for an additional three years – a sort of sliding scale for tax liability.

Year	Percent Exempt
1	100%
2	100%
3	75%
4	50%
5	25%
6+	0%

According to the fiscal note prepared for this legislation, HB 1516 would reduce state tax revenue by about \$1.8 million during the first fiscal year of implementation and approximately \$11.3 million the first biennium.<sup>8</sup> The cost to the state would reach approximately \$36 million the next biennium as more businesses take advantage of the tax exemption. However, the idea is that the cost to the state will eventually lessen as more business startups eventually start generating more revenue.

**Pros and Cons:** According to the state's Employment Security Department, there are 165,838 registered businesses employing at least 1 employee and fewer than 20 employees. These businesses employ over 715,000 people. HB 1516 would apply to more than 165,000 businesses.<sup>9</sup>

This idea has the potential to save businesses hundreds of dollars per year. For the initial 12 months, a new business (large or small) would save on average \$420 or more per year.<sup>10</sup>

Often times policymakers are hesitant to allow a benefit for a particular group or business based solely upon number of employees. One concern is that a policy

<sup>7</sup> "Richardson re-starts plan to dismantle the tax pyramid," *New Mexico Business Weekly*, Dennis Domrzalski, January 28, 2005.

<sup>8</sup> See Department of Revenue Fiscal Note for HB 1516, <https://fortress.wa.gov/ofm/fnspublic/legsearch.asp?BillNumber=1516&SessionNumber=60>

<sup>9</sup> ESD breaks the number of firms by employees into sections of 0 employees, 1-4, 5-9, 10-19, 20-49, 50-99, 100-249, 250-499, 500-999, and above 1,000. There is no information available that states how many businesses with 25 or fewer employees could be affected.

<sup>10</sup> Calculation based on fiscal note for HB 1516 (09-11 biennium) and DOR estimates of new businesses per year (85,000): <http://dor.wa.gov/docs/reports/businesssurvivalreportoct2007.pdf>, p. 8.

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like this could potentially create a disincentive to businesses that want to expand to more than 25 employees. The B&O tax liability could be large enough to affect the behavior of a business that is on the fence about expanding. There could potentially be cases in which businesses take on extra work or clients but keep employees at 25 or less to minimize its tax liability.

Another concern is that a business might engage in the practice of restructuring itself in order to game the system for tax breaks. However, it is common practice to write provisions into tax codes to prevent that sort of action.

### Threshold Increase

For several years Washington Policy Center has endorsed the idea of increasing the threshold at which B&O liability begins to accrue.<sup>11</sup> Currently, the Business and Occupation Tax liability kicks in once a business brings in more than \$28,000 of gross receipts. There are hundreds of exemptions, deductions and credits that, when applied, can raise the threshold. However, the \$28,000 threshold remains for a business that enjoys none of these legislative relief measures.

Currently, the small business B&O tax credit benefits small businesses earning up to approximately \$176,000 per year. Even though there is a \$28,000 gross receipts threshold for reporting taxes, small businesses do not incur any state B&O tax liability until it grosses over about \$87,000 per year (about \$7,231 per month), assuming the commonly-used 0.484% tax rate.<sup>12</sup>

The state Department of Revenue says that in 2006, about 168,000 firms benefitted from the small business tax credit. About 96,000 firms paid no B&O tax, and an additional 72,000 firms had their tax liability reduced because of the credit.<sup>13</sup>

According to the Department of Revenue, raising the threshold to \$250,000, for example, would exempt approximately 211,000 firms. The relief to businesses would be about \$110 million per year. This would represent less than 4% of B&O collections from calendar year 2007.

**Business & Occupation Taxes:  
Tax due for firms with less than \$250,000 in Gross Revenue, less than  
\$500,000 in Gross, Less than \$750,000 in Gross, and for All Firms  
Figures Based on Calendar Year 2007 Data**  
source: Washington State Department of Revenue

Size of firm based on gross revenue	# of firms	Total taxdue
Less than \$250,000	211,330	\$110,428,078
Less than \$500,000	242,727	\$194,047,139
Less than \$750,000	257,708	\$260,927,354
All Firms	307,583	\$2,953,453

This idea is similar to HB, 1171, which would exempt small businesses from paying the B&O tax if the business' gross receipts are under \$200,000. The Department of Revenue estimated that the cost of exempting the first \$200,000 of

<sup>11</sup> See "New B&O Tax Reform Proposal Would Help Washington's Small Business," by Eric Montague, Washington Policy Center, October 2004.

<sup>12</sup> The Washington State Department of Revenue classifies a small business as a business entity with fewer than 50 employees and less than \$3 million in gross receipts.

<sup>13</sup> "Tax Reference Manual – 2007" Washington State Department of Revenue.

all business gross receipts from the B&O tax would be about \$23.3 million the first fiscal year and just over \$50 million for the first biennium.<sup>14</sup>

**Pros and Cons:** Increasing the amount of gross receipts at which businesses become liable for B&O taxes would decrease a business' tax liability. If lawmakers wanted small businesses (fewer than 50 employees, less than \$3 million in revenue) to continue to receive an extra credit, the current credit limits would have to be increased as well to coincide with the higher threshold.

However, there will be resistance to this, or any tax relief plan in 2009 that might increase the state's projected \$3.2 billion budget shortfall.

## Conclusion

As shown by this three-part Policy Note series, Washington's Business and Occupation tax is far from perfect. There are several reforms that policymakers should consider in order to alleviate the negative effects the B&O tax has on small, unprofitable and new businesses. A tax system that dampens entrepreneurial endeavors should be scrutinized.

Unfortunately, many states and municipalities across the nation are beginning to take a look at implementing some sort of gross receipts tax in order to make up for budget shortfalls. This type of behavior is expected during rough times for the economy. But most research shows that there is no way to adequately impose a gross receipts tax on businesses without doing extensive economic damage.

The lack of transparency and inability to effectively remove the damaging pyramiding effect should be enough to start a discussion of solutions among policymakers. For the most part, this is not happening.

Two suggested changes to the B&O tax that would help small and new businesses:

- Increasing the B&O threshold to \$250,000 would help over 200,000 businesses in Washington providing approximately \$110 million (0.003% of the state 07-09 budget) in tax relief.
- Reducing both the number of rates and the rate itself in order to move towards a more neutral and fair tax program.
- Explore options towards letting businesses deduct the cost of business-to-business transactions for the production of a product

Other, broader options include examining replacement of the B&O system altogether and replacing the revenue stream with consumption taxes or sales taxes--taxes that target consumption instead of production.

Policymakers should consider the characteristics of a responsible business taxation system as a tool when deciding how to properly tax people or businesses. Evidence from real world situations, as well as the data from those examples, is also a tool to help make the correct decisions.

The gross receipts tax may have some limited advantages, but as research clearly shows, the negative effects vastly outweigh those advantages. Washington state implemented the gross receipts tax during the Great Depression as a temporary measure. It should have stayed that way and never survived into today's economy.

<sup>14</sup> See Department of Revenue Fiscal Note for HB 1171, <https://fortress.wa.gov/ofm/fnspublic/legsearch.asp?BillNumber=1171&SessionNumber=60>

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