



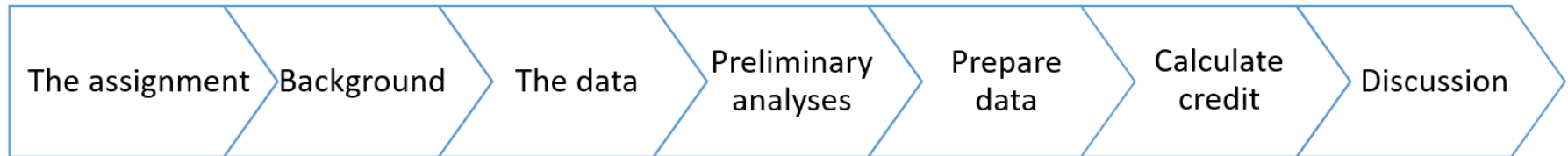
*"Working together to
fund Washington's future"*

B&O credit Personal Income Tax Model

March 2020

Sara del Moral, Tax Policy Specialist
Research & Fiscal Analysis

Overview



The assignment

Calculation of WA personal income tax

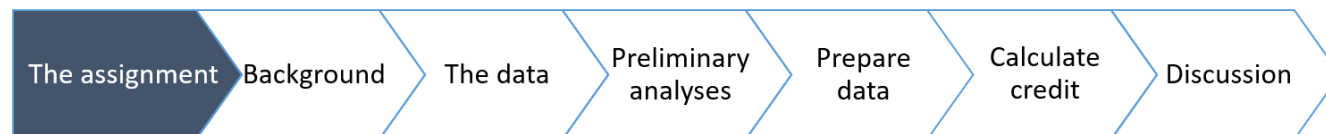
$$[\text{Taxable Income}] = \text{AGI} - \text{Deductions} - \text{Exemptions}$$

- **Deductions** = [Standard Deduction] + [Elderly Deduction] + [Disabled Deduction]
- **Exemptions** = 2,900 x [Count of filer, spouse, dependents]

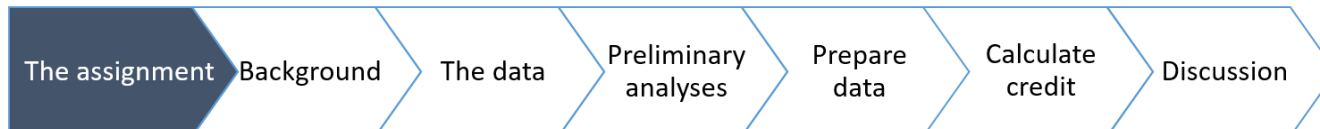
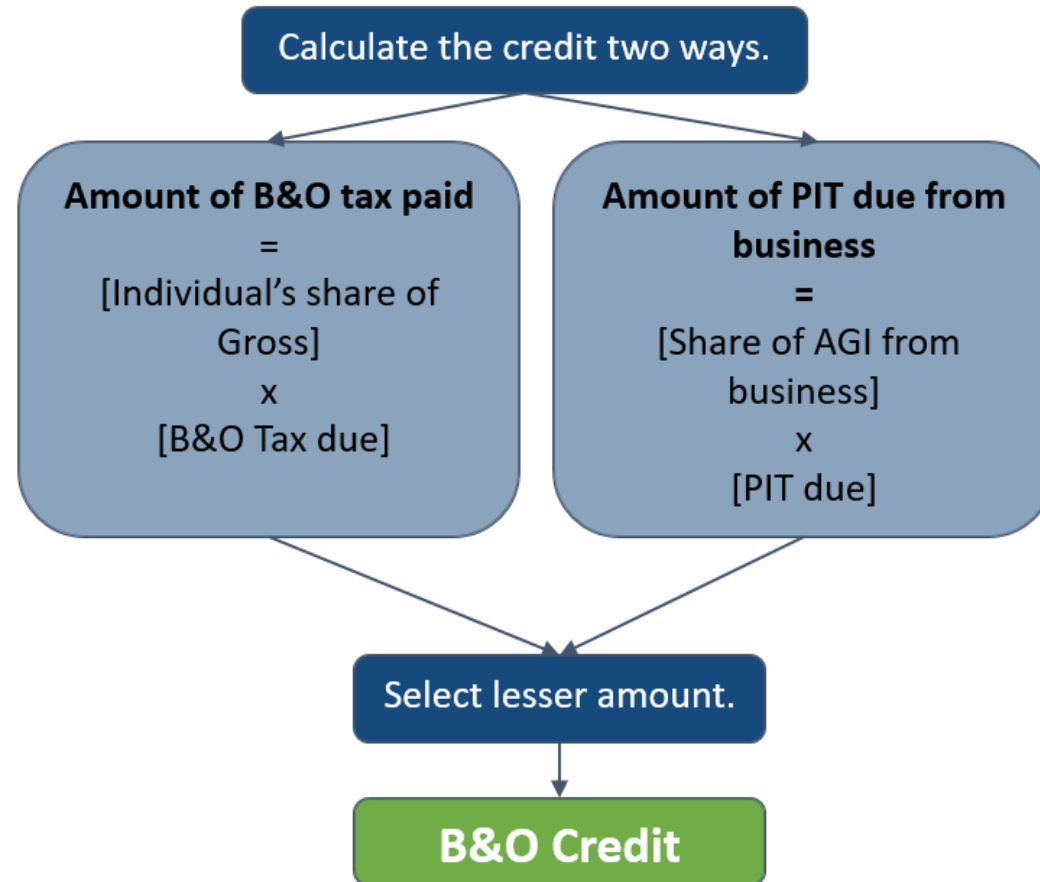
$$\text{Tax} = [\text{Tax Rate}] \times [\text{Taxable Income}]$$

