Tax Structure Work Group

January 9, 2022

TO: Sarah Banister, Secretary, Washington State Senate
Bernard Dean, Chief Clerk, Washington State House of Representatives

FROM: Senator Noel Frame, Co-Chair, Tax Structure Work Group
Senator Keith Wagoner, Co-Chair Tax Structure Work Group

In 2017, the Washington State Legislature established the Tax Structure Work Group (TSWG) to identify options to make the Washington State tax code more fair, adequate, stable, and transparent. In 2018, the TSWG held public meetings across Washington to assess taxpayers' interest in changing the state's taxes.

In 2020, the Department of Revenue conducted economic modeling to better understand potential alternatives to the business and occupation tax, sales tax, and property tax. The results of this work can be found in the TSWG Preliminary Report: Results of Economic Analyses. The TSWG then held a series of listening sessions with key stakeholders to better understand the strengths and weaknesses of various tax policies.

In early 2021, the TSWG developed a set of tax scenarios that included different combinations of tax types with the goal of addressing fairness, stability, transparency, and adequacy within the tax structure. In summer and fall of 2021, the TSWG conducted engagement with nearly 5,000 taxpayers across Washington, including both individual taxpayers and businesses. This engagement included 14 tax town halls, 30 presentations to community and business groups, five multilingual listening sessions, and two surveys. The results of this community and business engagement are described in the TSWG Interim Report and Final Survey Technical Summary.

Throughout 2022, the TSWG used these engagement findings, along with technical analysis conducted by the Department of Revenue, to inform discussions about potential changes to the state tax structure. The Work Group eliminated tax types from consideration and refined policy details during their meetings in March, May, September, and November. In December 2022, the TSWG decided on policy recommendations to the Washington State Legislature:

- Replace Washington State's current Business and Occupation Tax with a Margin Tax (six TSWG votes in favor).
- Replace the current 1% Property Tax Limit Factor with a limit factor tied to population growth and inflation for local governments (five TSWG votes in favor).

The following documents describe these policy recommendations. They can also be found on the TSWG website at: TSWG Recommendations.

Bill drafts are expected to be introduced to the legislature later in January.

Thank you for the opportunity to serve in this capacity for the people of the State of Washington.

Attachments

cc: Members, Tax Structure Work Group
Members, Senate Ways and Means Committee
Members, House Finance Committee
Members, Senate Local Government, Land Use & Tribal Affairs Committee
Members, House Local Government Committee
David Schumacher, Director, Office of Financial Management
Drew Shirk, Executive Director, Legislative Affairs, Office of the Governor

TAX STRUCTURE WORK GROUP Recommendation:

Convert the Business and Occupation Tax into a Margin Tax

Current Law

Washington levies its primary business tax, the business and occupation (B&O) tax, on gross income from Washington-based business activity.

A business must report B&O tax if the business meets any of the following thresholds in the current or prior calendar year:

- Has more than $100,000 in combined gross receipts sourced or attributed to Washington.
- Has physical presence nexus in Washington.
- Is organized or commercially domiciled in Washington.

These thresholds apply to all Washington income, including retailing, wholesaling, service activities, and other apportionable activities.

For B&O tax purposes, businesses engaging in apportionable activities may apportion their income to determine the amount subject to B&O tax. The formula for apportionment is Washington gross apportionable receipts divided by worldwide gross apportionable receipts for the taxing period.

The B&O tax includes a flat rate structure with different rates by activity. There are several surcharges on certain industries and activities, including the Workforce Education Surcharge. The B&O tax also includes approximately 200 tax preferences in the form of credits, deductions, exclusions, exemptions, and preferential rates.

While most businesses with activity in Washington are subject to the B&O tax, some businesses are instead subject to the public utility tax. The public utility tax is a tax on public service businesses, including businesses engaging in transportation and the supply of energy, natural gas, and water. This tax is in lieu of the B&O tax, meaning that businesses would pay one or the other but not both taxes on the same activity.

Each legal entity must register and report taxes separately from other affiliated entities within or affiliated with the same business. This stands in contrast with reporting at the federal level that is done on a consolidated basis, where all affiliated entities are reported on one return as a part of a consolidated corporate entity.

Proposal

This proposal converts Washington's B&O tax into a modified gross receipts tax called a "margin tax" modeled after Texas's franchise tax. A margin tax is often considered a modified gross receipts tax.

Under this margin tax proposal, businesses are taxed on their margin, which is calculated as gross income minus the greater of four deductions:

- Cost of goods sold,
- Compensation paid,
- A fixed percentage of gross receipts (e.g., 30%), or
- A flat amount (e.g., $1 million).

Unlike Texas's franchise tax, for this margin tax proposal the compensation and cost of goods sold deductions are based on federal reporting.

After the deduction amount is subtracted, a single-factor sales apportionment method is used to determine the amount of the business's worldwide margin that is attributable to Washington. For combined groups, each member of the group is included for purposes of attributing Washington income, if any member of the combined group has nexus in Washington. This is referred to as the Finnigan apportionment method. The amount attributable to Washington is multiplied by a flat revenue neutral rate to determine the tax due.

Under this proposal, the margin tax is imposed on the same entities that are subject to B&O tax, including corporations, partnerships, limited liability companies, sole proprietorships, and nonprofits. Activities subject to public utility tax under current law remain subject to public utility tax and are excluded from the margin tax. This proposal maintains Washington's surcharges which are imposed on certain industries and activities. It also maintains Washington's current registration and nexus thresholds.

Washington's definition of gross income is unchanged. Most of Texas's exclusions from total revenue are not qualified exclusions from gross income under this proposal, with the exception of bad debts and cash and trade discounts.

