Understanding Gross Receipts Taxes and Steps for Complying with Washington State and City Business and Occupation Taxes

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July 2016

State and local gross receipts taxes are simple in concept, where all revenues received are multiplied by a rate to determine the tax due, yet they can be deceptively complex. This article addresses the steps a state tax specialist can take to identify, understand, and comply with gross receipts taxes, and places particular emphasis on Washington State’s notorious Business and Occupation (B&O) tax and the gross receipts taxes independently imposed by various Washington cities.

What Are Gross Receipts Taxes?
State and local gross receipts taxes are unique but not entirely unfamiliar to a state tax specialist. They are neither wholly sales or income taxes but share characteristics of both, which makes gross receipts taxes a strange hybrid.

Gross receipts taxes can be generally defined as: A tax imposed on an organization for the privilege of doing business in a jurisdiction which is measured by the total compensation derived from activities associated with the jurisdiction, without deduction for the cost of doing business, and calculated by multiplying the rate assigned to the activity performed to generate the compensation.

For state tax specialists familiar with sales and/or income taxes, it may be more helpful to identify a gross receipts tax by comparing its characteristics to the other taxes:

<table>
<thead>
<tr>
<th>General Gross Receipts Tax Characteristic</th>
<th>Tax Type Similarity</th>
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</thead>
<tbody>
<tr>
<td>Imposed on the seller</td>
<td>Income tax</td>
</tr>
<tr>
<td>Imposed on all industries</td>
<td>Income tax</td>
</tr>
<tr>
<td>Not separately invoiced to the customer</td>
<td>Income tax</td>
</tr>
<tr>
<td>Revenue from selling services must be apportioned</td>
<td>Income tax</td>
</tr>
<tr>
<td>Minimum threshold before the tax is due</td>
<td>Income tax</td>
</tr>
<tr>
<td>Assessed on the selling price</td>
<td>Sales tax</td>
</tr>
<tr>
<td>Few deductions</td>
<td>Sales tax</td>
</tr>
<tr>
<td>Reported monthly or quarterly</td>
<td>Sales tax</td>
</tr>
<tr>
<td>Activity performed may determine the tax rate</td>
<td>Neither</td>
</tr>
<tr>
<td>Rates are generally very low (2% or less)</td>
<td>Neither</td>
</tr>
<tr>
<td>Pyramiding in nature</td>
<td>Neither</td>
</tr>
</tbody>
</table>
There does not appear to be any definitive list of jurisdictions with true gross receipts taxes, which lends to the mystique of the tax. While open to debate, a handful of states and many cities and counties impose what may be considered true gross receipts taxes. Some of these jurisdictions include:

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Tax Name</th>
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<tbody>
<tr>
<td>Washington</td>
<td>Business and Occupation Tax (B&amp;O)</td>
</tr>
<tr>
<td>Ohio</td>
<td>Commercial Activities Tax (CAT)</td>
</tr>
<tr>
<td>Texas</td>
<td>Franchise Tax (Margin Tax)</td>
</tr>
<tr>
<td>Nevada</td>
<td>Commerce Tax</td>
</tr>
<tr>
<td>Delaware</td>
<td>Gross Receipts Tax (GRT)</td>
</tr>
<tr>
<td>Various cities in California, including Los Angeles</td>
<td>Business Tax</td>
</tr>
<tr>
<td>Various cities in Washington, including Seattle</td>
<td>Business License Tax or Business and Occupation Tax</td>
</tr>
<tr>
<td>Various cities in West Virginia</td>
<td>Business and Occupation Tax (B&amp;O)</td>
</tr>
<tr>
<td>Various cities and counties in Virginia</td>
<td>Business, Professional, and Occupational License (BPOL)</td>
</tr>
</tbody>
</table>

It is important to define what a true gross receipts tax is and which jurisdictions have them so court case holdings and other laws can be applied appropriately. For example, the nexus protection for certain sales activities provided by Public Law 86-272 applies to income taxes but not gross receipts taxes. Other jurisdictions have “gross receipts” taxes, which are more similar to a sales tax and therefore likely subject to the physical presence nexus requirement discussed in Quill.

History of Gross Receipts Taxes – Gross receipts taxes gained popularity in some states around the Great Depression. Businesses struggled to make a profit and did not have the cash to pay property taxes. For this reason, state income and property taxes were not creating a sufficient source of funds for the government, and gross receipts taxes were alluring.