$$\text{Credits} = [\text{B\&O Credit}] + [\text{Out-of-State Credit}]$$

$$\text{Tax Due} = \text{Tax} - \text{Credits}$$



The calculation



The Business and Occupation Tax Credit

2003 bills described the credit this way.

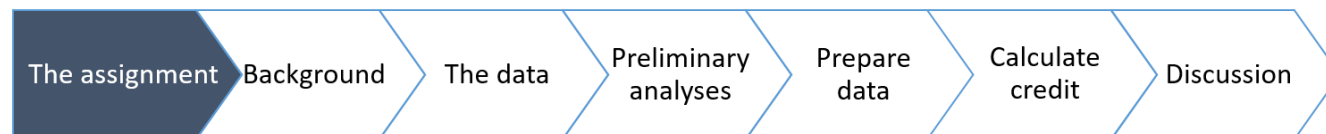
“(2) The credit shall not exceed the smaller of:

(a) The **amount of business and occupation tax paid**; or

(b) The **amount of [personal income] tax ... multiplied by a fraction:**

(i) The numerator is the amount of the taxpayer's adjusted gross income attributable to activities subject to business and occupation tax; and

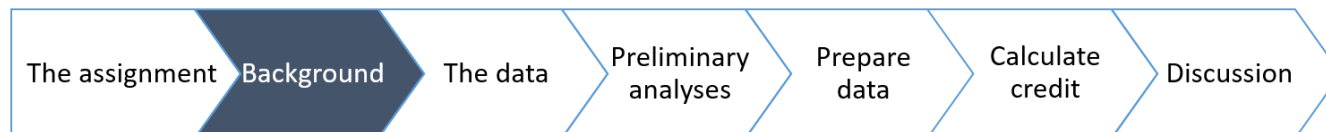
(ii) The denominator is the taxpayer's adjusted gross income as modified by this title. The fraction shall never be greater than one.”¹



Background

The business and occupation (B&O) tax

Gross receipts tax	Taxable = value of products, gross sales, or gross income No deductions for operating costs.
Exemptions	All businesses: Rental income Businesses not in financial sector: Investment income
Rates	Retailing: 0.471% Manufacturing & wholesaling: 0.484% Services: 1.500%
2020 reforms	Starting April 2020, services rate rises to 1.75% and certain businesses pay a 1.22% surcharge. ²



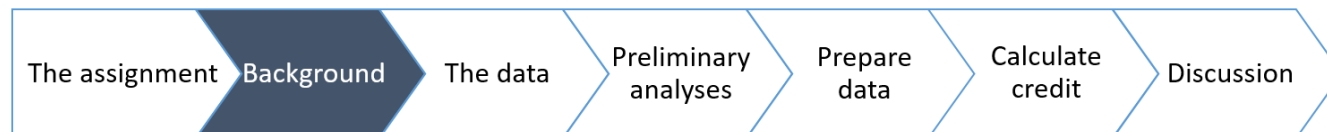
Pass-through businesses pay individual income tax.

