HOUSE BILL REPORT
HB 2940

As Reported by House Committee On:
Finance

Title: An act relating to making the business and occupation tax more progressive.

Brief Description: Making the business and occupation tax more progressive.

Sponsors: Representatives Lytton, Chapman, Frame, Tarleton, Tharinger, Ormsby, Pollet and Macri.

Brief History:

Committee Activity:

Finance: 1/30/18, 2/5/18 [DPS].

Brief Summary of Substitute Bill

- Increases the business and occupation (B&O) tax filing threshold to $125,000, beginning January 1, 2020.
- Implements a B&O credit and a B&O surcharge based on the calculation of a taxpayer's "margin," beginning January 1, 2020.
- Repeals the small business tax credit, effective January 1, 2020.
- Creates the Task Force on Business and Occupation Tax Fairness.

HOUSE COMMITTEE ON FINANCE

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 6 members: Representatives Lytton, Chair; Frame, Vice Chair; Dolan, Pollet, Springer and Wylie.

Minority Report: Do not pass. Signed by 5 members: Representatives Nealey, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; Condotta, Stokesbary and Wilcox.

Staff: Tracey O'Brien (786-7152).

Background:

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

Business and Occupation Tax.
Washington's major business tax is 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.

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 for services and for activities not classified elsewhere. Several preferential rates also apply to specific business activities.

In addition, a taxpayer may be eligible to utilize other tax preferences, including credits and deductions, to reduce their tax liability. For example, a taxpayer engaging in activities subject to different B&O tax rates may be eligible for a Multiple Activities Tax Credit. A taxpayer may also be eligible for a small business credit that will either eliminate or reduce their B&O tax liability. In general, the credit is $70 per month for service businesses and $35 per month for all other businesses, multiplied by the number of months in the reporting period. The amount of the credit available phases out based on the business's gross receipts.

A business does not have to file an annual B&O tax return if the business does not owe other taxes or fees to the Department of Revenue (DOR) 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 not classified elsewhere.

The Economic and Revenue Forecast Council.
In 1984 the Economic and Revenue Forecast Council (ERFC) was created. The ERFC consists of two members appointed by the Governor and four members of the Legislature. One legislative member is appointed by the chairman of each of the two largest caucuses in the Senate and the House of Representatives. The ERFC was established to oversee the preparation of and approve the official state economic and revenue forecasts.

The ERFC is authorized to employ an economic and revenue forecast supervisor. The supervisor, Washington State's Chief Economist and Executive Director of the ERFC, is given the authority to hire staff to produce forecasts. The ERFC is an independent agency; it is not part of the Executive or Legislative branches.

Four times each year, the supervisor must prepare an official state economic and revenue forecast, an unofficial state economic and revenue forecast based on optimistic economic and revenue projections, and an unofficial state economic and revenue forecast based on pessimistic economic and revenue projections.

Summary of Substitute Bill:

Beginning January 1, 2020, the filing threshold for B&O taxes is raised to $125,000 for all businesses, and each taxpayer must calculate their margin in order to determine their eligibility for a B&O credit or a surcharge:

- If a taxpayer's margin is less than $250,000, the taxpayer is eligible for a credit equal to the B&O tax otherwise owed.
- If a taxpayer's margin is $1,000,000 or more, a surcharge of 6 percent is imposed on the B&O tax otherwise owed.
- If the taxpayer's margin is equal to or greater than $250,000, but less than $1,000,000, no credit is allowed and no surcharge is imposed on the B&O tax otherwise owed.

"Margin" for a current tax year is calculated by deducting the taxpayer's cost of goods sold and cost of labor, accrued for the immediately preceding tax year, from the greater of the taxpayer's total gross income of the business, or value of products manufactured or extracted, for that same tax year. Margin is only used to calculate eligibility for a credit or surcharge.

By October 1, 2019, the DOR must adopt rules necessary to implement the margin calculations. This includes definitions for "cost of goods sold," "cost of labor," and "new business." In addition, the rules adopted must include a method of allocating and apportioning cost of goods sold and cost of labor. The rules must also include provisions to deny taxpayers the benefits of a credit if they engage in arrangements or transactions in an attempt to unfairly avoid B&O taxes. Rulemaking to implement the margin calculation, credit, and surcharge portions of the act is exempt from significant legislative rulemaking requirements under the Administrative Procedures Act.

If a new taxpayer files quarterly or monthly and believes they will qualify for a B&O credit, they may claim the credit on each of the returns for the initial taxable year. However, if during the initial year the taxpayer reports a gross taxable amount of at least $250,000, the taxpayer may no longer continue to claim the credit and must correct prior tax returns to eliminate the credit election.

The surcharge of 6 percent is applied to the amount of B&O tax otherwise due if a taxpayer's margin is at least $1,000,000. Prior to implementation, the DOR may adjust the amount of the surcharge if the DOR determines the estimated collections of B&O tax will fall below or exceed projections by at least 1 percent during the first 18 months of implementation. Within the first 12 months of the surcharge being imposed, the DOR may adjust the surcharge by emergency rule if the DOR determines the estimated collections of the B&O tax will fall below or exceed projections by at least 1 percent during the first 18 months of implementation. The latest published fiscal note on this act will serve as the projection for the calculations.

