April Meeting

Date	April 14, 2020
Attendees	The following people attended the meeting via WebEx or on the phone:

Technical Advisory Group	**Department of Revenue**
Adam Cline	Kris Bitney
Doug Conrad	Preston Brasher
Lucy Dadayan	Sara del Moral
Robert Heller	Ian Doyle
Hart Hodges	Braden Fraser
Gary Holcomb	Don Gutmann
Patrick Jones	Melissa Howes
Sharon Kioko	Valerie Torres
Ashley Kitterll	
Steve Lerch	
Jeff Mitchell (phone in)	
Andy Nicholas	
Pete Parcells	
Rick Peterson	
Jim Schmidt	
Kriss Sjoblom	

Disabled Deduction

Sara presented.

Did you consider using categorical variables for age in a microdata regression instead of regression on continuous category means variable?
We will look into this and consider alternative model forms, in addition to the linear model shown as an example in the presentation. However, currently, we plan to use summary statistics from the American FactFinder.

Comment:
I looked at the ACS data Although ACS is a rich data source, I see how you are limited in how you would tie its data/definitions to IRS data when modelling disability, because of differences in definition, etc. One advantage of age is that it is clearly exogenous - age drives disability, not the other way around. Income, for example, may be endogenous as disability status also affects age. It seemed like explaining to someone could make it harder if you used other variables.

Response:
I would add that income variables in the ACS dataset have different definitions from those in the IRS dataset, which would introduce bias if income were included in the model. Since the ACS statistics reflect a strong association between age and disability, we prefer using only age as an explanatory variable.

Value Added Tax/ Margins Tax

Preston presented.

What is the logic behind providing a choice of deduction in the Margins Tax?
We will need to get back to you with detailed answer, but this is how the Texas Margin's Tax works and how the 2018 Study outlined a Margins Tax working in Washington.

Comment:
This could create higher taxpayer compliance and favorability to the system with businesses having a choice. However, this could create challenges to predicting revenues.

Response:
Yes, we agree. This may make it more palatable for certain taxpayers. This could also contribute to higher compliance.

Technical Advisory Group Question 1

> Nonprofits may be subject to taxation under the B&O tax. **Is it appropriate/practical to include these entities in the tax base for a VAT/margins tax? Are there other types of entities that are taxable under the B&O that we should model as nontaxable under a VAT/margins tax?**

There is some logic to exempting public and private non-profits that provide a community benefit. Many of these entities receive an income tax exemption because they provide an economic or community benefit (such as uncompensated care, education, research, etc.). In some states, the benefit must exceed or equal the tax they would pay or they do not receive an exemption. They act as a quasi-governmental entity. Bottom line – if an entity is providing a benefit/income to shareholders that is different than being a non-profit. Some health care providers have become taxable, even though their history and mission was nonprofit.

Comment:
Currently, the Legislative determined that B&O tax applies to non-profits. If the Legislature entertained an exemption for these types of entities from a VAT/Margins tax then they may need to consider that under the B&O tax.

Response:
Our initial determination was to include non-profits in the model, but to be prepared model both ways (in and out). They are not easy to include in the model. These entities file a different form with the IRS and we do not have as much data as we have for entities filing on other forms.

Is there a list of which non-profits are subject to the B&O tax and which are not subject to the B&O tax, so we could make an assumption of who would or would not be subject to the B&O tax?
From our data, we can find non-profits reporting B&O tax; however, finding non-profits not reporting tax to the Department is difficult. The Department does not have good data on taxpayers that do not report and/or pay taxes.

Value Added Tax/ Margins Tax, *continued*

How are tribal lands taxed?
Activities occurring on tribal land is not taxable; however, taxable activities occurring off tribal land by tribal members, the State can tax.

Comment:
Just a reminder, there are large municipalities that pay a great deal of public utility taxes and are classified as non-profits. For this reason, we would likely need to include them in the modeling.

Technical Advisory Group Question 2

> We plan to add back COGS and subtract bad debt from IRS total income to improve comparability with B&O taxable income. **What other adjustments to IRS total income will improve comparability with B&O taxable income? How can we calculate these?**

Comment:
B&O tax is more a revenue (gross) tax than a tax on income/profit. Some structures or exemptions used in a B&O tax may not be a good basis for a net income tax. Margins or VAT are more of a tax on your net, would not seem like the B&O tax would be a great basis for deciding if nonprofits are subject to tax.

Response:
Yes, a VAT/Margins tax is somewhere in the middle (between the B&O and these types of taxes) and we are in uncharted territory with this modeling.

Comment:
While exploring revenues related to the new Oregon Corporate Activities Tax (effective 1/1/2020) the COGS from federal return, is not accurate for smaller taxpayers. It is a geography on the tax return issue in that some smaller taxpayers now are moving income previously deducted on other lines to the COGS deduction. Basically, paying closer attention to get the most deduction from the Oregon Corporate Activities Tax. So, they are still taking a deduction – just a different deduction – mainly smaller taxpayers are moving to the COGS deduction; larger taxpayers appear accurate.