For federal tax purposes, roughly **half of U.S. business activity** is reported as individual income:

- Some LLCs
 - Some corporations
 - Partnerships
 - Sole proprietorships
- Collectively known as
pass-through
businesses

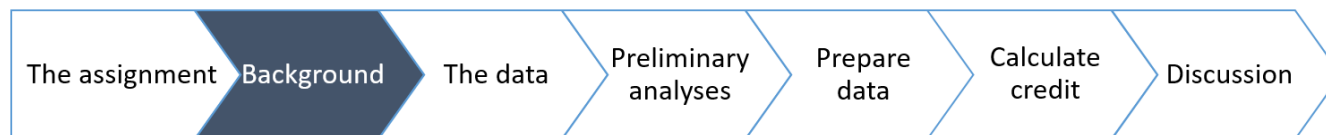
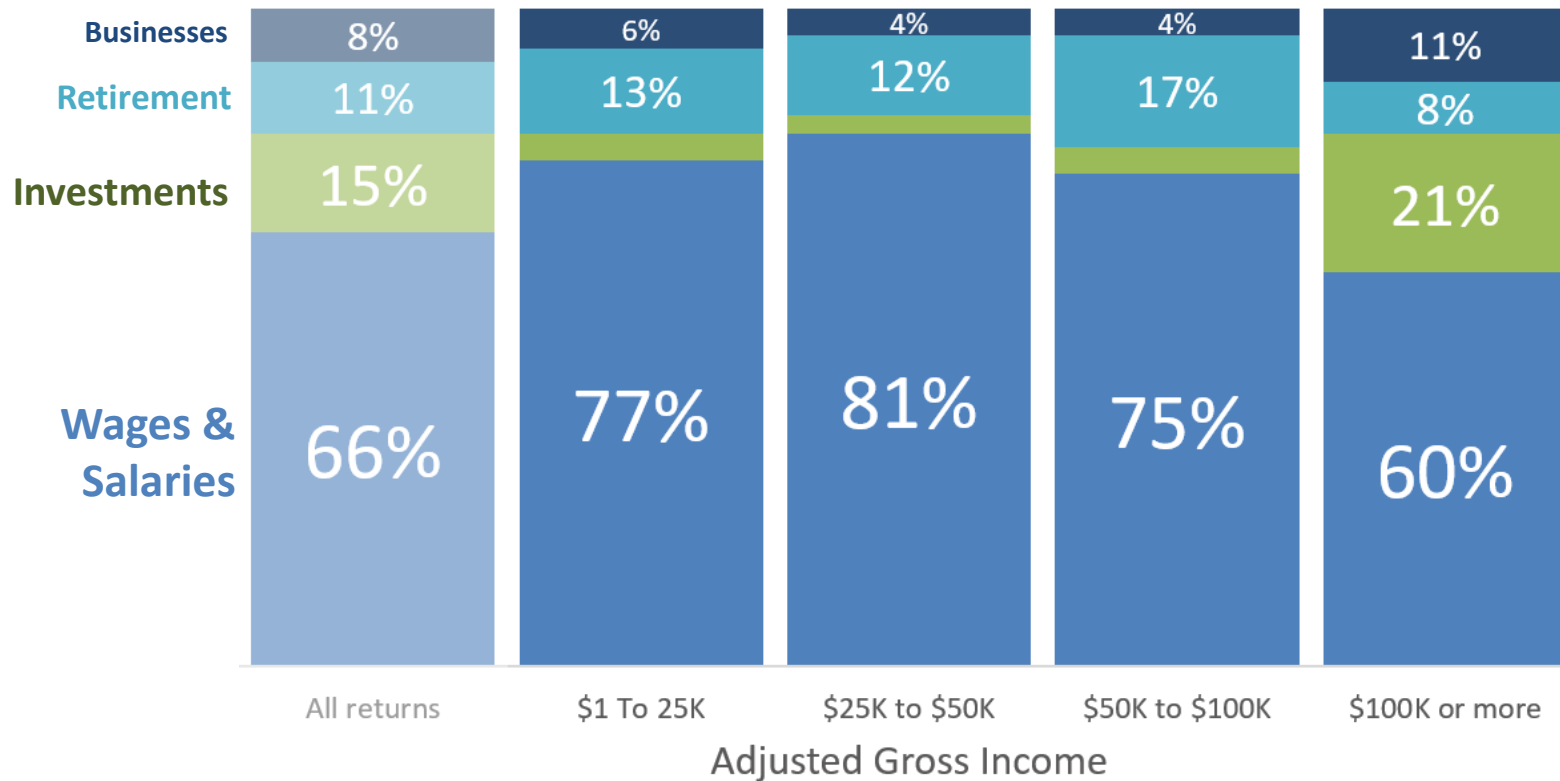
Partners and shareholders report amount of businesses income allocated to them.