Washington imposed its B&O tax in 1933, on the same day the state’s income tax was found to be in conflict with the state’s constitution. The B&O tax was intended to be a temporary measure to fill the emergency fiscal situation.\(^1\) Since then, a state income tax has been proposed several times to replace the B&O tax. Washington voters enjoy no personal income tax and soundly reject attempts to impose an income tax, even if it is just limited to imposition on businesses, perhaps fearing a slippery slope toward personal income taxation.

Public Policy – There are several reasons why pundits claim gross receipts taxes are poor public policy. First, because gross receipts taxes are imposed on the selling price

of each transaction in a product’s supply chain without a deduction for the cost of goods sold, gross receipts taxes intentionally pyramid. Tax pyramiding creates an artificial incentive for vertical integration within one legal entity. Second, gross receipts taxes are not equitable because companies not generating profits, such as startups, are taxed the same as companies with solid profit margins. Third, gross receipts taxes are not transparent and raise the cost of doing business in an imposing jurisdiction.

Despite these criticisms, businesses based in jurisdictions with long-standing gross receipts taxes tend to tolerate the taxes out of fear of changing to a new and unknown system of taxation. The Los Angeles Times wrote an editorial stating: “The gross receipts tax Los Angeles imposes on businesses is like a parasite that’s embedded itself deeply into the body of its host. Everyone wants to remove it, but no one wants to go through the pain.” The Washington B&O tax is another example of a relatively simple gross receipts tax concept which has mutated over time due to meeting constitutional requirements and providing businesses with incentives and the state with funding.

Trends – There is no consensus on whether a gross receipts tax is the right form of taxation. In recent years, several states and local jurisdictions are adopting, considering, and revising gross receipts taxes. Some of these jurisdictions include:

- Ohio - Adopted the Commercial Activities Tax in 2005.
- Texas - Adopted the Margin Tax in 2008.
- City of San Francisco - Adopted a gross receipts tax by voter approval in November 2012.
- City of Los Angeles - Revised its gross receipts tax in 2015 to reduce the rate applicable to professional service providers in an attempt to create a better business environment.
- Nevada - Adopted the Commerce Tax in 2015 with considerable turmoil. The first tax return is due in August 2016. An effort failed to put a public referendum on the ballot in November 2016 to repeal the tax.
- Oregon - Considering changing its taxation system to impose a gross receipts tax which will be voted on in November 2016 (Initiative Petition 28). Under the proposed revised taxation scheme, corporations with more than $25 million of Oregon-sourced receipts will pay a minimum tax of $30,001 plus 2.5% of the excess gross receipts over $25 million.

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3 Los Angeles Times, February 18, 2015.
Corporate Compliance Responsibility
Because gross receipts taxes have characteristics of sales and income taxes, a small company probably assigns gross receipts compliance tasks to its accounting department, whereas a large corporation’s tax department may struggle with whether to assign responsibility to its sales tax or income tax group.

For purposes of tax reporting compliance, an informal poll of state tax specialists revealed that the compliance task is typically assigned to the corporate tax department’s indirect tax group, likely because most gross receipts taxes have more sales tax characteristics when it comes to compliance issues, such as monthly or quarterly filing, and tax is imposed on the selling price. However, the gross receipts taxes, which have characteristics more similar to an income tax, such as the Texas Margin Tax, might be handled by the income tax group.

Washington’s B&O tax is typically handled by a company’s sales/indirect tax group because the Washington Department of Revenue administers the B&O tax and sales/use taxes without much differentiation; both tax types are reported on the same return and audited by the same auditor. This creates a symbiotic relationship between the two taxes, which does not exist in other states where the sales tax is administered separately. For example, in Washington, the definition of a “retail sale,” which is subject to sales tax, is found in the statute chapter on B&O taxes. This close tie between the B&O and sales/use taxes creates some challenges but also opportunities in terms of tax planning.

Washington City Tax Compliance - In Washington, there are 43 cities that independently impose their own gross receipts tax. The city taxes are similar to the state’s B&O tax in some respects but different in many others. The resulting additional compliance burden coupled with inconsistency and complexity is frustrating to many taxpayers who just want an easy method for reporting and paying these local taxes. The cities are working to solve some of these problems by creating an electronic portal called FileLocal, which is touted as a one-stop for local business licensing and tax filing needs. However, perhaps the most significant challenge for taxpayers is understanding the differences between the city and state’s methods of determining nexus, tax classifications, and apportionment and then creating special reports and workpapers to account for these differences. Many of the underlying frustrations with city taxes may not be solved by merely making the return submittal process easier. As a result, Engrossed House Bill 2959 was passed by the Washington Legislature in 2016. This law creates a task force to evaluate and recommend legislation and options for simplifying the administration of local business taxes and licensing.

