

Tax Structure Work Group

Replace the Business and Occupation Tax with 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.

Each legal entity must register and report taxes separately for affiliated entities.

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 that engage 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.

Proposal This proposal replaces Washington's B&O tax with 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.

Tax Structure Work Group

Replace the Business and Occupation Tax with a Margin Tax

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:

- Changes the filing frequency for all entities to an annual return due April 15th.
- 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, 2025, and the margin tax begins for gross income earned in 2025. The first quarterly estimated payments are due April 2025 with the annual tax return for 2025 due April 15, 2026.

Tax Structure Work Group

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Revenue Estimates

The first table shows the net revenue impact if we assume a margin tax rate of 2.8887% with revenue neutrality for the 2025-27 Biennium.

The second table shows the net revenue impact if we assume a margin tax rate of 2.8334% with revenue neutrality for the 2027-29 Biennium.

Shifting the revenue neutral biennium out allows for a lower overall rate, as we are assuming higher reporting compliance over time. Under either rate scenario, we would expect to see revenue impacts similar to what is shown for Fiscal Year 2029 in the out years.

Fund - Source	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
GF-State – Margin Tax	0	1,518,100,000	6,224,300,000	6,763,500,000	7,093,500,000	7,422,700,000
GF-State - Business and Occupation Tax	0	(2,522,700,000)	(6,353,500,000)	(6,634,100,000)	(6,957,700,000)	(7,280,700,000)
Fiscal Year Total	0	(1,004,600,000)	(129,200,000)	129,400,000	135,800,000	142,000,000
Biennial Total		(1,004,600,000)		200,000		277,800,000

Fund - Source	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
GF-State – Margin Tax	0	1,489,000,000	6,105,100,000	6,634,000,000	6,957,700,000	7,280,600,000
GF-State - Business and Occupation Tax	0	(2,522,700,000)	(6,353,500,000)	(6,634,100,000)	(6,957,700,000)	(7,280,700,000)
Fiscal Year Total	0	(1,033,700,000)	(248,400,000)	(100,000)	0	(100,000)
Biennial Total		(1,033,700,000)		(248,500,000)		(100,000)

Revenue Assumptions

- Taxpayer affiliated groups that file a consolidated federal income tax return will file a combined margin tax return.
- Nexus applies to a combined group if one or more companies within the group have substantial nexus in Washington (RCW 82.04.067).
- Taxpayers (or taxpayer groups) first determine their total worldwide income before deductions.
- Businesses then choose the largest available deduction from:
 - Cost of goods sold,
 - Compensation paid,
 - 30% of gross income, or
 - \$1 million.
- Compensation is capped at \$400,000 per individual.
- After subtracting the chosen deduction from total worldwide income, the business apportions the portion of worldwide margin attributable to Washington.

Tax Structure Work Group

Replace the Business and Occupation Tax with a Margin Tax

- The percentage of a business's worldwide taxable margin apportioned to Washington under the margin tax equals the percentage of the business's worldwide taxable gross receipts apportioned to Washington under the B&O tax.
- This estimate assumes that manufacturing and extracting activities will generate the same revenue under a margin tax as we receive currently under the B&O tax.
- Taxpayers with a negative margin in a given fiscal year have no tax liability for that fiscal year. These taxpayers are not able to accrue a deduction or credit against the tax for future years.
- The growth of income and deduction line items follows the growth of before-tax corporate profit forecasts from the Bureau of Labor Statistics (BLS) with an adjustment to account for the higher forecast of Washington employment vs. U.S. employment.
- Because of this significant change in Washington's business tax, a compliance factor of 90% is applied to the first year of collections and 95% for each subsequent year.

NOTE: The following are not included in the modeling for this estimate, as the specific details have not yet been determined:

- A carryover provision for earned but unused B&O tax credits that will be allowed as a credit against the margin tax due for a limited amount of time.
 - Retailer compensation through a retail sales tax credit.
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Data Sources

- Economic and Revenue Forecast Council: September 2022 forecast
 - Internal Revenue Service (IRS): Form 1120, Form 1120S, and Form 1065 returns
 - IRS: W2 wage data
 - Washington State Department of Revenue: Excise tax data
 - Bureau of Economic Analysis (BEA): Before-tax corporate profits with IVA and capital consumption
 - Economic Revenue forecast Council: nonfarm payroll employment, Washington
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Local Government Impact

None

Expenditure Assumptions

- Expenditures assume first quarterly estimated payments can be received April 2025.
 - FTE counts brought on by the Department to administer the margin tax will phase out as FTEs associated with the B&O tax convert labor efforts to the margin tax. This phase out may occur earlier for some divisions and job classes than others.
 - After implementation of the margin tax and cessation of labor efforts for the B&O tax, the ongoing FTE count required for the Department to administer the margin tax may be slightly more than what the Department required to administer the B&O tax.
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**Expenditure
Estimates**

The estimate of the Department's implementation and administration costs are in process.

Note

Please note that our review, comments and any estimates provided are not intended to reflect a policy position by the Department and are solely to assist you in exploring options under development.

**Further
Information**

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