Sole proprietors report income received.



Business income concentrated among higher-AGI individuals

Washington state, 2017



The data

IRS: Individual Income Tax Data

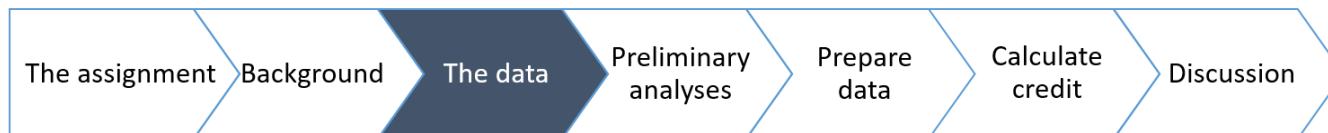
Returns dataset - for each individual:

- AGI
- Investment income
- Sole proprietor information

K-1 forms data:

- Most income components
- Deductions
- Lacks detail for some types of income

Like the W-2 for wage earners, the K-1 forms show income allocated to individuals with an interest in an S corporation or a partnership.



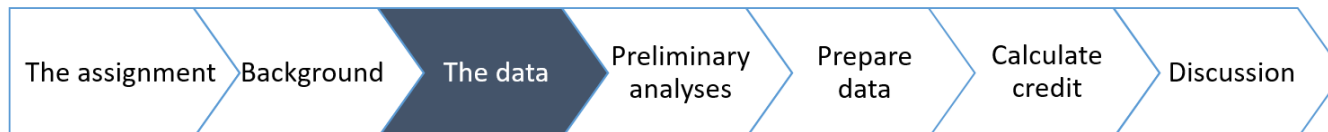
DOR: B&O tax data

Variables used:

- Washington gross receipts
- B&O tax paid
- Industrial sector

Match to IRS individuals data:

- Primary match on Federal Employer Identification Number (FEIN)
- Secondary match on address

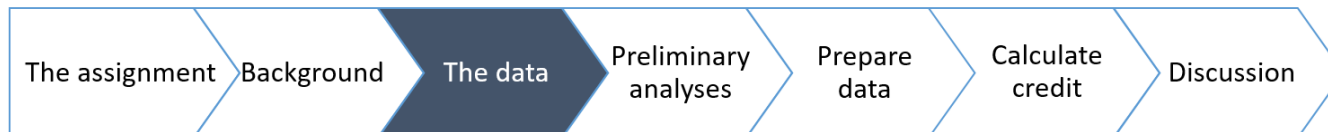


IRS: Business Returns

Variables used:

- National gross receipts and/or income
- Industrial sector
- Business structure (C corp, S corp, partnership)

Match to IRS individuals data on FEIN.



Preliminary analyses

Form assumptions about income components

To calculate the credit based on AGI, we need to know:

"... the amount of the taxpayer's adjusted gross income attributable to activities subject to business and occupation tax."

The IRS data lacks certain information:

Type	Limited information for:
S corporations, Partnerships	Other Income Sec. 1231 gains
Sole proprietors	Royalties Investment income

Form assumptions based on IRS Statistics of Income tables.



