Time to Decide on an Oregon Gross Receipts Tax

by Michelle DeLappe

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In this edition of Skookum Tax News, DeLappe evaluates two Oregon gross receipts tax proposals in light of Washington's long experience with gross receipts taxes.

Oregon has two proposals for gross receipts taxes on the table. Initiative Petition 28 (IP 28) will likely appear on the ballot in November. A legislative proposal that did not pass (or even get formalized as a bill) during this year's short session might still gain traction in the future. In analyzing these proposals, Oregon should look to its neighbor to the north. Washington's long experience with gross receipts taxes provides important lessons. If Oregon is determined to impose a gross receipts tax, the legislative proposal presents the far wiser option.

Oregon, Washington, and the 3-Legged Stool

About 20 years ago, my mother returned from a trip to Africa with a beautifully carved wooden stool. The stool has an unusual two-part design: two pieces ingeniously cross to form both the seat and two legs of the stool. This two-legged stool is remarkably comfortable and stable — in some cases more than the typical three- or four-legged stool.

Perhaps because of that, I tend to question the proverbial three-legged stool as ideal for state tax structures. The metaphor is convenient for explaining differences in each state regarding the three traditional sources of tax revenue: income, sales, and property. It also wisely emphasizes the value of diversification and the dangers of relying excessively on one source of revenue. Applying the metaphor to Oregon and Washington highlights the stark differences in their tax structures and the weaknesses both encounter in relying mainly on one type of tax revenue. Understanding this provides a helpful backdrop for Oregon's current debate on gross receipts taxes.

Oregon's structure consists of income tax as the main leg and property tax as a half leg. Aside from some sin taxes, such as the new tax on retail sales of recreational marijuana, Oregon has no general retail sales tax. Oregon relies on income taxes more than any other state.[1] This includes both a personal income tax and a corporate income tax. The state's property tax is severely limited because of ballot measures adopted in the 1990s (Measure 5 and Measure 50).[2] An Oregon newspaper editorial published just before the 1997 vote on Measure 50 noted "the traditional criticism that [Oregon] needs another major tax to give its tax system the stability of a three-legged stool" but observed, "History may record that at this point in the evolution of their tax policy, Oregon voters actually preferred not just a two-legged stool but, with the property tax significantly reduced, a one-and-a-half-legged stool."[3]

Over the years, it has become clear that this structure suffers from lack of diversification as well as volatility over economic cycles. As explained by Oregon's Legislative Revenue Office, "Oregon's state tax system is highly volatile due to its high level of dependence on the personal income tax and to a lesser degree its dependence on the corporate income tax."[4]

In contrast, Washington's tax structure consists of sales tax as the main leg, with its business and occupation (B&O) tax and property tax as shorter legs. Washington has one of the highest sales tax rates in the nation, with a state tax rate of 6.5 percent, plus a local component that increases the total tax rate to nearly 10 percent in some areas. Washington is one of seven states without an income tax.[5] Instead it imposes tax on businesses' gross receipts. Through a combination of legislative and voter-initiated actions over the

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[1] David Brunori, "Want Bad Tax Policy? Here's a Blueprint," *State Tax Notes*, Jan. 12, 2015, p. 94.

[2] *See* Oregon Blue Book, Oregon Election History: Initiative, Referendum and Recall, *available at* http://bluebook.state.or.us/state/elections/elections06.htm (Measure 5 was adopted May 15, 1990; Measure 50 was adopted May 20, 1997).

[3] "Who Wants Three Legs? Probing Oregon's Tax Preferences," The Register-Guard, Oct. 29, 1997, p. 12A (*available at* https://news.google.com/newspapers?id=cdZWAAAAIBAJ&sjid=x-sDAAAAIBAJ&pg=6046%2C7378178).

[4] State of Oregon Legislative Revenue Office, "Analysis of Options for Restructuring Oregon's State and Local Revenue System," Research Report #4-15 (Dec. 2015).

[5] Richard S. Conway Jr., "Washington State and Local Tax System Dysfunction & Reform" (Nov. 2014), *available at* http://www.tre.wa.gov/news/news_waLocTxSysDysRef.pdf.

years, Washington has shortened its property tax leg, too, but its limits on this tax are not nearly as severe as in Oregon. The greater problem for Washington is the lack of diversification and high volatility because of its strong dependence on tax revenue from sales of consumer goods and new construction, both of which fluctuate greatly with economic cycles.[6] This imbalance also makes Washington's system one of the most regressive tax structures in the nation.[7]

The Highs and Lows of Washington's B&O Tax

Since it was introduced in 1935, Washington's tax on gross receipts — or B&O tax — has provided a relatively stable source of tax revenue.[8] That it applies to sales of both goods and services, not to mention other business activities such as manufacturing and wholesaling of those same goods, contributes to its stability.

