Business & Occupation Tax Reform, Part II

The pyramid problem: Washington's B&O tax results in the second-highest corporate tax rate in the nation

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Key Findings

• Washington's Business and Occupation tax results in pyramiding— a process that taxes the production of a product multiple times before it reaches the consumer, thereby raising the retail price.

• The B&O tax, when converted into the more commonly-used corporate income tax, ranks second-highest in the nation at 13%.

• The B&O Tax is an inherently non-transparent tax. Consumers rarely see the amount of B&O tax they pay on a product.

• Businesses are incentivized to bring in out-of-state material during production to cut costs.

• Larger businesses with more resources are able to vertically integrate operations to cut costs but smaller firms are not able to take similar measures.

Introduction

In order for a state to attract new businesses or encourage current businesses within the state to expand, lawmakers must offer a competitive tax system – one that incorporates many of the responsible principles such as transparency, simplicity, neutrality and more, as laid out in Part I of this series.[1]

Even though state governments have historically raised revenue from the business community by taxing corporate profits, Washington state primarily collects tax revenue from businesses through a gross receipts tax – the Business and Occupation (B&O) tax. During fiscal year 2007, the Department of Revenue estimated business owners paid approximately $2.6 billion in B&O tax – about 13% of total state revenues.

The gross receipts tax applies to all business transactions – as opposed to only the final sale of the product. Therefore, all transactions to produce the final product are taxed (this includes business-to-business purchases of supplies, raw materials and equipment).

One of the consequences of the gross receipts tax policy is the extra layer of taxation applied to each stage of production – called "pyramiding." The economic consequences of this policy can result in larger companies vertically integrating their operations, in order to avoid higher taxes. Pyramiding punishes companies that are small or unable to integrate. It also results in a lack of transparency, particularly for the consumer, as the cost of the many B&O taxes levied on the end product is indecipherable from the cost of the product itself.

The resulting effect of the multiple stages of taxation leads to the problem discussed in this second part of WPC's look at Washington's Business and Occupation tax: the tax "pyramiding" problem and its implications upon the business community.

What is Pyramiding?

A tax that pyramids is one that applies more than once to multiple sales of the same product or service. Unlike a retail sales tax or corporate income tax, the B&O tax is the only tax that truly pyramids.

[1] See "Business and Occupation Tax Reform: Part I – Characteristics of a Responsible Business Tax System," Policy Note, Washington Policy Center, June 2008.

The pyramiding effect is intentional and dates back to the implementation of the state's early version of the B&O tax system in the 1930s. Lawmakers' intent was to be able to keep the rate low and broaden the taxable base by taxing a product or service several times—as opposed to a retail sales tax that can only pyramid to a much more limited, and less alarming, degree. Interestingly, the Department of Revenue described the early days of the B&O tax as a "temporary, emergency revenue measure during the Depression."[2] Seventy years later, this "temporary" tax is still in place.

The B&O tax was originally a temporary tax to generate revenue during the Great Depression.

In the production line of a log being turned into a piece of lumber for use of building a house, pyramiding works like this:

- A logging company selling its logs to a mill will pay a B&O tax of .484% on the gross sale price to the mill.
- The mill will sell the finished lumber to a distributor and will pay a B&O tax of .484% on the full gross sale price to the mill, unreduced by the price the mill paid to the logging company.
- The distributor will sell the lumber to a contractor and pay yet a third B&O tax of .484% on the full gross sale price to the contractor, unreduced by the price the distributor paid to the mill.
- Finally, the contractor will include the log in the construction of a house and pay a B&O tax of .471% on the price for which the house is sold to the consumer, unreduced by the price the contractor paid for materials, including the log in question.

Therefore, the tax has pyramided all the way down to the consumer – raising the price of the finished product, in this case a house. The price increase may be small compared to the overall price of the house, but it is still not visible to the consumer.

