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Policy Note

Washington Policy Center's Proposal to Replace the Business and Occupation Tax

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Washington Policy Center has developed a proposal to improve the business climate and expand economic opportunities for all Washingtonians by replacing the Business and Occupation (B&O) tax with a simple, fair and uniform business tax. The benefits of the proposal are that it is:

- Revenue neutral
- Treats all business owners equally by moving from multiple rates to one flat tax rate
- Eliminates loopholes and special treatment
- Simplifies administration of state and local business taxes to improve the business climate

Components of Constitutional Reform

WPC proposes replacing the current gross receipts tax paid on each business activity with a gross receipts margins tax based on total receipts. This would be a variation of the Texas Franchise Tax.[1] The following provisions would be part of a constitutional amendment creating the tax:

- A single Business Tax (gross receipts margins tax) would be created as the only tax the state and cities (but not counties) can levy on employers.
- All existing state and city taxes on employers would be eliminated except for the new single Business Tax – Counties, which currently do not impose business taxes, would continue to be prohibited from doing so. Employers would continue to pay the same state and local sales and property taxes they pay now.
- The new business tax would be computed by subtracting from an employer's total gross receipts the cost of either production or compensation to determine the amount of money against which to levy the tax rate. The taxable amount could not be more than 60% of total receipts. A uniform tax discount may be provided and defined by statute. Special credits and exemptions that give breaks to favored industries would be prohibited. Production and compensation deduction would be defined by statute. The business tax rate would be defined by statute but is

[1] "Texas Franchise Tax," Texas Comptroller of Public Accounts, at www.window.state.tx.us/taxinfo/franchise/

constitutionally required to be uniform for all business owners (everyone pays the same rate).

- Cities could charge a separate business tax rate, but the same requirements as above would apply. The tax would be administered by the state; the city portion would be distributed by the state to the cities.

While the above provisions would be defined in the Constitution, the enacting statute would need to focus on setting the initial single Business Tax rate (which would need to be revenue neutral), defining the uniform "cost of production" and "compensation" deductions as well as the "uniform tax discount."

For discussion purposes, here are some proposed definitions:

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

- Compensation deduction: "Compensation includes W-2 wages and cash compensation paid to officers, directors, owners, partners and employees; benefits provided to all personnel to the extent deductible for federal income tax purposes, including workers' compensation, health care and retirement benefits."

- Uniform tax discount: After computing the taxable amount all business entities would be entitled each year to the following sliding discount schedule (indexed to inflation):
  - » 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

This proposal would result in radical simplification of current business taxes by eliminating the confusing multiple rates on business activities and repealing and prohibiting special interest credits and exemptions for favored industries. The new, simpler tax system would need to be phased in over three or four years to allow employers and taxing jurisdictions time to adjust.

Example of Calculating Proposed WPC Business Tax

To determine an employer's tax liability the first step would be to determine the employer's taxable margin. This could be done one of three ways:

1. Total gross receipts minus uniform "cost of production" deduction;
2. Total gross receipts minus uniform "compensation" deduction; or
3. 60% of total gross receipts.

The law would allow the business owner to choose the method that results in the lowest tax burden.

The next step would be to apply whatever apportionment factor is ultimately defined in the enacting statute.

The taxable amount would then be determined by multiplying the apportionment factor by the margin from the first step.

The tax due would be determined by multiplying the single Business Tax rate by the taxable margin, and then applying the "uniform tax discount."

Visit http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf for an example of the tax calculator used in Texas.

Tax Foundation Analysis

Washington's B&O tax is nationally recognized as one of the worst ways to tax businesses. Among the B&O's national critics are the tax experts at the D.C.-based non-partisan Tax Foundation. Founded in 1937, the Tax Foundation "has been a national leader in promoting a sense of 'tax consciousness' in the public. Its distribution of information has helped provide policy makers with the lay of the land in the ongoing debate over tax and budget policies, as well as with a greater understanding of the policies proposed."[2]

Due to its national reputation and critiques of Washington's B&O tax, WPC asked the Tax Foundation for its analysis of moving the state towards a Texas styled margins tax.

Economist Kail Padgitt provided this analysis on behalf of the Tax Foundation:[3]

> "The current Washington B&O tax is a deeply flawed and damaging system. The problems with such gross receipts taxes have been well documented.[4] Washington has to face the issue of how best to mitigate these distortions. There are two main directions that reform effort can take when dealing with the gross receipts tax (GRT). The first is to work towards repeal and replacement with an alternative tax. The second is to reform the structure and procedures of the GRT.
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> Both methods have positives and negatives. A repeal effort will be costly and have a lower probability of success. If it is successful, however, it will remove a major drain on the tax system.
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> A partial reform will not completely remove all of the distortions from the GRT. It does, however, stand a better chance of adoption. A secondary consideration is the affect this partial reform will have on future reform efforts. Will this be a catalyst for future reform or a hindrance? These questions are difficult to answer.
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> On the specific issue of reforming the current B&O tax, the main alternative is the Texas Margins Tax. The margins tax has both benefits and drawbacks over the B&O tax. The margins tax differs in a few ways. The most significant is that there are only two rates implemented, wholesaler rate and other businesses. Each business is then able to deduct either compensation costs or productions costs, whichever yields the greater deduction. Alternatively, it allows a deduction on 30 percent of revenue.
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> This two rate system is much simpler than the multi-rate system under the B&O tax. These multi-rate systems are designed to reduce the amount of tax pyramiding that GRT creates. The problem is that it requires a legislature to determine these different rates. This creates the potential for special interest groups to lobby for lower rates. A Texas style margin taxes

[2] "About the Tax Foundation," at www.taxfoundation.org/about/
[3] "RE: WA B&O Reform," email from Kail Padgitt, Economist, Tax Foundation, October 13, 2009
[4] "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," by John L. Mikesell, Indiana University, Tax Foundation, January 2007 at www.taxfoundation.org/files/bp53.pdf

reduces the ability for special interests to lobby for lower rates. It does not, however, eliminate the ability for a special interests group to lobby because there is still the ability to seek exemptions.

A Texas Franchise Tax also increases the compliance costs for business. Businesses are forced to calculate their tax liability in three ways. These additional compliance costs need to be factored in.

My summary opinion is that the Texas Margin tax is on the whole a better version of the gross receipts tax than the B&O tax. However, the margins tax is a gross receipts tax that comes with many distortions.

As to the specifics, the (WPC) proposal is in good order."

The WPC Business Tax proposal addresses the concern about special interests groups lobbying for exemptions by constitutionally prohibiting targeted exemptions. Only the uniform "cost of production" or "compensation" deduction can be applied to determine a business' taxable amount, meaning all employers receive the same deduction. Coupled with the repeal of the existing B&O credits and exemptions, if elected officials determine to move forward a new business tax as proposed by WPC, extensive stakeholder input will be necessary to help define the uniform statutory deductions to help mitigate any competitiveness issues created by moving to a single business tax rate.

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