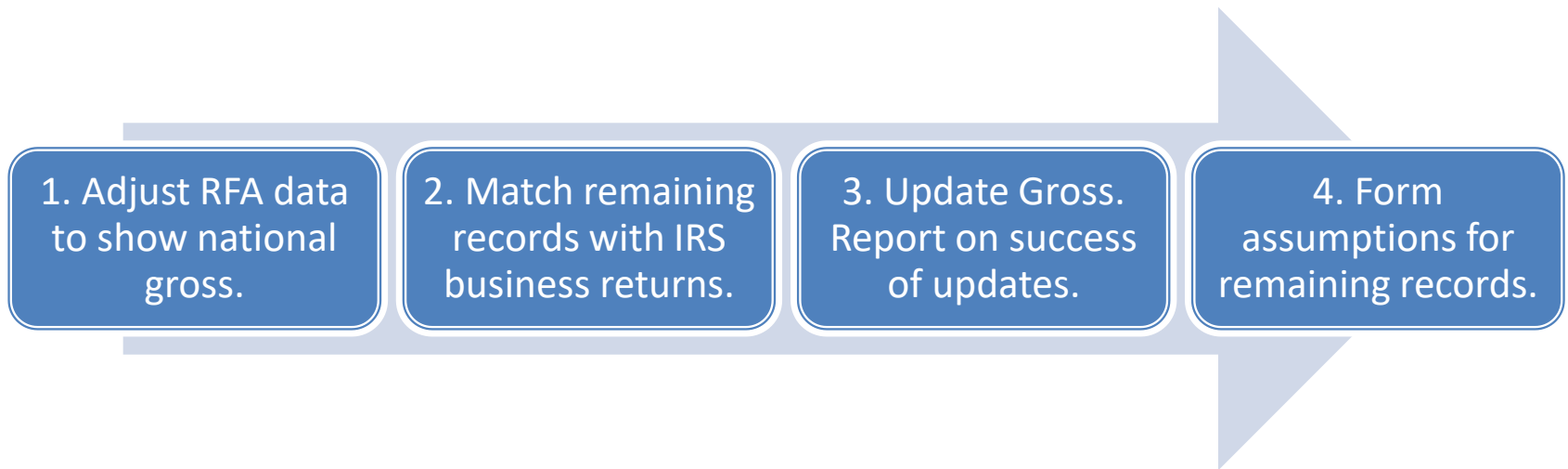
National gross receipts

To calculate the credit based on B&O tax paid, we need to know the amount of national gross receipts.

RFA data shows WA gross, rather than national gross.

For some businesses:

- DOR data shows national receipts only for some businesses.
- IRS business returns data shows total national income.



B&O gross receipts

To calculate the credit based on B&O tax paid, we need to know the amount of gross receipts for each individual.

But IRS data shows net income, rather than gross receipts.

Example calculation

Individual reports \$100,000 in net income from a partnership.

Obtain ratio of Net income: Business Receipts for sector (0.25).

Divide by 0.25 to estimate \$400,000 in gross receipts

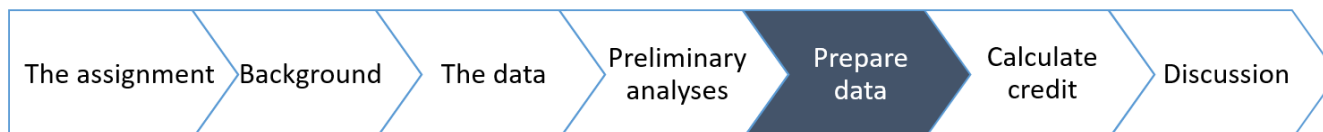
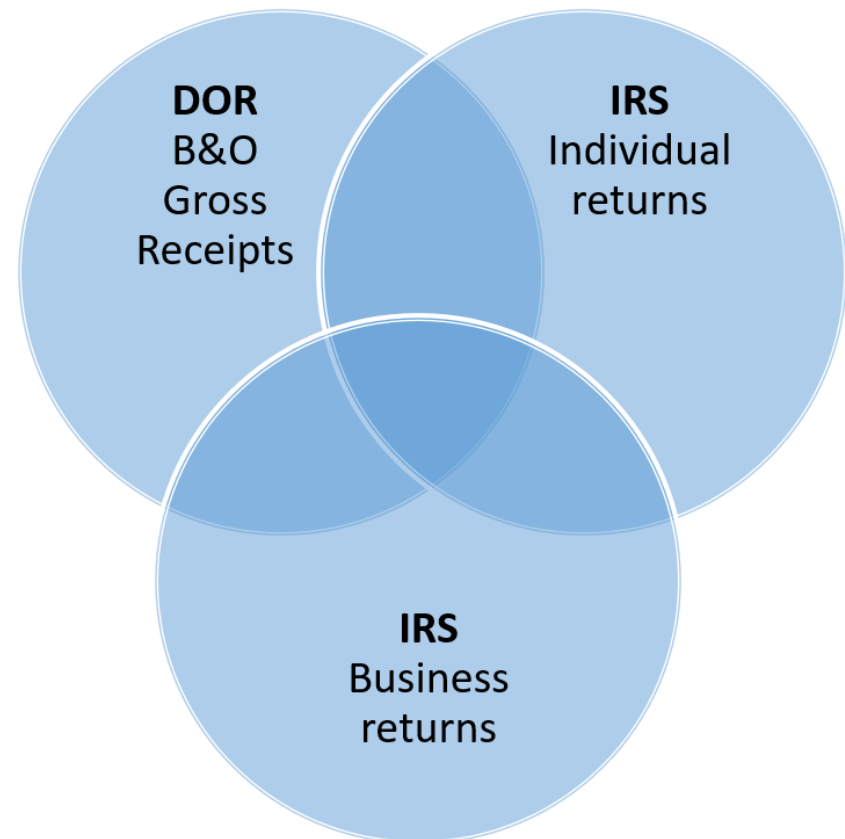