In 2002, the legislature convened a task force to analyze the state's tax structure and submit recommendations for improvement. Commonly known as the Gates Commission, the report also detailed the degree of pyramiding in several industries. Food is taxed an average of 6.7 times. Aircraft parts and manufacturing are taxed 5.3 times. Construction is taxed 3.3 times, and retail trade is taxed 1.6 times during the typical production process.

The effect of the pyramiding in different industries creates a situation where some industries are forced to pay a disproportionate number of times into the system. Through the years the legislature and Department of Revenue (DOR) have created numerous exemptions, deductions and credits to help mitigate the negative impact that some industries face because of higher instances of pyramiding.

[2] Washington State Department of Revenue, *Tax Reference Manual 2007,* p. 108.

The chart below highlights just a few areas where excessive pyramiding creates problems:

Industry	Effective Tax Rate on Value Added	Degree of Tax Pyramiding	Industry	Effective Tax Rate on Value Added	Degree of Tax Pyramiding
Manufacturing – Food	2.00%	6.7%	Manufacturing – Misc. Manufacturing Industries	1.2	2.7
Manufacturing – Petroleum Refining	3.1	6.7	Manufacturing – Printing and Publishing	1.4	2.6
Manufacturing – Aircraft & Parts	2.6	5.3	Railroad, Air, Water & Other Transportation	1.8	2.5
Manufacturing – Rubber & Plastics	2	4.3	Mining & Quarry	1.2	2.4
Manufacturing – Primary Metals	2	4.1	Manufacturing – Fabricated Metal	1.1	2.3
Manufacturing – Apparel & Textiles	2	4.1	Lodging Services	1.1	2.2
Manufacturing – Lumber & Wood Products	1.9	4	Barbers, Dry Cleaning and Other Personal Services	2	2.1
Manufacturing – Professional & Scientific Instruments	1.8	4	Agriculture, Forestry & Fishing	1.4	2
Manufacturing – Industrial & Commercial Machinery & Equipment	1.8	4	Auto Repair Services	1	2
Manufacturing – Furniture & Fixtures	1.8	3.7	Communications	1.2	1.9
Manufacturing – Other Transportation Equipment	1.9	3.7	Wholesale Trade	0.9	1.9
Manufacturing – Paper Products	1.7	3.7	Legal, Engineering & Accounting	2.1	1.8
Manufacturing – Stone, Clay & Glass	1.6	3.4	Advertising, Mailings and Other Business Services	1.6	1.7
Manufacturing – Chemical Products	1.5	3.3	Retail Trade	0.8	1.6
Construction	1.6	3.3	Medical & Health Services	2	1.6
Manufacturing – Electronic Equipment (Except Computers)	1.4	2.8	Finance, Insurance & Real Estate	1.5	1.6
Manufacturing – Leather & Leather Products	1.4	2.8	Electric, Gas & Other Utilities	3.2	1.5
Movies, Amusement & Recreation	2.3	2.7	Computer Programming & Data Processing	1.3	1.4
Miscellaneous Repair Services	1.4	2.7	***State Average***	***1.50%***	***2.5%***

Source: Washington State Tax Structure Study Committee, "Tax Alternatives for Washington State: A Report to the Legislature," Volumes 1 & 2 (November 2002)

Non-Neutrality of the Tax

The "Gates Report" described Washington's B&O system as one that results in substantial tax pyramiding and as highly non-neutral across products and industries, violating basic principles of good tax design.[3]

A neutral taxing structure minimizes its effect on the economic behavior of those businesses or individuals subject to the tax. A neutral tax code will also do a better job of determining the actual cost of an item, as well as how businesses choose to function. In the case of the B&O, because of pyramiding, lawmakers have created a strong incentive for a business to vertically integrate their operations in order to avoid a higher tax liability, because the system is essentially penalizing external transactions more than internal ones. This policy is particularly harmful to small business owners and their employees.

[3] More information on the benefits of a neutral tax structure can be read in "Characteristics of a Responsible Taxing System," Policy Note, Washington Policy Center, June 2008.

