Replace the B&O Tax with a Margin Tax

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Under a margin tax, businesses are taxed on their margin, which is generally calculated as gross receipts minus the greater of the following:

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

The Department's model

The margin tax model created by the Department of Revenue uses data from the IRS and the Department to estimate the revenue expected to be generated (under the assumption of revenue neutrality) if Washington State were to replace the business and occupation (B&O) Tax with a margin tax.

The model assumes that each taxpayer will select the largest of the four standard deductions (i.e., compensation paid, cost of goods sold, 30% of gross receipts, or $1 million) to determine its pre-apportioned taxable margin.

Possible approaches

The Department has determined that there are two potential approaches to developing a proposal for the compensation paid and cost of goods sold deductions. We could:

1. Use the IRS's method of calculating the compensation and cost of goods sold deductions as a guide, or
2. Use Texas's method in developing custom definitions for the compensation and cost of goods sold deductions.

We outline and compare the two methods for each deduction below.

Compensation paid deduction

IRS method background

For Federal income tax withholding purposes, the term "wages" is defined in IRC section 3401(a) as all remuneration for services performed by an employee for his employer, with certain specific exceptions.

Employers use Form W-2 to report:

- Wages, tips, and other compensation paid to an employee, including some but not all stock-based compensation.
- Income and social security taxes withheld.
- Information regarding deductible benefits, etc.

Partners or other owners of pass-through entities are not employees and do not receive a Form W-2. The pass-through entity must furnish copies of Schedule K-1 for Forms 1065 or 1120-S to each partner. Each partner reports their share of the partnership's income or loss on their personal tax return.

Form 1099-MISC and Form 1099-NEC are used to report payments to independent contractors and other non-employees, including corporate directors.

Considerations

- Taxpayers will already be familiar with W-2 wages.
- Using the IRS forms would be easier to administer and audit for the Department.
- Not allowing wages outside of W-2 wages might make the compensation deduction less attractive.

Texas method background

The Texas compensation deduction 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.
- The net distributive income from entities treated as partnerships for federal tax purposes and LLCs treated as either S-Corps or sole proprietors for federal income tax purposes. Such income is not included on Form W-2, nor is it considered wages under IRC 3401. Generally, such distributions would be included on Schedule K-1 for Forms 1065 or 1120-S.
- Fees paid to directors of the business. These fees are not generally included on Form W-2. They would normally be included in Form 1099.
- Stock awards and stock options deducted for IRS purposes, to the extent not included in W-2 wages.

Texas imposes a wage limitation on W-2 wages and cash compensation paid to officers, directors, owners, partners, and employees. The wage limitation is adjusted each even-numbered year using the consumer price index. The limitation is $400,000 per person for reports due in 2022 and 2023.

Considerations

- Allowing wages outside of W-2 wages makes the compensation deduction more attractive.
- Including wages outside of W-2 wages increases complexity.
- Capping the deduction keeps businesses from claiming higher than expected compensation deductions.
- Capping the compensation deduction might make the deduction less attractive.

The Department's model

With respect to compensation, the model assumes salaries and wages as reported on the underlying IRS forms (i.e., 1120, 1120-S, and 1065) along with an option to include benefits (i.e., pensions, profit sharing plans, and employee benefit programs). This model does not assume that businesses would be allowed to deduct compensation paid to contractors, which would be reported on IRS Form 1099. Additionally, the model does not assume the definition of compensation used under the Texas franchise tax and therefore does not cap compensation to an inflation-adjusted amount of $400,000 per employee.

Decisions requested

The table below includes items we need a decision on for proposal development.

Decision	Options	Department Recommendation
How should Washington calculate the compensation paid deduction?	• Limit the deduction to IRS W-2 wages • Create a Washington definition of compensation	**The Department recommends using the IRS W-2 wages.** Limiting the compensation deduction will help keep rates low and reduce the complexity.
Should Washington allow contractor compensation to qualify for the compensation deduction?	• Allow contractor compensation • Do not allow contractor compensation	**The Department recommends not allowing a deduction for contractor compensation.** This might incentivize businesses to use more contractors rather than employees earning W-2 wages.
Should Washington cap the per employee compensation deduction?	• Cap the deduction to a set amount (i.e., $400,000) • Do not cap the deduction	**The Department does not have a recommendation.** Limiting the compensation deduction with a per employee cap will help keep rates lower.
Should Washington limit the compensation deduction to a certain percentage of possible compensation costs?	• Cap the deduction at a certain percentage (e.g., 35%) of compensation costs • Do not cap the deduction at a certain percentage of compensation costs	**The Department does not have a recommendation.** Limiting the compensation deduction with a percentage cap will help keep rates lower.

