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## Finance Committee

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### HB 1644

**Brief Description:** Concerning the margin tax.

**Sponsors:** Representatives Walen, Ramel, Duerr, Pollet and Macri.

<p style="text-align: center;"><b>Brief Summary of Bill</b></p> <ul style="list-style-type: none"><li>• Replaces the State of Washington's business and occupation tax with a margin tax.</li></ul>
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**Hearing Date:** 2/20/23

**Staff:** Kristina King (786-7190).

**Background:**

Washington Business and Occupation Tax.

Since 1935, Washington's main business tax has been the business and occupation (B&O) tax. The B&O tax is imposed on the gross receipts of business activities conducted within the state without any deduction for the costs of doing business. Businesses must pay the B&O tax even though they may not have any profits or may be operating at a loss. Each legal entity must register and report taxes separately for affiliated entities.

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 a physical presence nexus in Washington; or
- is organized or commercially domiciled in Washington.

A business does not have to file an annual B&O tax return if the business does not owe other

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taxes or fees to the Department of Revenue and has annual gross proceeds of sales, gross income, or value of products for all B&O tax classifications of less than \$28,000 per year, or less than \$46,667 if at least 50 percent of its taxable income is from services or activities that are not classified elsewhere. 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 is a flat rate based on activity. A taxpayer may have more than one B&O tax rate, depending on the types of activities conducted. Major B&O tax rates are:

- 0.471 percent for retailing;
- 0.484 percent for manufacturing, wholesaling, and extracting; and
- 1.5 percent (businesses with taxable income of less than \$1 million) or 1.75 percent (businesses with taxable income of \$1 million or more) for services and for activities that are not classified elsewhere.

There are several surcharges on certain industries and activities, including surcharges on advanced computing and certain services for workforce education, timber or timber products manufacturing, specified financial institutions, and contests of chance. The B&O tax also includes approximately 200 tax preferences in the form of credits, deductions, exclusions, exemptions, and preferential rates for business activities, such as the preferential rate for newspaper publishers. A taxpayer may be eligible to utilize other tax preferences, including credits and deductions, to reduce their tax liability. For example, taxpayers engaging in business as a manufacturer or extractor are subject to state B&O tax regardless of whether the product manufactured or extracted is sold within or outside the state. If a taxpayer sells the manufactured or extracted product within the state, the taxpayer is subject to retailing or wholesaling B&O tax. However, a taxpayer engaging in activities subject to different B&O tax rates may be eligible for a Multiple Activities Tax Credit.

For the 2021-23 biennium, the state B&O tax is estimated to generate approximately \$12.5 billion and constitutes approximately 20 percent of near general fund revenue.

#### Local Business and Occupation Tax.

Washington cities are permitted to levy local B&O taxes. Local B&O taxes are levied at a percentage rate on the gross receipts of a business, less some deductions. Businesses activities fall under different classifications such as manufacturing, wholesaling, retailing, and services. Within each class the rate must be the same, however it may differ among classes. Forty-nine of Washington's 281 cities levy local B&O tax.

#### Public Utility Tax.

In lieu of B&O tax, certain businesses pay public utilities tax on income derived from the operation of publicly and privately owned utilities (transportation, the supply of energy, natural gas, and water).

### Texas Franchise Tax.

The Texas franchise tax is a privilege tax imposed on each taxable entity formed or organized in Texas or doing business in Texas. Unless a taxable entity qualifies and chooses to file using the EZ Computation, the tax base is the taxable entity's margin, and is computed in one of the following ways:

- total revenue times 70 percent;
- total revenue minus cost of goods sold (COGS);
- total revenue minus compensation—capped at \$400,000 per employee; or
- total revenue minus \$1.23 million.

If a taxable entity's annual revenue is \$20 million or less, the business can use the EZ Computation method to file its tax return. This method applies a tax rate of 0.331 percent to all Texas-based earnings.

Total revenue is determined from revenue amounts reported for federal income tax minus statutory exclusions. The COGS generally includes costs related to the acquisition and production of tangible personal property and real property. The compensation deduction includes the following: (1) W-2 wages and cash compensation paid to officers, directors, owners, partners and employees, subject to an inflation-adjusted per person wage and cash compensation limitation; and (2) benefits provided to all personnel to the extent deductible for federal income tax purposes, including workers' compensation, health care and retirement benefits.

Margin is apportioned to Texas using a single-factor apportionment formula based on gross receipts. The tax rates are:

- 0.375 percent for retailing and wholesaling;
- 0.75 percent for activities other than retailing and wholesaling; and
- 0.331 percent for the EZ Computation.

The franchise tax constitutes a little over 5 percent of Texas' general fund revenue.

### **Summary of Bill:**

Beginning in calendar year 2027, Washington's B&O tax is replaced with a margin tax modeled after Texas's franchise tax. A margin tax is often considered a modified gross receipts tax.

Businesses are taxed on their margin, which is calculated as worldwide gross income minus the greater of four deductions:

- cost of inputs, for example cost of goods sold;
- compensation paid—capped at \$400,000 per employee;
- 30 percent of gross receipts; or
- a flat amount of \$1 million.

Unlike Texas's franchise tax, 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 attributable to the state. 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. The amount attributable to Washington is multiplied by a 3.1966 percent tax rate to determine the tax due.

A taxpayer subject to the margin tax with gross income of not more than \$5,000,000 may elect to pay the tax based on an easy computation. The easy computation is a business's gross income attributable to Washington multiplied by a rate of 1.75 percent.

The margin tax is imposed on the same entities 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. Washington's surcharges for certain activities and industries, as well as registration and nexus thresholds are maintained. Local B&O taxes are maintained. Manufacturers and extractors, like the B&O tax, would owe the margin tax regardless of whether products are sold within or outside the state.

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 except for bad debts and cash and trade discounts.

The measure also:

- changes the filing frequency for all entities to an annual return due on April 15;
- 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 most deductions, exclusions, and exemptions except those 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; and
- compensates retailers by creating a retail sales tax credit.

**Appropriation:** None.

**Fiscal Note:** Available.

**Effective Date:** The bill takes effect on January 1, 2027.