BUSINESS AND OCCUPATION TAX
Chapter 82.04 RCW

<u>Tax Base</u> Gross receipts of all businesses operating in Washington, as a measure of the privilege of engaging in business. The term "gross receipts" means gross income, gross sales, or the value of products, whichever is applicable to a particular business.

<u>Tax Rate</u> As of January 2010, ten different business and occupation (B&O) tax rates apply to various classifications of business activities. These are summarized as follows:

Manufacturing, wholesaling, and certain other activities*............	0.484%
Retailing, retail sellers of digital goods, environmental cleanup, and radioactive waste cleanup for the U.S.	0.471%
Extracting timber & manufacturing timber/wood products:**......	0.3424%
Manufacturing aluminum (until 1/1/2012); repair of commercial aircraft (until 7/1/2011); manufacturing or selling commercial aircraft & components (until July 1, 2024); and printing/publishing newspapers..................................	0.2904%
Travel agents, tour operators, stevedoring, freight brokers, licensed boarding homes, repair of aircraft, manufacturing computer microchips or semiconductor materials, solar energy equipment manufacturing (until 6/30/2014), 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; (starting 7/1/2012); warehousing/reselling of prescription drugs; and manufacturing biodiesel/alcohol fuel	0.138%
Disposal of low-level radioactive waste	3.3%
Development of aerospace products...	0.9%
Games of chance/pari-mutuel wagering***	1.63%
Services; public/nonprofit hospitals; all other activities	1.5%

*Extracting, extracting and processing for hire, commissions of insurance agents/ brokers, printing and publishing, child care, income derived from royalties, warehousing, radio and television broadcasting, public road construction, government contracting, treatment of chemical dependencies, retailing of interstate transportation equipment and services (inspecting, testing, labeling, storing) provided for firms that can salmon products, advertising income of newspapers associated with on-line editions (until 6/30/2011).

**The tax rate for extracting/wholesaling of timber and manufacturing of timber or wood products includes a surtax of 0.052 percent (RCW 82.04.261). The basic B&O tax rate on these activities is 0.2904 percent (until July 1, 2024) plus the permanent surtax enacted in 2006, the receipts of which are dedicated to the forest and fish support account.

***Includes the service rate. Applies to operators of certain gambling activities which gross more than $50,000 annually and wagering at horse races.

Businesses are taxable according to the activities in which they engage and may be subject to more than one tax rate, depending upon the source of their income. Further, firms are taxed according to their final level of activity in Washington. Thus, a firm that manufactures a product and sells it at wholesale within the state is taxed as a wholesaler, not a manufacturer. (Technically, such firms report on both the manufacturing and wholesaling tax lines but take a multiple activities tax credit for the manufacturing activity.)

Four principal tax rate classifications accounted for 98 percent of total B&O tax liability, prior to credits, in Fiscal Year 2009. These percentages do NOT reflect the industrial classification of the firms, only the tax lines on the tax return:

0.484 Percent:		
Manufacturing*	=	3.9%
Wholesaling**	=	20.4
Other activities	=	2.3
0.2904 Percent		
Various preferential activities	=	3.1%
0.471 Percent: Retailing	=	24.5%
1.5 Percent: Services***	=	43.9%

*Basically, out-of-state sales of products produced in Washington, not including commercial aircraft which is subject to the 0.2904% rate.
**Including in-state sales by manufacturers.
***Business and personal services, plus financial and real estate.

Levied by State

Traditionally, there has been no statutory or administrative relationship between the state B&O tax and the local gross receipts taxes levied by some cities. However, legislation adopted in 2003 required cities to adopt their local business taxes according to a model ordinance, which is linked with the state B&O tax definitions.

Administration

Department of Revenue. Firms register with the Department by filing a Master Business Application (Form #BLS 700-028) with the Department of Licensing before they commence operations. The fee for the Master Business License is $15 ($20 if the firm is registering a trade name). The Department of Revenue assigns the applicant to monthly, quarterly, or annual reporting frequency for state excise tax purposes depending upon the type and estimated level of business activity. Each firm is assigned to an industrial classification, based on the applicant's description of the firm's primary activity. The six-digit number reflects the North American Industrial Classification System (NAICS), an identification system used by the federal governments of the U.S., Canada, and Mexico.