Vertical integration is defined as when a company integrates operations upstream – in the case of extracting the aforementioned log from the ground – as well as downstream – in the instance that the same company acts as mill, distributor, and contractor. Bringing these services inside the company lessens tax liabilities because all transactions take place inside the company, instead of with other firms that may specialize in milling, wholesaling, contracting, etc.

The DOR itself says that one of the major disadvantages of the B&O tax system is that the "Tax liability pyramids, thus favoring vertically integrated operations."[4]

Unfortunately, sometimes the incentive for a firm to vertically integrate results in an unintended consequence for the firm: it can actually become less efficient.[5] But if the tax avoidance advantages outweigh the cost of becoming less efficient, then the cause of the inefficiency across the whole economy, the tax structure, should be reviewed and reformed. A tax system that encourages, even unwittingly, economic inefficiencies among the private sector is poor public policy, and is limiting economic growth in the state.

The Commission's report states:

> "The finding for the Washington State tax system is that it causes substantial nonneutralities for both businesses and households. The pyramiding of the B&O tax creates the main non-neutralities for businesses… This causes effective B&O tax rates (the rate paid on the value added to goods and services by an enterprise) to vary considerably from industry to industry."[6]

The B&O tax hurts Washington businesses that rely primarily on purchases and production that take place in-state, because the business is subject to pyramiding (see example of log-to-house above). An out-of-state firm that sells a product in Washington will only have to pay the B&O tax once, at the final sale, therefore escaping much of the effects of pyramiding and negating the "fair and equitable" tax principle. State lawmakers have thus put Washington state business owners at a disadvantage compared to businesses from out of state.

The Effective Tax Rate Ramifications from Pyramiding

The effective tax rate a business pays is determined by dividing the actual tax paid by the firm's net taxable income and is expressed as a percentage. Codified tax rates are the rates most people see published in the tax code, but the effective tax rate is important, because that is the rate businesses actually pay. It takes into account government offsets and therefore can dramatically alter the amount of taxation.

When one company enjoys more offsets (deductions, credits, etc.) than another company, the first company's effective tax rate is less than the second company's. It is virtually impossible to keep a tax system neutral when there is a possibility for one company to benefit from tax breaks that other companies cannot also cash in on. This uneven system is inherently unfair to those businesses not able to take advantage of the tax breaks or deductions. Unfortunately, this becomes a game of "who has the more powerful lobbyist in Olympia." But tax codes should

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[4] Washington State Department of Revenue, http://dor.wa.gov/docs/reports/wa_tax_system_11_17_2004.pdf. (Accessed online June 19, 2008).
[5] William F. Fox and Matthew Murray, "Economic Aspects of Taxing Services," *National Tax Journal* (March, 1988) p. 28.
[6] Washington State Tax Structure Committee, "Tax Alternatives for Washington State: A Report to the Legislature," Volumes 1 & 2 (November 2002).

not be made by only serving special interests at the expense of broadly applied tax relief.

Most others states rely on a corporate income tax – a tax that exhibits higher rates but is only applied to net income as opposed to gross receipts. A Tax Foundation report in 2006 that ranked all the state's corporate income tax rates used a formula to convert Washington's B&O tax into the more widely used and recognized corporate income tax. They found that Washington's effective business tax rate ranked second highest in the nation at 13.12 percent.[7]

This high rate is disconcerting because it demonstrates that, even with its listed "low" tax rates, Washington's B&O tax can have a tremendous negative impact on the business community. This is due largely because the B&O tax pyramids.[8]

More Consequences of Pyramiding

Policymakers routinely recognize the negative impact that pyramiding has on the state's businesses and often take steps to alleviate some of its liabilities. However, this results in complicating the tax code with myriad tax deductions, credits, exemptions, etc.

