Replacing the B&O with a Single Business Tax

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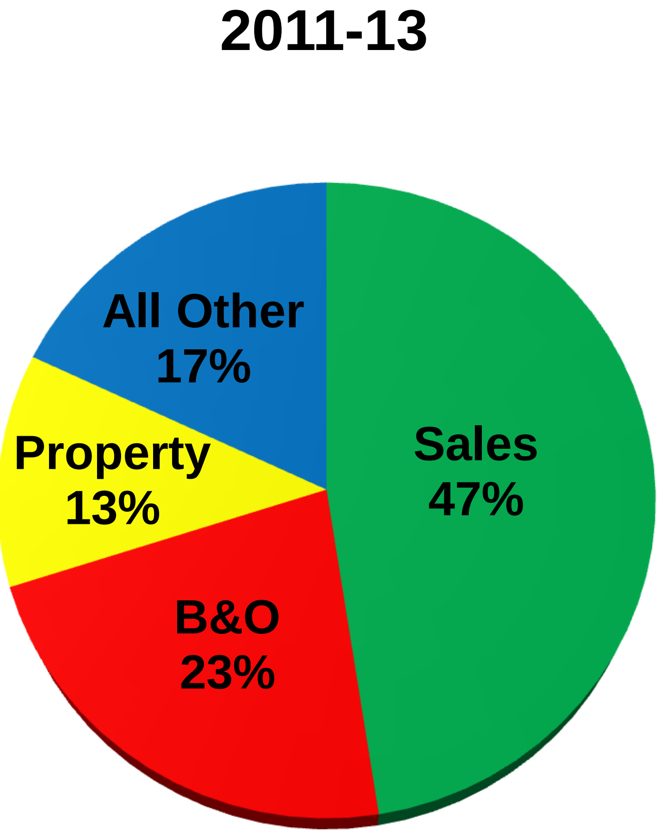
What is the B&O Tax?

Washington’s Department of Revenue defines the B&O tax as a tax on “gross receipts of all business operating in Washington, for the privilege of engaging in business. The term gross receipts means gross income, gross sales, or the value of products, whichever is applicable.”

Today’s B&O tax stems from the Business Activities Tax enacted in 1933, which was the state’s first gross receipts tax on businesses. Lawmakers imposed the tax as a temporary, emergency measure to raise revenue for the government during the Great Depression. After an unsuccessful court challenge, the Supreme Court upheld the tax later that year.

Major State Tax Sources



What is the B&O Tax?

As a levy on gross receipts, the B&O tax does not allow business owners to deduct the cost of doing business, such as payments for materials, rents, equipment or wages, when calculating the amount of tax they must pay. However, over the years the legislature has passed numerous special deductions, credits and exemptions as a benefit to some industries. At the same time, lawmakers have increased B&O tax rates over time, so that revenue going to the state treasury would not decline as some industries received favored treatment.

Problem of Pyramiding

One of the problems with the B&O tax is the extra layer of taxation it applies to all products and services at each stage of production – an effect called “pyramiding.” Pyramiding means the tax is structured so that it is applied more than once to the same product or service.

The effect of the pyramiding in different industries means some businesses are forced to pay the B&O tax a disproportionate number of times. Through the years the legislature and the Department of Revenue have created numerous exemptions, deductions and credits to mitigate the negative impact that some industries face because of high rates of pyramiding.

Example of Pyramiding

A logging company sells its cut trees to a mill and pays the state a B&O tax of 0.484% on the gross sale price to the mill

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The mill owner sells the finished lumber to a distributor and pays the state a B&O tax of 0.484% on the full gross sale price to the distributor, unreduced by the price the mill owner paid to the logging company

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The distributor sells the lumber to a contractor and pays the state a B&O tax of 0.484% on the full gross sale price to the contractor, unreduced by the price the distributor paid to the mill, or the price mill owner paid to the logging company

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Finally, a contractor uses the finished lumber to build a house, and pays the state a B&O tax of 0.471% on the price the house is sold to the end consumer, unreduced by the price the contractor paid to the distributor, or the price the distributor paid to the mill owner, or the price the mill owner paid to the logging company for the original cut tree

Reform Options

There is wide consensus in Washington that the B&O tax is badly in need of thorough reform. There is equally wide disagreement, however, over exactly what should replace the current tax structure.