The B&O tax is generally reported on the Combined Excise Tax Return which is sent to registered taxpayers. Other specialized tax returns may be sent to selected types of taxpayers, e.g., a "B&O Activities" return or a "Retailing and Other Activities" return. Also, aerospace, timber, and certain other firms that qualify for a reduced tax rate must file specialized tax returns and submit them electronically. All monthly taxpayers are required to file their returns electronically and to submit payment via electronic funds transfer. The due date for monthly reporters is the 25th of the following month. Quarterly filers report by the end of the month following the close of the quarter, and annual taxpayers file by the end of January for the prior calendar year. Firms other than monthly reporters are also encouraged to file their tax returns and submit payments electronically. Information on "E-file" is available on the Department's web page at: http://dor.wa.gov.

Firms whose annual gross income does not exceed $28,000 are not required to file excise tax returns if they have no other state excise taxes to report (RCW 82.32.045(4)). However, any business that collects any retail sales tax must file, regardless of the amount of sales tax. A small business tax credit (RCW 82.04.4451) relieves a major portion of B&O tax liability for many small firms. For example, a firm subject to the 0.484 percent tax rate would incur no B&O tax liability until annual income exceeds $86,777. During Fiscal Year 2009 approximately 197,000 firms benefited from the small business credit; an estimated 120,000 firms paid no B&O tax, and an additional 77,000 firms had their tax liability reduced because of this credit.

Recent Collections ($000)

Fiscal Year	Collections	% Change	% of All State Taxes
2009	$2,650,526	(7.8)%	17.0%
2008	2,874,339	6.0	16.9
2007	2,712,048	9.5	16.1
2006	2,477,831	9.2	16.1
2005	2,269,105	9.7	16.4
2004	2,067,872	7.5	15.9
2003	1,923,370	(1.8)	15.9
2002	1,958,283	(2.7)	16.6
2001	2,012,403	8.5	16.9
2000	1,854,948	1.5	15.7

Distribution of Receipts

State general fund, with the following exceptions:

- the 0.13 percent tax on games of chance and pari-mutuel wagering which is deposited in the problem gambling account ($495,000 in FY 2009); and

- the 0.052 percent surtax on extracting of timber and manufacturing of timber and wood products for the forest and fish support account ($3.5 million in FY 2009).

Until June 30, 2009, the tax on public and nonprofit hospitals, which represented about 3.3 percent of Fiscal Year 2009 collections, was dedicated to the health services account. However, this account was eliminated at the start of Fiscal Year 2010 and the receipts now go to the general fund.

Major Business Tax Incentives

Listed below are some of the important B&O tax incentive programs intended to encourage business expansion in Washington. Some of these incentives were indicated above under the tax rate section (especially under the 0.2904; 0.275, and 0.138 percent categories), since they offer reduced business tax rates. Following this section is a more general listing of some examples of B&O tax exemptions, credits, deferrals, and other tax preference items. There is not a bright-line distinction between a business tax incentive program and a more routine type of tax exemption, and certainly businesses can benefit from some of the exemptions listed in that section as well.

Some of the following programs require that participants report annually to the Department and provide data on the utilization of the tax incentive and related employment statistics. Various "accountability" statutes require the Department to report some of these data to the Legislature in the form of annual descriptive statistics. Further, some of the tax incentive statutes require an evaluation to determine the effectiveness of the program, often shortly before the scheduled termination of the program. These evaluations are to be conducted either by the Department or by the staff of legislative fiscal committees.

- Credit for R&D expenditures by certain high technology firms (expires 1/1/2015).
- Credit for new employment ($1,000 per job) by computer programming and software development firms in rural counties (expires 1/1/2011).
- Credit for new employment ($3,000 per job) by semiconductor manufacturers (expires 12 years after the effective date, which has yet to occur).
- Credit for all income derived by firms that offer information technology help-desk services in rural counties (expires 1/1/2011).
- Credit for property and leasehold taxes paid on facilities used in the production of commercial aircraft by aerospace manufacturing firms (expires 7/1/2024) and property taxes paid on aluminum smelters (expires 1/1/2012).
- Exemption for income from manufacturing semiconductor microchips (expires nine years after the effective date, which has yet to occur).
- Exemption for income of processors of fresh fruit and vegetables, dairy products, and seafood products, if the products are shipped out of state (expires 7/1/2012).
- Credit for pre-production expenditures by commercial aircraft manufacturers and other expenditures associated with development of aerospace products by nonmanufacturers, e.g., tooling (expires 7/1/2024).
- Credit for up to 20 percent of employee training costs for firms that participate in the rural county sales tax deferral program.
- Credit for one-half of the cost of customized training programs at community or technical colleges for employees (until 7/1/2016).