This margin tax proposal also:

- Provides an EZ rate option for businesses with gross income of $5 million or less annually. An eligible business can elect to pay the margin tax on their gross income, with no standard deductions allowed, at a lower EZ rate of 1.75%.
- Adjusts the threshold for eligibility to use the EZ rate annually for inflation.
- Imposes additional margin taxes on manufacturing and extracting activities in Washington.
- Includes multiple activity tax credits similar to those provided under the B&O tax.
- Changes the filing frequency for all entities to an annual return due April 15th.
- Requires entities with gross income over $500,000 to file an annual return.
- Requires quarterly estimated payments.
- Requires combined reporting for corporations required to file consolidated federal returns.
- Eliminates all preferential rates.
- Eliminates all deductions, exclusions, and exemptions except those that are necessary for legal compliance or practical administration.
- Allows businesses to carryover earned but unused B&O tax credits to be credited from margin tax due for a limited amount of time.
- Compensates retailers by creating a retail sales tax credit.

Effective Date

The B&O tax is eliminated starting January 1, 2027, and the margin tax begins for gross income earned in 2027. The first quarterly estimated payments are due in April 2027, with the annual tax return for 2027 due April 15, 2028.

Comparison: B&O Tax / Texas Franchise Tax / Margin Tax

The table below provides a snapshot of Washington's current business and occupation (B&O) tax as compared to the Texas Franchise Tax and the Margin Tax proposal.

Categories	Washington B&O Tax	Texas Franchise Tax	Margin Tax Proposal
Filing is consolidated or single entity	Single entity	Consolidated	Consolidated
Conforms with federal tax definitions	No	No	Yes
Tax is activity-based or revenue-based	Activity-based	Revenue-based, with a lower rate for retailers and wholesalers	Hybrid, it is mostly revenue-based but includes activity-based taxes for manufacturing and extracting activities when those activities take place in Washington, but the sales of those products takes place outside of Washington
Filing threshold	$125,000	$1 million	$500,000
Measure of the tax	Gross receipts (gross income of the business or value of products manufactured or extracted)	Total income of the business less the business' choice of the greater of: • Cost of goods sold, • Compensation paid, • 30% of total revenue, or • $1 million.	Gross receipts of the business less the business' choice of the greater of: • Cost of goods sold, • Compensation paid, • 30% of total revenue, or • $1 million.
Rate structure and basis	Flat rate based on activity	Flat rate based on activity w/ EZ rate option for small businesses	Flat rate based on receipts w/ EZ rate option for small businesses
Lower tax rate for retailers	Yes, businesses pay a rate of 0.471% on retailing activity, rather than the 0.484% rate for many other B&O taxable activities	Yes, retailers and wholesalers pay a rate of 0.375%, rather than the 0.75% rate that other businesses pay under the Texas Franchise Tax	No, but it includes a sales tax credit which is equivalent to the benefit provided to retailers by the lower B&O tax rate on retailing activity
Tax base	All enterprise activities regardless of type of entity (for-profit, non-profit or municipal government)	All enterprise activities, except for activities performed by certain entities (non-profit, municipal government, or sole proprietors)	All enterprise activities regardless of type of entity (for-profit, non-profit or municipal government)
Taxes on manufacturing or extracting activities	Yes, where sales take place outside of Washington with a multiple activities tax credit to avoid double taxation	No	Yes, where sales take place outside of Washington with a multiple activities tax credit to avoid double taxation
Apportionment based on single factor sales apportionment	Yes, Washington's current apportionment method is essentially equivalent to single-factor sales	Yes	Yes

TAX STRUCTURE WORK GROUP Recommendation: Update the Property Tax Limit Factor for Local Levies Only with Changes in Population and Inflation

Current Law

Current law annually limits taxing districts' property tax levy increases to the levy growth limit, often referred to as the "101% levy limit" or the "1% growth limit," plus any increase in levy capacity for the following add-ons:

- New construction.
- Construction of wind turbine, solar, biomass, and geothermal facilities.
- Improvements to property.
- Increased value of state-assessed property.
- Increases in real property value within a local tax increment finance area designated by a local government.

Current law also defines:

- Inflation as the percentage change in the implicit price deflator (IPD) for personal consumption expenditures for the United States as published for the most recent 12-month period by the Bureau of Economic Analysis of the Federal Department of Commerce by September 25th of the year before the taxes are payable.
- The limit factor:
    - For taxing districts with a population of less than 10,000 as 101%.
    - For all other districts as the lesser of 101% or 100% plus inflation. If inflation is less than 1%, then taxing districts who adopt a substantial need resolution can have a limit factor up to 101%.

Proposal

Except for the state property tax levies, this proposal revises the 101% levy limit for all local taxing districts' regular property tax levies, as follows:

- Revises the definition of "inflation" to mean the annual percentage increase in the consumer price index for all urban consumers (CPI-U) in the western region for all items as provided for the most recent 12-month period by the Bureau of Labor Statistics of the United Stated Department of Labor by July 25 of the year before the year the taxes are payable.
- Revises the definition of "limit factor" to mean 100% plus population change and inflation, but not to exceed 103%.
- Defines "population change" to mean the annual percent increase in the population of a taxing district between the two most recent years as provided in the official population estimates published by the Office of

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Financial Management for April 1 of the year before the taxes are payable. It also provides the following:

- If a taxing district's population decreases, the population change is zero.
- Allows for population change for districts in more than one county or city.
- Excludes changes in population resulting from an annexation by a city.
- Repeals existing substantial need resolution requirements.
- Requires local taxing districts to include the district population change as part of the district's annual budget resolution to their county legislative authority, or the county assessor if required.
- Requires county assessors to calculate the levy limit calculations, except for the state school levies and intercounty rural library levies.

Effective Date	This proposal takes effect beginning with property taxes due for Calendar Year 2024.