Prepare data

Match IRS Individual Returns with DOR data

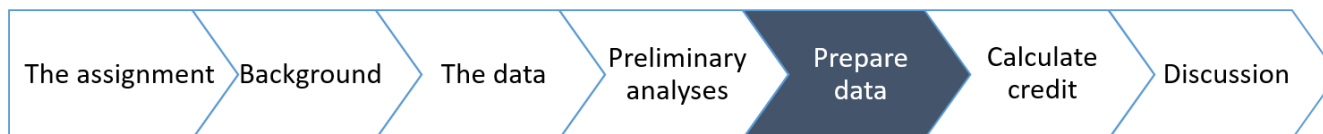
For each business in the IRS data, we want to know:

1. Industrial sector
2. Amount of B&O tax
3. Amount of national gross receipts



Produce matched table listing businesses.

FEIN	NAICS	B&O National Gross Receipts	Final Tax Due
Allows matching to individuals in IRS data	Is this a financial sector business?	Needed for calculation (2)(a) of the credit	



Adjust for false misses

In the B&O data, 16 percent of Tax Due is for records with no FEIN.

→ Failure to match an IRS business does not mean it isn't in the B&O data.

**Step 1:
Manually review.**

a. Select top
unmatched
businesses.

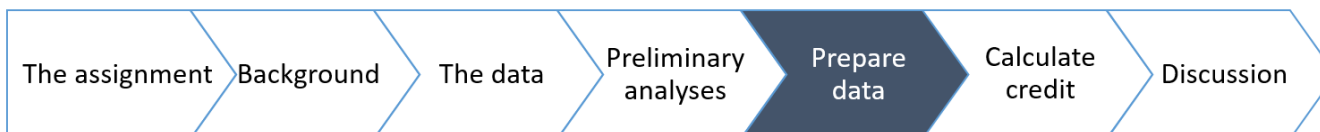
b. Use manual procedures to
attempt matching.

**Step 2: Assume
certain
businesses were
false misses.**

a. Sum up IRS
business
income with
DOR match.