Other Exemptions, Deductions and Credits

The B&O tax is basically a tax on gross business receipts with no deduction for costs of doing business, such as payments for raw materials or wages paid to employees. Nonetheless, many exemptions, deductions, and credits are provided for specific types of business activities. Some of the major ones are summarized below.

EXAMPLES OF EXEMPTIONS:

- salaries and wages received by employees (not considered as engaging in business);
- income from the sale or rental of real estate;
- agricultural producers who grow crops or raise animals for sale at wholesale;
- operating income of public utilities (subject instead to public utility tax);
- international banking facilities;
- credit unions;
- insurance premiums (subject instead to insurance premiums tax);
- commuter ride-sharing and nonprofit transportation of persons with special needs;
- fund-raising activities of nonprofit organizations;
- health care organizations (subject to insurance premiums tax);
- nonprofit adult boarding homes;

- nonprofit cancer care centers;
- day care provided by churches;
- income of the American Red Cross;
- nonprofit sheltered workshops and group training facilities;
- grants and income received by local governments (except for proprietary activities);
- federal grants for small business for R&D purposes;
- direct sales by out-of-state firms via manufacturers' representatives;
- accommodation sales between firms that sell the same type of product;
- income of small timber harvesters.

EXAMPLES OF DEDUCTIONS:
- income which the state may not tax for constitutional reasons (e.g., interstate commerce);
- membership dues, contributions and donations, and tuition fees;
- investment income of nonfinancial businesses and dividends of subsidiary firms;
- network advertising representing the out-of-state income of radio/TV broadcasters;
- cash discounts taken by purchasers;
- credit losses incurred by taxpayers who use accrual accounting;
- sales representing federal and state gas taxes;
- interest from first mortgage residential loans and certain agricultural loans;
- government grants for nonprofit social/health programs and community health centers;
- income of nonprofit artistic and cultural organizations;
- income from biodiesel, alcohol (E-85), and wood biomass fuels (expires 7/1/2015).

EXAMPLES OF TAX CREDITS:
- small business credit ranging from $35 to $70 per month;
- payments for ride-sharing/commute trip reduction programs (expires 7/1/2013);
- gross receipts taxes paid in other states or countries by manufacturers or extractors;
- $3,000 credit for new jobs created by international service firms;
- purchases of electricity/natural gas by aluminum smelters;
- contributions for donations to community revitalization "main street" programs;
- $1.00 per gallon tax paid on carbonated beverage syrup;
- contributions to motion picture competitiveness program (expires 7/1/2011);
- credit equivalent to state/local sales tax for upgrades of commercial appliances to meet energy standards (expires 7/1/2010);
- $3 per ton of biomass used to produce electricity (expires 6/30/2015).

History

The Business Activities Tax of 1933 was the state's first gross receipts tax on business. It was adopted as a temporary, emergency revenue measure during the Depression. The gross receipts form of taxation was upheld by the State Supreme Court in 1933 when it determined that a gross receipts tax was a proper measure of the privilege of engaging in business, rather than a tax on income.

Two years later, the Revenue Act of 1935 included the current B&O tax as a replacement for the Business Activities Tax. Initial tax rates were 0.25 percent for all business activities, except services which were taxed at 0.5 percent. Subsequent rate increases were enacted via surtaxes in 1951, 1955, 1959, 1976, 1982, and 1983. Over the years a number of specialized tax rates, typically at lower levels, were created for particular business activities, so that by the mid-1990s there were as many as 13 different B&O tax rates. In 1998, many of the specialized rates were consolidated into the existing 0.275 or 0.138 percent rates.