Cost of goods sold deduction

IRS method background

The IRS allows businesses that manufacture products or purchase them for resale, to deduct cost of goods sold. If an expense is included in the cost of goods sold, it cannot be deducted again as a business expense. Corporations and partnerships use [Form 1125A] to calculate their cost of goods sold. Sole proprietors calculate cost of goods sold on Schedule C.

Generally, the IRS calculates cost of goods sold as follows:

Inventory at the beginning of the year.

- \+ Add purchases.
- \+ Add labor costs that are a necessary part of the manufacturing process.
- \+ Add other costs incurred in the manufacturing process, such as packaging, freight-in and overhead expenses allocable to the manufacturing operation.
- − Subtract inventory at the end of the year.

Considerations

- Taxpayers will already be familiar with how they calculate cost of goods sold for IRS purposes.
- The IRS calculation is easier to administer and audit for the Department and reduces complexity for businesses.
- Taxpayers may be able to manipulate what is included in the cost of goods sold amount reported on the IRS return. For IRS reporting purposes, taxpayers are simply trying to arrive at net income. Therefore, the IRS does not appear to strictly regulate which expenses are included in cost of goods sold.
- The calculation is narrower than Texas's definition and may exclude many businesses from being able to claim a cost of goods sold deduction.
- Does not allow businesses to deduct labor costs related to acquiring goods, only the labor costs related to the production of goods.

Texas method background

Texas allows entities that sell real property, tangible personal property and digital products in the ordinary course of business to claim a cost of goods sold deduction. Texas has also expanded its definition of cost of goods sold to allow certain service providers to claim a cost of goods sold deduction, including construction contractors, movie theaters, restaurants, oil change service providers, and others. Texas does not use the IRS cost of goods sold calculation. Texas created its own definition but generally allows expenses that are capitalized for federal tax purposes.

Unlike the IRS, Texas details all allowable costs under Texas's definition of cost of goods sold. Texas's definition of cost of goods sold is broader than the IRS' because it allows businesses to deduct costs for both producing and acquiring goods. Specifically, Texas includes the following costs to the extent they are allocable to acquiring or producing goods:

- Labor costs including W-2 wages, contractor compensation, temporary labor, payroll taxes and benefits.
- Costs attributable to processing, assembling, repackaging, storing, warehousing and inbound transportation.
- Indirect costs subject to IRS capitalization rules.

Considerations

- Using Texas's approach gives Washington more flexibility to specifically define which costs qualify.
- Allows retailers and wholesalers, in addition to manufacturers, to deduct qualifying labor costs, because businesses can deduct the costs of producing or acquiring goods.

- Allows service businesses who sell or provide tangible personal property while performing their services to claim a cost of goods sold deduction.
- Texas has found their definition of cost of goods sold to be difficult to administer.
- A broader definition increases complexity and makes it more difficult for both taxpayers and the Department to determine which labor costs qualify.
- Determining allowable costs for digital products increases complexity as technology changes rapidly.

The Department's model

With respect to cost of goods sold, the model uses the cost of goods sold reported on the underlying IRS forms (i.e., 1120, 1120S, and 1065). This does not assume the Texas definition of cost of goods sold which includes certain adjustments based on the nature of the business activity (e.g., the cost incurred for production versus acquisition).

Decisions requested

The table below includes items we need a decision on for proposal development.

Decision	Options	Department Recommendation
How will Washington calculate cost of goods sold?	• Start with the IRS cost of goods sold calculation • Create a Washington definition of cost of goods sold	**The Department recommends starting with the IRS cost of goods sold calculation.** Limiting the cost of goods sold deduction will help keep rates lower and reduce the complexity.
Should Washington limit the cost of goods sold deduction to a certain percentage of possible cost of goods sold?	• Cap the deduction at a certain percentage (i.e., 35%) of cost of goods sold • Do not cap the deduction at a certain percentage of cost of goods sold	**The Department does not have a recommendation.** Limiting the cost of goods sold deduction with a percentage cap would help keep rates lower.