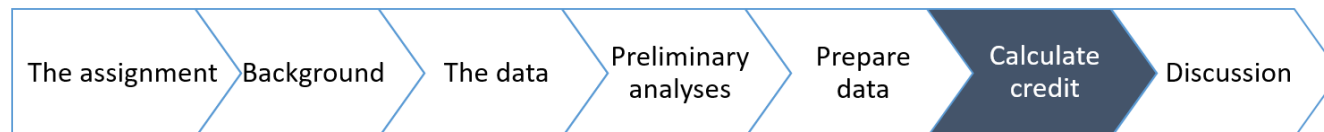
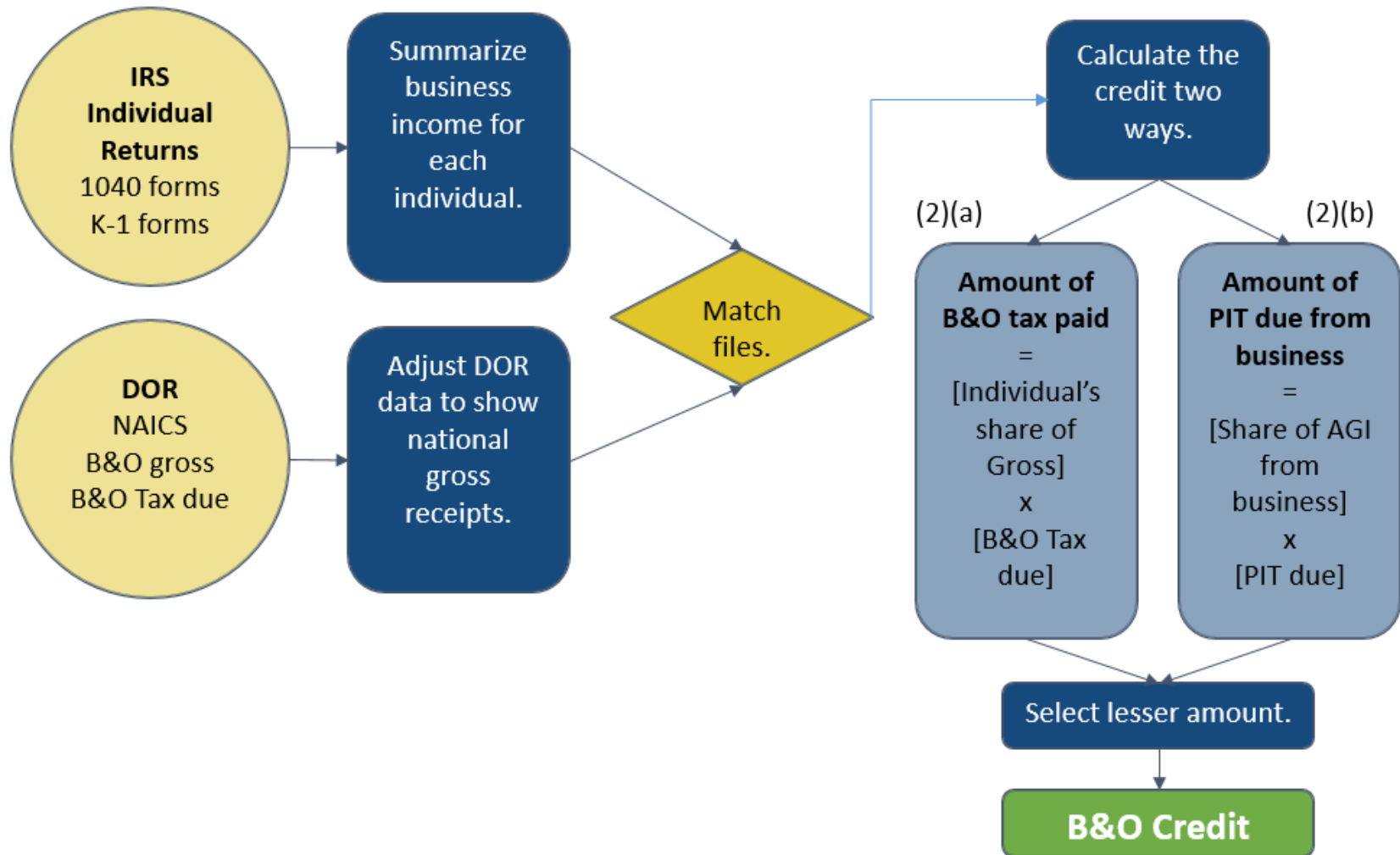
b. Obtain ratio
of unmatched
income to
matched (0.19).

c. Randomly select
additional businesses –
assume these are false
misses



Calculate credit

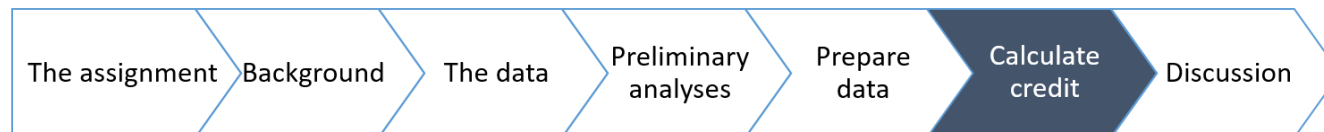
Two ways to calculate the credit



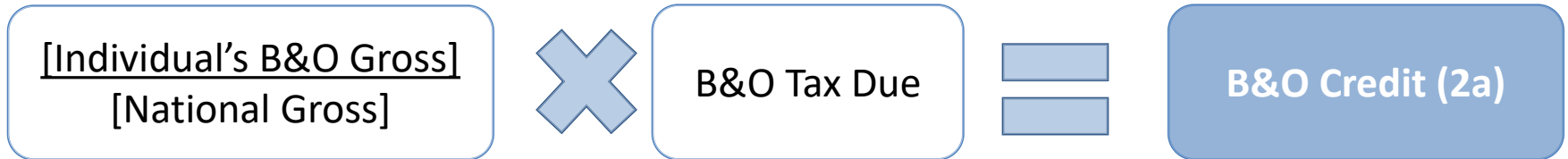
Prepare for calculation

Gather amounts calculated or matched in earlier steps.