Proposed reformed tax systems are often based on the goal of securing a specific amount of money, generally stated as, “in order to raise $X amount of tax dollars the legislature needs to enact this particular proposal.” However, a just and efficient tax system should be based upon fundamental principles that emphasize the protection of taxpayers and the efficiency of government services.

Principles of Taxation

In replacing the B&O tax, it makes sense to start at the beginning – to focus on sound building blocks on which to base recommendations for improvement. Replacement of the B&O tax should incorporate these principles:

- Simplicity
- Accountability
- Economic Neutrality
- Equity and Fairness
- Complementary
- Competitiveness
- Reliability

Single Business Tax

- Revenue neutral
- Treat all business owners equally by using one flat rate
- Eliminate tax preferences
- Simplify administration of the tax to reduce compliance costs for business

Single Business Tax

The initial Single Business Tax rate would be set by the legislature and would comply with the constitutional requirement that taxes be applied uniformly to all business owners. In other words, adoption of a Single Business Tax would assure that everyone pays the same rate. The legislature would set the tax rate at a level that would be revenue neutral; the state would continue to collect the same amount of money under a Single Business Tax as it does under the current B&O tax.

Local officials (excluding counties) could impose a separate tax on businesses located within their city borders, but the same uniformity requirement would apply. Any local business tax would have to be based on a single rate applied equally to all business owners. For simplicity, all business taxes, state and local, would be collected by the state and the local portion would be distributed each year to city treasuries.

Constitutional Reform

The following provisions would be part of a constitutional amendment needed to create a Single Business Tax in Washington:

- A Single Business Tax (also called a gross receipts margins tax) would be created as the only tax the state and cities (but not counties) could levy on employers.
- All existing state and city taxes on employers would be repealed, except for the new Single Business Tax.
- Counties, which currently do not impose business taxes, would continue to be prohibited from doing so.
- The change would only affect the business tax. There would be no change in state and local sales taxes and property taxes currently paid by businesses.

Taxable Margin

The Single Business Tax would be computed by subtracting from an employer’s total gross annual receipts the cost of either production or total compensation to determine the amount of money against which the tax rate is applied. The taxable base could not be more than 60% of total gross receipts.

A uniform tax discount would be provided to reduce the impact of the Single Business Tax on small businesses with low profitability.

Credits and exemptions that give special tax breaks to some industries would be eliminated. The exact legal definitions of production costs and of compensation cost would be defined by the legislature.

Determining Tax Base

The business owner would be given a choice of three ways to calculate their taxable margins, and would be allowed to choose the one that results in the lowest tax burden. Calculating the taxable margins could be based on either the business':

1. Total gross receipts minus labor costs
2. Total gross receipts minus all production costs except labor
3. 60% of total gross receipts

Then the business owner would multiply the taxable margin by the Single Business Tax rate for each taxing jurisdiction. The final amount owed for each taxing jurisdiction would be sent to the state in one payment and then distributed by the state to local governments.

Uniform Tax Discount

- Less than $1,000 – no taxes paid
- $1,000 to $299,999 – pay 10 percent of tax due
- $300,000 to $399,999 – pay 20 percent of tax due
- $400,000 to $499,999 – pay 40 percent of tax due
- $500,000 to $699,999 – pay 60 percent of tax due
- $700,000 to $899,999 – pay 80 percent of tax due
- $900,000 to $999,999 – pay 90 percent of tax due

Firms making more than one million dollars would pay 100% of tax due. This schedule would be indexed to inflation, so the discount would maintain a consistent economic value over time.