Any adjustments to the amount of the surcharge must not exceed the amount needed to achieve revenue neutrality from January 1, 2020, to June 30, 2021, and must be carried to the fourth decimal point. A surcharge change is prospective only and must take effect on the first day of the calendar quarter that is at least 60 days following the publishing of the adjusted surcharge. In addition, any surcharge adjustment must also be approved by the director of the Office of Financial Management.

A method for recalculating the surcharge is provided, beginning in 2022 and each even-numbered year thereafter:

- First, the DOR must calculate the estimated amount of collections for the two previous calendar years had this act not been enacted. The baseline amount is the actual B&O collections for calendar year 2019 (CY19). The DOR must adjust the CY19 actual collections by the total percentage change in state personal income, as reported by the ERFC, from CY19 to the calendar year for which the DOR is calculating the estimated collections.
- Second, the DOR must calculate the adjusted actual B&O collections for the two previous calendar years. To accomplish this, the DOR must deduct the amount of collections resulting from the surcharge from the actual collections for that calendar year. The DOR must also adjust for changes in the B&O laws since December 31, 2019.
- Third, the DOR must calculate what the surcharge rate would have been required to be in the previous two calendar years to have been within 1 percent of the estimated amount of collections.
- The surcharge rate for the upcoming two calendar years will be the lesser of the surcharge from the previous two calendar years or the surcharge calculated under this formula, if approved by the ERFC.

By September 1, 2022, the DOR must notify the ERFC of the surcharge rate being proposed for the next two calendar years. By September 30, 2022, and September 30 every even-numbered year thereafter, the ERFC must consider and approve any change in the surcharge rate. If approved, the new surcharge rate will be in effect for two calendar years, beginning with the next odd-numbered calendar year.

The surcharge rate must not exceed the greater of the highest surcharge imposed in CY20 and 6 percent.

Effective January 1, 2020, the small business tax credit is repealed.

The Taskforce on Business and Occupation Tax Fairness (Task Force) is created. The Task Force is composed of the following 12 members:

- one representative from the Governor's Office;
- one representative from the DOR;
- one representative from the Department of Commerce;
- one representative from each of the two largest caucuses of the Senate, appointed by the President of the Senate;
- one representative from each of the two largest caucuses of the House of Representatives, appointed by the Speaker of the House of Representatives; and
- five members to be appointed by the Governor, taking into consideration representation from large businesses, small and independent businesses, advocates for economic security and social opportunity, and persons with expertise in Washington state tax law and policy.

The Task Force chair will be selected by the members from among its membership. The DOR will provide staff support. The Task Force must review existing B&O tax preferences to determine whether they are still necessary following the enactment of this act. Decisions will be made by a simple majority. A report is due to the appropriate legislative fiscal committees by January 1, 2022. The report may include recommendations for the elimination of any B&O tax preferences, options for improving the fairness of the B&O tax, options for replacing the B&O tax, and recommendations for future legislative oversight of the DOR's implementation of this act. A minority report is allowed if the Task Force does not reach complete agreement on the report contents.

This act is exempt from the tax preference performance requirements and the automatic 10-year expiration.

The act is named the "Small Business Tax Fairness Act."

Substitute Bill Compared to Original Bill:

The substitute bill provides for the recalculation of the surcharge beginning in 2022 for calendar years 2023 and thereafter. The maximum surcharge is the greater of 6 percent or the surcharge imposed by the DOR in 2020.

Appropriation: None.

Fiscal Note: Available.

Effective Date of Substitute Bill: This bill takes effect 90 days after adjournment of the session in which the bill is passed, except for sections 2, 4, 8, and 9, relating to the change in the B&O filing threshold, the tax credit availability for new businesses, the Task Force on B&O Tax Fairness, and the repeal of the small business tax credit, which take effect January 1, 2020.

Staff Summary of Public Testimony:

(In support) This proposal is a way to help small businesses thrive. It is a common complaint from businesses that Washington's B&O tax does not consider costs and expenses. This bill allows a business to qualify for a credit based on a margin calculation that will account for costs of goods and labor. This bill is designed to be revenue neutral. Under this bill, 80 percent of Washington businesses will owe $0 in B&O taxes and 14 percent will pay the same amount of B&O taxes as they do under current law. The remaining 6 percent will see a modest increase in their B&O taxes. This bill will have a positive impact on the economy by allowing businesses to expand, increasing hiring of employees, and opening additional business locations. The Task Force has great potential to further improve our tax climate by looking at tax preferences.

(Opposed) There are some ideas in this legislation that need further work. The lack of definitions for cost of goods and cost of labor makes it difficult to judge the impact for businesses. In addition, the DOR's ability to adjust the surcharge creates uncertainty for business. One of the benefits of our current B&O system is the stability of revenues. However, under this proposal a large company could have a bad year, bringing down the margin calculation and it could not owe any B&O taxes. Tax relief can be achieved without a surcharge and question if this is an unconstitutional graduated rate.

(Other) This bill takes from one set of taxpayers in order to give to another set of taxpayers. This is unfair. Moreover, there is already a substantial surcharge on the base. This would be a surcharge on a surcharge.

Persons Testifying: (In support) Representative Lytton, prime sponsor; Patrick Connor, National Federation of Independent Business/Washington; and Amber Carter, The Vancouver Clinic and Identity Clark County.

(Opposed) Clay Hill, Association of Washington Business.

(Other) Mark Johnson, Washington Retail Association; and John Ehrenreich, Washington Forest Protection Association.

Persons Signed In To Testify But Not Testifying: None.