Two major attempts to broaden the B&O tax base - one successful, one not - occurred just before and just after the 1960s. In 1959, the Legislature attempted to extend the tax to income derived from the rental of real estate. However, the State Supreme Court ruled that the tax constituted double taxation, because the income was essentially derived from the real estate itself and this was already subject to property taxes. In 1970, the tax was broadened to include financial institutions under the service classification, following a revision in federal tax requirements.

The initial tax incentive to encourage economic development was enacted in 1965. This manufacturer's tax credit was intended to help manufacturing firms invest in new facilities. Another credit was adopted two years later; this continues to assist firms with costs incurred in upgrading pollution control facilities. The B&O tax was used to help deal with personal property taxes on business inventories; from 1974 through 1983 an increasing percentage of the inventory tax was creditable against B&O tax liability until inventories were exempted outright from property tax.

In the mid-1980s a major issue arose concerning the potential for double taxation of the same income for firms that operate in multiple states. The U.S. Supreme Court ruled in 1987 that Washington's B&O tax presented this possibility. In response, "multiple activity" tax credits were enacted for in-state firms that both manufacture and sell at wholesale or retail and for firms that operate both in Washington and in other states.

Major changes to the B&O rate structure occurred in 1993. New classifications for business services were created with rates as high as 2.5 percent, and existing rates were increased. By 1997 the new classifications were eliminated and the tax rates for all activities were returned to the pre-1993 levels. Also, in 1993 public and nonprofit hospitals were made fully taxable at the service rate, with the receipts dedicated to health care programs.

Prior to 1994, the B&O tax featured a threshold equivalent to $1,000 of taxable income per month. If a firm had gross receipts above this level, the B&O tax fully applied to all of the firm's income. In 1994 the current small business tax credit was adopted; this provided significantly broader tax relief for very small companies.

A major change in the tax for the distribution industry was enacted in 1998. The B&O tax intentionally pyramids, i.e., different firms at different levels in the chain of production are each subject to the tax. Thus, the same product can be subject to tax multiple times. This can present an advantage for integrated firms, e.g., those that distribute products they own to their retail outlets. To help offset that advantage, since 1955 a tax on "internal distributions" was applied to firms that distribute products they own to two or more of their own outlets. However, the internal distribution tax was repealed in 1998.

A variety of business incentives were adopted in recent years, starting primarily in 2003. These include preferential tax rates on manufacturing commercial aircraft, smelting of aluminum, production of semiconductor materials, and most recently timber harvesting and manufacturing of timber and wood products. The total exemption of income derived from processing fresh fruit and vegetables dates from 2005; it was expanded to include dairy and seafood products in 2006.

Two new taxes for specialized funds were instituted in the past two years: the 0.13 percent tax on games of chance and pari-mutuel wagering in 2005 and the additional 0.052 percent surtax for the timber industry in 2006.

Although technically subject to tax previously, legislation in 2009 specifically extended retail sales tax to digital goods, digital codes, and digital automated services. The bill also created specific B&O tax classifications for sellers of digital goods – 0.471 percent for retailers and 0.484 percent for wholesalers. Also in 2009, a permanently reduced tax rate of 0.2904 percent was allowed for printing and publishing of newspapers.

Discussion/Major Issues

As of July 2009, there were 804,145 firms registered with the Department for state excise tax purposes (excluding timber tax accounts and other taxes in lieu of property tax). However, many of the registered firms are temporarily inactive or are below the $28,000 filing threshold. Over 325,000 businesses were assigned to nonreporter status, meaning that they neither had to pay B&O taxes nor were required to submit tax returns. During Fiscal Year 2009 there were approximately 318,000 firms that actually had B&O tax liability (prior to credits) during the year.

Washington's B&O tax is unique; no other state, with the possible exception of Ohio, relies exclusively upon a comprehensive gross receipts tax on all businesses as its principal business tax. (Note: a variety of cities in other states do impose gross receipts business taxes, as do certain cities in Washington.) However, several other states do have elements of a gross receipts tax:

- West Virginia used to levy a similar gross receipts tax on all businesses, but their business and occupation tax is now confined to utilities.
- Several states - e.g., Hawaii, and New Mexico - impose a gross receipts tax which is in essence a broader form of sales tax. Although they include services, wholesalers, and even manufacturers in the gross receipts tax base, neither state has a separate retail sales tax and they also impose a corporate net income tax.
- Delaware also levies a gross receipts tax on business. It has a variety of tax rates, like Washington's B&O tax. However, Delaware also imposes a corporate net income tax on businesses.