As for fairness, though, Washington's B&O tax has disparate effects on different types of businesses. It tends to favor vertically integrated businesses, in which all levels in the chain of production occur within a single entity. It hits start-ups, small businesses, and businesses experiencing low profit margins hard. The tax applies even when a company is experiencing true losses. By their very nature, gross receipts taxes can have extremely different effective tax rates when measured against different businesses' profits.

Washington's B&O tax is also invisible to consumers because it is embedded in the business overhead and is not obvious to those paying for goods and services. As a result, Washington households cannot calculate the amount they spend on state and local taxes. Though the tax rate is low — generally between 0.138 percent and 1.5 percent depending on the activity — the overall effect of the tax is high because of its intentionally pyramiding structure: The same product can be subject to multiple layers of B&O tax as it progresses through the chain of production, which ultimately adds to the cost of the product. Due in part to the B&O tax, Washington has one of the least transparent tax systems in the nation.[9] Because income taxes are considered the most transparent type of tax, Oregon, in contrast, ranks as having the most transparent tax system in the nation.[10]

Moreover, though gross receipts taxes enjoy some advantages of simplicity by avoiding complicated calculations of net income, the B&O tax imposes several layers of complexity. There are 10 different B&O tax rates depending on the business activity, and many businesses perform multiple activities, each taxed at a different rate. Also, businesses operating in any of over 40 cities that impose business taxes must contend with the separate administration and compliance duties each imposes; efforts to centralize administration and reporting of state and local B&O taxes have failed in the face of fierce opposition, from Seattle and Tacoma in particular.[11]

While improved stability in tax revenue and simplicity in administering and reporting tax is desirable, Oregon should carefully consider the lack of fairness and transparency that would accompany a gross receipts tax.

IP 28: The Worst of All Worlds

Our Oregon, a coalition of government employee unions and others, is collecting signatures to put IP 28 on the ballot in November. The theme is "economic and social fairness for all Oregonians." The initiative would simply change the alternative corporate minimum tax that voters approved as Measure 67 in 2010. Currently, the minimum tax starts at $150 and gradually increases in set amounts based on a C corporation's gross revenues from Oregon-related sales of tangible goods; it essentially operates like a gross receipts tax with a tax rate of about 0.1 percent.[12] IP 28 would change this treatment for C corporations: Instead of a gross receipts tax of about 0.1 percent, it would impose a 2.5 percent tax rate on sales over $25 million.[13] This would be in addition to the corporate income tax. S corporations and other entity types — that is, partnerships and limited liability companies taxed as partnerships — statutorily escape the jaws of this tax. S corporations pay only the $150 minimum tax. The minimum tax does not apply to other types of entities. IP 28 would not change this result. If it passes, IP 28 would take effect January 1, 2017.[14]

All the criticisms discussed above regarding the lack of fairness and transparency in Washington's B&O tax apply with even greater force to IP 28 given its extremely high rate for a gross receipts tax. Washington's B&O tax rate on sales of tangible goods is less than 0.5 percent, and Ohio's commercial activity tax (CAT) has a rate of 0.26 percent. Some industries have net profit margins lower than 2.5 percent of sales even when the businesses in the industry have a high sales volume.[15]

The following is an example of a business with sales of $50 million under current law and under IP 28:

[6] *Id.* at 18-20 (based on state and local tax revenue for fiscal 1995 to 2011, Oregon ranks 21st most stable tax system in the nation, and Washington ranks 47th).

[7] *Id.* at 8.

[8] *Id.* at 24; Department of Revenue, Business and Occupation Tax Report (2010), *available at* http://dor.wa.gov/docs/reports/2010/tax_reference_2010/28bando.pdf.

[9] *Supra* note 5, at 25.

[10] *Id.*

[11] *See* Laws of 2015, ch. 55 (HB 2959) (forming a task force to study the problem and make recommendations for simplifying compliance with local B&O taxes).

[12] ORS 317.090(2)(a).

[13] Oregon Secretary of State, Initiative 28 (2016), *available at* http://bit.ly/1WGdgYh.

[14] Initiative 28, section 4.

[15] Mary Ellen Biery, "The Least Profitable Businesses in the U.S.," *Forbes*, Aug. 31, 2014 (listing 10 industries in which privately held companies averaged net profit margins below 2.5 percent after excluding taxes and including owner compensation in excess of market-rate salaries).