Definitions

Lawmakers would enact precise definitions for the legal meanings of the terms "cost of production," "cost of compensation," and to set the "uniform tax discount." For discussion purposes, here are potential definitions:

- Cost of production means "the cost of materials, equipment and other overhead items devoted to the production of a good or service."

- Cost of compensation means "W-2 wages and cash compensation paid to officers, directors, owners, partners and employees; the cost of benefits provided to all personnel to the extent they are deductible for federal income tax purposes, including workers' compensation, health care and retirement benefits."

- Uniform tax discount means after computing the taxable amount all business entities would be entitled each year to a sliding discount schedule.

Tax Foundation Comments

"A gross-receipts business tax is one of the worst possible tax sources state or local government could utilize. This is why the Tax Foundation continues to aggressively warn policymakers not to create a gross-receipts business tax when considering tax reform proposals. Since Washington's gross-receipts Business and Occupation (B&O) tax has been on the books since the 1930's, the question is what should the state do next?"

Tax Foundation Comments

“There are several revenue-neutral options:

1. Repeal and replace with an increased sales tax rate with broader base (include services). Even with broadening the current sales tax base this would likely result in a state sales tax rate in excess of 10%.

2. Repeal and replace with a corporate/personal income tax. While a gross-receipts tax is one of the worst possible tax sources, creating a corporate/personal income tax would be just as economically damaging and remove one of Washington’s most prominent competitive advantages.

3. Replace with a Single Business Tax or gross-receipts margins tax as proposed by the Washington Policy Center (WPC). While still a gross-receipts tax, the WPC Single Business Tax is a better alternative to not making any changes to the current B&O tax or replacing it with a corporate/personal income tax.”

Tax Foundation Comments

“What about the problems with the Texas Margins Tax?

Though modeled on the much maligned Texas Margins Tax, the Single Business Tax as proposed by the Washington Policy Center addresses several of the problems that have faced Texas.”

Tax Foundation Comments

“Among the criticisms of the Texas Margins Tax:

- Different industries face different rates. The WPC Single Business Tax addresses this by relying on one rate for all industries.

- Tax base was broadened to cover new businesses that weren’t previously subject to Texas Franchise Tax. Because all businesses are already subject to the Washington B&O tax the WPC Single Business Tax won’t add new business to the base. In fact, the uniform sliding discount scale proposed will instead reduce the tax liability of unprofitable small businesses rather than increase their tax burden.”

Tax Foundation Comments

Criticisms of the Texas Margins Tax continued:

- “Encourages businesses to seek tax preferences to receive favorable treatment. The WPC Single Business Tax explicitly prohibits this type of favorable tax treatment by constitutionally preventing new tax preferences while repealing existing tax preferences.
- Confusing definitions of ‘production’ and ‘payroll’ deductions. Since the WPC Single Business Tax leaves this definition up to the Legislature the same concerns are prevalent. Care should be taken to closely align with federal tax reporting definitions.”

Tax Foundation Comments

"While the Tax Foundation encourages state and local governments to avoid gross-receipts taxes, the WPC Single Business Tax is preferable to the existing B&O tax or replacing it with a corporate/personal income tax. The ultimate goal, however, should be full repeal of the B&O. Short of that the WPC Single Business Tax is worth exploring."

Next Steps

There is a need for both long-term and short-term fixes to our state's B&O tax. The short-term options will help reduce the compliance costs and complexity of paying the tax. The long-term recommendation, adopt a Single Business Tax, is designed to bring policymakers together to examine the need for a solid framework governing a better tax system and then the framework itself.

A solid set of tax principles must guide the adoption of any effective tax structure, otherwise our state would again end up with a system riddled with tax preferences.

There is no silver bullet to solving the problems inherent in the gross receipts tax. However, through embracing solid tax principles and meaningful reform – both in the short and long-terms – we can help encourage future economic growth.

Questions?

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