- Texas levies a form of value-added tax. In 2006, Texas restructured its corporate franchise tax so that an element of the calculation considers gross receipts less wages paid (a form of value-added tax).
- Several corporate income tax states have an element of this tax which imposes an alternative minimum tax based on gross receipts for firms with low taxable net income. Examples include Kentucky and New Jersey.
- Other unique business taxes: New Hampshire has a business enterprise tax which features an element of gross receipts in the calculation; Nevada levies a modified business tax measured by wages paid to employees; and Michigan's new business tax considers both taxable and gross income.

The state of Ohio has phased out its former corporate net income tax and replaced it with a Commercial Activities Tax measured by gross receipts. Thus, Ohio is the only state similar to Washington in terms of business taxation, i.e., reliance on a comprehensive gross receipts business tax with no corporate tax AND an additional retail sales tax. However, the Ohio tax features a very high threshold for tax liability and much lower tax rates, as compared to Washington's B&O tax; firms are not subject to Ohio's business tax unless their gross receipts exceed $1 million.

Most other states (44) rely upon a corporate net income tax, plus a personal income tax for the income of noncorporate firms, similar to the federal tax. Washington's business tax generates a much larger portion of total state revenues than do corporate income taxes in most other states. This, plus the fact that businesses pay a significant share of the retail sales tax on supplies and non-manufacturing equipment, results in a relatively heavy initial tax burden for businesses in Washington, compared with many other states.

A gross receipts tax has several important advantages. It is easy to understand, simple to calculate for taxpayers, and auditing is relatively uncomplicated. The complex determination of net income is avoided, and there is no need to apportion business income among states for most multistate operations. (Some interstate service businesses may apportion their income, based on separate accounting or the cost of doing business within Washington and in other states.) The tax is deductible for federal income tax purposes as a cost of doing business. There is no discrimination due to the structure of the firm - corporations and noncorporate firms are treated alike. It is generally easier for a company to forecast its sales than its profits, so it may be easier to include the amount of the tax in its prices, if market conditions permit.

A gross receipts tax assures that profitable businesses and those organized as nonprofit are taxed the same for engaging in the same activity. And it assures that even firms that are intentionally operated at low profit margins, e.g., by paying abnormally high salaries to its owners, will pay some tax to the state for the government services they enjoy. Economically, the tax encourages firms to operate with maximum efficiency. Finally, a gross receipts tax can be more productive in terms of revenue generation, and it is one of the more stable revenue sources because collections do not typically fluctuate to the same degree that many other forms of business taxes do over the course of the business cycle. However, as witnessed during this latest recession, even B&O tax revenues can be adversely impacted by economic down-turns; Fiscal Year 2009 B&O collections were 7.8 percent lower than the prior year.

Despite some advantages, the negative features of a gross receipts tax can be significant. Most importantly, it imposes a heavy burden on new and small businesses that may not have reached their maximum level of operating efficiency or have yet to fully develop their markets and as a result are less profitable. Because established, profitable firms are favored at the expense of new, start-up businesses, the tax is often viewed as a detriment to economic development.

Because the tax does not consider profit potential, there is continual pressure on the Legislature to grant new preferential tax rates or provide other incentives to industries that have difficulty competing either in local or global markets. One of the state's primary industries, agricultural production, is entirely exempt from the tax.

Washington's gross receipts tax pyramids. This means that income derived from the same product may be taxed at multiple levels of the chain of production. This favors vertically integrated companies and is a hardship for firms that operate only at a single level.

Finally, the tax favors low-volume, high-profit types of business activities. For example, compare the profit margins of two different service industries: legal services, with typical net profits before taxes of, say, 18 percent, and barber/beauty shops with an average margin of about 5 percent. The applicable B&O tax rate is the same for both industries at 1.5 percent. But the effective tax rate measured against the firm's profits is very different: 8 percent for the legal services firm compared with 30 percent for the barber/beauty shop.