As pointed out in Washington Policy Center's "Characteristics of a Responsible Business Taxation System," policymakers have enacted hundreds of deductions, credits and other tax-alleviating measures into the tax code.[9] About two hundred of the almost six hundred tax exemptions in the state target the B&O tax, and most of them target specific industries instead of using a broad-based tax relief approach.

When converted to a corporate income tax, Washington's B&O tax rate is the second highest in the nation.

The other way policymakers try to alleviate pyramiding is through differing tax rates. As mentioned above, the state's code is broken into 10 different rates, depending on industries:

Manufacturing, wholesaling and certain other activities	0.484%
Retailing, environmental cleanup, and radioactive waste cleanup for the U.S.	0.471%
Manufacturing/selling commerce aircraft and components	0.2904%
Manufacturing aluminum, manufacturing/wholesaling of solar energy systems and repair of commercial aircraft	0.294%
Extracting timber and manufacturing timber/wood products	0.2956%
Travel agents, tour operators, stevedoring, freight brokers, licensed boarding homes, repair of aircraft, manufacturing of computer chips or semiconductor materials, international investment management services	0.275%
Processing meat (at wholesale); processing soybeans, canola, and dry peas; manufacturing wheat into flour, raw seafood, fresh fruit, vegetables and dairy products; warehousing/reselling of prescription drugs; and manufacturing biodiesel/alcohol fuel	0.138%
Disposal of low-level radioactive waste	3.3%
Services, public/nonprofit hospitals, and all other activities	1.5%
Games of chance/pari-mutuel wagering	0.13%

[7] Curtis S. Dubay and Scott A. Hodge, "State Business Tax Climate Index," *Background Paper, Number 51.* Tax Foundation. February 2006.
[8] For a more detailed and mathematical analysis of how pyramiding has an effect on effective tax rates among industries, see Appendix A in "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes," by Andrew Chamberlain and Patrick Fleenor, *Special Report*, No. 147, Tax Foundation, December 2006. pgs. 11-12.
[9] Carl Gipson, "Business and Occupation Tax Reform Part 1 – Characteristics of a Responsible Business Taxation System," *Policy Note*, Washington Policy Center, June 2008.

The DOR does say, however, that 95 percent of the total B&O revenues comes from only five of the tax classifications. These classifications include manufacturing, wholesaling, retailing, services and public/nonprofit hospitals. This discrepancy is a microcosm of the predicament facing those businesses with this tax system. If 95% of the B&O revenues are coming from only half of tax classifications, why aren't the other five rates adjusted to coincide with the rates that are used the most? The answer probably has something to do with the fact that special exemptions were made for industries that pay only 5% of the B&O revenues.

The attempts at mitigating the pyramiding process through tax incentives or differential rate structures serve only to complicate the entire system – thereby defeating the supposed simplicity of the system.

Conclusion

Washington's businesses deserve a fair and equitable tax system. The Business and Occupation tax makes this goal virtually unachievable. Due to economies of scale, a complex business tax system disproportionately harms small businesses because the larger businesses have more resources to devote to tax preparation and compliance.

Several problems exist with this system, chief among them are the problems of tax pyramiding and a lack of transparency.

Policymakers habitually try to fix this outdated system with tax deductions, exemptions, or other incentives but the problems remain – tax pyramiding, a lack of transparency and politically favored industries.

Rather than picking and choosing specific industries that should benefit from these various forms of incentives, policymakers should concentrate on three policy changes:

1. Lower the overall rate across all industries,
2. Make B&O taxes more transparent to both consumers and businesses, and
3. Incentivize new business creation across all industries by raising the B&O tax liability threshold – currently at $28,000, before application of any credits.

These recommendations do not constitute a silver bullet in solving all the problems of Washington's gross receipts tax problem, but the can help make Washington's business climate more appealing to entrepreneurs, out-of-state businesses wishing to locate here and current in-state businesses wishing to expand.

The third part of this series will summarize and analyze some of the B&O tax reforms that have been proposed over the years as well as some of the changes to gross receipts taxes that other states have successfully implemented.

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