Technical Advisory Group Question 3

> **Should we group by additional variables, bearing in mind, for example, that the IRS and DOR data may assign the same taxpayer to different NAICS codes?**

The answer is yes, there is going to be a lot of confusion about NAICS categories. Particularly when the NAICS of the entity as a whole can be different from the NAICS for a firm within the entity. Having some way to double check is going to be crucial. Other variables for cross checking will be helpful. Our experience with looking at firms by NAICS and where they connect to national data we find discrepancies between entity NAICS and firm level NAICS. Therefore, anything you can do to cross check will help.

Value Added Tax/ Margins Tax, *continued*

Can you clarify interest and rent? What items are costs of production versus income earning/revenue gaining?

It is debatable how interest should be treated in a value added framework, but we don't think that interest charged adds to the amount of value added in a period. The amount of capital and labor used by a business and its productivity determines the business's production. The source of financing (debt vs. equity) does determine how much the business produces. The question is to whom the value added is attributed. Is the company that utilizes the capital and labor fully responsible for the full value of production, or should the lender be treated as creating value (a return on capital) equal to their interest income?

Under the current B&O tax, some interest income is taxable (financial service firms), but the rest is not. (To identify a "true" theoretical value added base, in a closed economy there should be the same amount of interest deduction allowed as interest income. However, in the interest of taking a more conservative approach, we would propose modelling all interest expenses as deductible, and only including interest income for financial service companies.)

A similar question arises with respect to rent. Is the company that utilizes real estate or tangible property fully responsible for the full value of production, or should a landlord, say, be treated as creating value added equal to their rental income? Under the current B&O tax, income from rental of real estate is not taxable, but rental of tangible property (e.g., vehicle rental) is taxable. We would like our model to remain consistent with this treatment, such that the VAT tax base includes only the portion of rental income associated with tangible property. Likewise, we would estimate the portion of rent expenses associated with tangible property, and assume that taxpayers can deduct that amount under a VAT.

Comment:
We endorse the way you are handling land rent and building rent. If you were doing a credit invoice, we would not be charging that to the rental business so there would be no deduction for that on the rental payment in the calculation.

Technical Advisory Group Question 4

> **How can we refine our approach to more accurately project the 2018 and 2019 VAT tax base and margins tax base?**

One thought we had was to compare the VAT to the Margins tax and evaluate if they are drastically different. If they are, we may need to use a more macro approach for the preliminary report and dig into the details after the preliminary report to validate the micro approach to the VAT model.

Technical Advisory Group Question 5

> **Are there any additional categories of taxpayers (or alternative groupings of existing categories) for which we should calculate tax paid as a percentage of total revenue?**

Value Added Tax/ Margins Tax, *continued*

Would there be ways to look at potential differences in markets served? Meaning is there a geographical basis that would add value to the analysis?
There are challenges to doing/adding value with a geographical location. It adds a level of complication in that businesses may do a particular activity in multiple locations and we may not have data to allocate the activity to the location.

Related Comment:
Thank you, for acknowledging, there is complexity and we always have to consider data. There would also be the added difficulty of these businesses having both an in-state market and an out-of-state market. I am glad you were thinking along these lines already.
Any comments or discussion related to the layout of the results.
Comment:
There will likely be quite a bit of interest in the incidence by industry. It would be good to be prepared for that, the slides appear to show results/incidence at the 2-digit NAICS and within some of the larger level industries there may be a lot of discussion.

We can accommodate additional granularity. It is just that the more granular we go; we have to watch and protect taxpayer confidentiality.

Comment:
As we have tackled the topic of corporate income type taxes and incidence, I have done some economic literature reviews. I was looking for consensus on a method about the incidence of business taxes. There are many articles but they appear to be old (2005 was the most recent). What I have found is there is not much consensus on the approach of determining the incidence of business taxes.

Meaning the ultimate incidence versus the initial tax incidence. After shifting who really pays the tax. The articles do not provide a definitive answer.

Response:
There would be some shifting of incidence depending on the portion; the value added tax may shift as much as the B&O tax. However, we do anticipate the questions regarding the behavior by taxpayers related to passing on the tax.

However, to be clear, what we mean by incidence here – is the direct incidence not the economic incidence.

Related Comment:
One article on this "incidence" question is by Ablett and Hart (2005) available in EconLit from Economic Analysis and Policy.

Is the tax paid as a % of Revenue before or after the B&O deductions?
Tax paid would be after the deductions, and the revenue would be before deductions but only represent the revenue apportioned to Washington.

Next Meeting	May 14, 2020 (1 to 4 pm) **Agenda:** Washington Tax Structure – Dick Conway Presentation Washington Tax Structure – Changes Since 2002