Type of Corporation	Current Minimum Tax	Minimum Tax Under IP 28
C corporation	$50,000	$655,001
S corporation	$150	$150

For a C corporation experiencing true losses, the minimum tax under IP 28 may well force a business to close its doors or at least move out of Oregon. For any C corporation with a large volume of Oregon sales, the tax represents an unprecedented increase.

Tax attorney Larry J. Brant of Garvey Schubert Barer in Portland, Oregon, has argued that IP 28 would hurt a significant number of Oregon businesses. He has advised several C corporations that have Oregon gross sales exceeding $25 million to convert to S corporation status. He also recollected the campaigns that ended with voters approving Measure 67 (which was coupled with Measure 66, raising the highest tax rate on personal income taxes). Both sides of the political debate focused on emotional appeals rather than on how the measure would actually affect taxpayers. The proponents' ads told of working, middle-income families paying high taxes while corporations pay nothing; opponents tried to depict small businesses barely scraping by and having to cut jobs because of higher taxes.[16] Opponents of Measure 67 did not make it clear how the minimum tax would eliminate jobs.[17] Brant said he hopes this year's campaign against IP 28 will focus on what the change in the minimum tax would actually do to Oregon businesses. There is also the danger of unintended consequences. IP 28's supporters have likely given no thought to how this change might affect, for example, nexus analysis under PL 86-272.

Hass Has a Better Approach

Sen. Mark Hass (D), chair of the Senate Finance and Review Committee, responded to IP 28 with a narrative proposal to replace the corporate income tax with a 0.39 percent gross receipts tax modeled on Ohio's CAT. The tax would apply to all types of entities, not just C corporations. His proposal would also ease some of the personal income tax burden on low- and middle-income Oregonians while still generating $1 billion in new revenue. This proposal still suffers from the lack of fairness and transparency as discussed above regarding Washington's B&O tax.

Although a balanced three-legged stool is not necessarily the goal, Oregon's and Washington's tax structures each rely too heavily now on a single type of tax, to those states' detriment. Washingtonians continually debate reforms to achieve a less regressive, more transparent, and simpler tax system that will support economic development.[18] Last year Washington State Treasurer James L. McIntire proposed an overhaul that would include a reduction of property, B&O, and sales taxes, along with a constitutional change to establish a flat tax on personal income above set exemption amounts.[19] For its part, the Washington Policy Center has advocated for a Texas-style gross receipts margins tax that would permit some deductions from taxable revenue.[20]

In Oregon, voters paying one of the highest personal income taxes in the nation[21] are quick to conclude that large businesses should pay more tax. And the Oregon Center for Public Policy, which took a prominent role in the campaign for Measure 67 to raise the corporate minimum tax, fuels that sentiment in its frequent publications on state corporate tax avoidance.[22] Hass's proposal includes measures to provide some relief on personal income tax; IP 28 does not. IP 28 would simply increase Oregon's reliance on the income leg of the stool without remedying the overall imbalance. Though Washington's experience should dissuade Oregon from adopting any gross receipts tax, between IP 28 and Hass's proposal, the less harmful option by far is Hass's. Educating voters about the harmful consequences of passing IP 28 is the main task ahead. ✰

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[16] William Yardley, "Voters in Oregon Approve Tax Increases," *The New York Times*, Jan. 27, 2010; and Jeff Mapes, "Ad Watch: Oregon Tax Measures 66 and 67," *The Oregonian*, Jan. 14, 2010.

[17] *See, e.g.*, William Hays Weissman, "Oregon's Measures 66 and 67: What They Really Showed Us," *State Tax Notes*, Feb. 15, 2010, p. 499 (discussing the difficulty of knowing what to believe in the competing sides' political advertisements).

[18] *See, e.g.*, Chris Grygiel, "The Infamous B&O Tax," *Seattle Business*, Feb. 2012.

[19] Joseph O'Sullivan, "State Treasurer Calls for Income Tax to Help Fund Education," *The Seattle Times*, Apr. 20, 2015. *See also* Washington State Treasurer website, *available at* http://www.tre.wa.gov/news/eduFinReform.shtml.

[20] Jason Mercier and Carl Gipson, "Replacing the Business and Occupation Tax With a Single Business Tax," Washington Policy Center (May 2010).

[21] *Supra* note 4, at 7.

[22] *See, e.g.*, Oregon Center for Public Policy, "Hundreds of Corporations Escape the Minimum Tax" (Mar. 30, 2015).