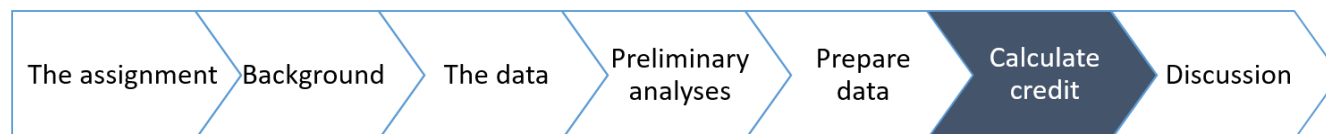
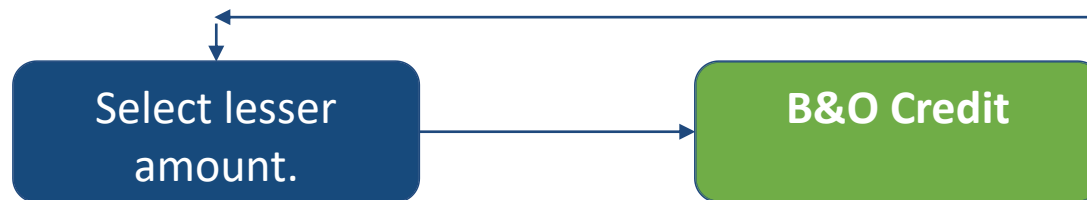
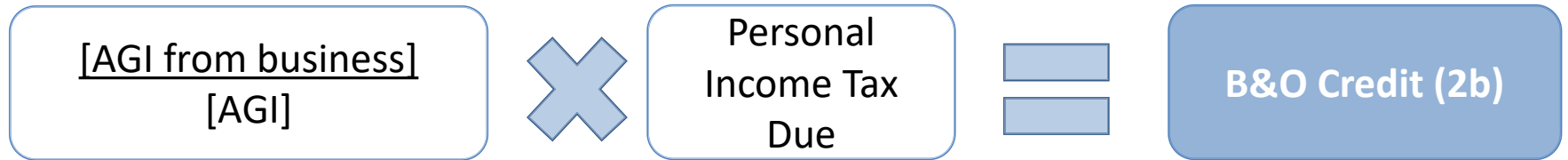
Individual					Business				
SSN	B&O Taxable Income	B&O Gross	PIT due	AGI from business income	AGI	FEIN	NAICS	National Gross	B&O Tax Due
999						888			
999						777			
998						888			
998						777			



Calculate amount of B&O tax paid.



Calculate amount of PIT due from business income.



Endnotes

1. Washington State Legislature (2003). *SB 5056: Implementing tax reform.*
(<https://app.leg.wa.gov/billsummary?BillNumber=5056&Year=2003&Initiative=false>)
 2. Washington State Legislature (2020). *SB 6492: Addressing workforce education investment funding through business and occupation tax reform.*
(<https://app.leg.wa.gov/billsummary?BillNumber=6492&Year=2019&Initiative=false>)
-

Discussion

For more information...

Model Review document

	Tax Structure Study – Technical Advisory Group
----------------------------------------------------------------------------------	-------------------------------------------------------

Model Review: B&O Tax Credit (Supplement to Personal Income Tax model)

Date	March 19, 2020
Contact	<u>Research and Fiscal Analysis Division (RFA)</u> Analyst: Sara del Moral; sarad@dor.wa.gov ; (360) 534-1525 Manager: Valerie Torres; valeriet@dor.wa.gov ; (360) 534-1521
Model Purpose	For the personal income tax (PIT) model, estimate the revenue impact of a business and occupation (B&O) tax credit, by estimating the credit amount for each filer.
Data Sources	(1) IRS: Individual income tax data (2) IRS: Business income tax data (3) Department of Revenue: B&O tax data
Requirements Model Used to Fulfill	This is a supplemental analysis, to support development of a model for a personal income tax, as required under ESHB 1109 (2019), Sec. 137(B) (c)(vii).
Questions for Technical Advisory Group	We do not have specific questions, but welcome advice and suggestions.
Questions from Technical Advisory Group	

Contact us:

Department of Revenue
Research and Fiscal Analysis Division

Analyst: Sara del Moral;
sarad@dor.wa.gov; (360) 534-1525

Manager: Valerie Torres;
valeriet@dor.wa.gov; (360) 534-1521