Steps to Understanding Gross Receipts Tax Issues
Usually the first step to determining if an organization is subject to a tax is to answer the question of whether the organization has nexus, or sufficient connection, with the taxing jurisdiction. However, Washington’s B&O tax does not follow the typical rules. In Washington, the first step is to determine how a company’s revenue streams are classified. Revenues must be classified to determine how they are sourced.
appropriate nexus test is then applied to the different classifications of sourced revenue. Deductions are subtracted to determine the taxable gross receipts, and the applicable tax rate(s) are multiplied to determine the tax due. Many jurisdictions set a minimum threshold of gross receipts within the jurisdiction before tax will be due. Finally any credits may be applied to determine the liability.

Revenue Classification
Washington takes a very complicated approach to gross receipts classification by requiring that each separately stated line of revenue on an invoice be classified. Washington has four major B&O tax classifications: retailing, wholesaling, manufacturing, and service and other activities. The majority of businesses will report their Washington gross receipts under one or more of these classifications. And then there are the 49 other specialized tax classifications, which are usually the result of a special interest group receiving a lower tax rate. These specialized tax classifications include a wide range of activities such as splitting/processing dried peas, radioactive waste disposal, stevedoring, manufacturing of timber or wood products, and manufacturing of commercial airplanes. This vast array of classifications makes tax compliance much more challenging, especially when one company generates gross receipts from several different taxable activities. Some out-of-state companies with Washington nexus selling products or services to customers in Washington are not aware that this level of detail is involved in classifying revenue and inadvertently pay too much, or too little tax.

Washington’s Manufacturing Classification - The activity of “manufacturing” is broadly defined in Washington’s law as “all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof, a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use.” The manufacturing classification of B&O tax is imposed on the value of the products produced in Washington as generally measured by the selling price of the product. Because Washington’s tax is imposed on the value generated from certain activities, there are some situations where the B&O tax is imposed but no sale takes place. For example, if a company manufactures items for its own use, the B&O tax applies to the value of the manufactured item even though there is no income associated with the activity. The manufacturing tax classification rate is .484%.

Washington’s Retailing and Wholesaling Classifications - A “retail sale” is any transaction that meets the definition Revised Code of Washington 82.04.050. In addition to sales of tangible personal property, Washington considers several types of services to be retail sales. These services include the construction and repair of real property, repairs to tangible personal property, amusement and recreation activities, charges for extended warranties, tattoo parlor services, and many others. The sale of digital goods and services became a retail sale in 2009. Transactions subject to the wholesaling classification are, rather obviously, retail sales that will be resold by the

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6 Revised Code of Washington 82.04.120(1).
purchaser without intervening use. The retailing B&O tax classification rate is .471%, while the wholesaling B&O tax classification rate is slightly higher at .484%.

**Washington’s Sourcing of Retail and Wholesale Transactions** - Retail and wholesale sales of tangible personal property are relatively easy to source because Washington uses the delivery location and links the B&O tax to the sales and use tax sourcing law as prescribed by the streamlined sales and use tax agreement.7

**Washington’s Service and Other Activities Classification** - The service and other activities tax classification includes gross receipts from performing professional and personal services, as well as gross receipts that are not otherwise classified. The tax rate for the service and other activities classification is much higher than the others at 1.5%.

**Other Classification Problems** - Another complication related to determining the Washington tax classification is a manifestation of sales tax reporting. Sales tax compliance software does a good job of capturing data related to retail transactions subject to sales tax so the proper amount of sales tax can be reported. However, for gross receipts tax reporting where there are different tax rates for different classifications of activities, the sales tax compliance report typically does not capture nearly enough detailed information about the transactions not subject to sales tax, so they can be properly classified. Companies not familiar with the B&O tax will often determine their sales to Washington customers are “not taxable”. However, these companies are applying sales tax concepts to the transaction but fail to understand that a transaction not subject to sales tax may still be subject to some classification of B&O tax. Even if a company does understand that a non-sales taxable transaction is subject to B&O tax, it is a common and usually costly mistake to presume that such transactions are reportable at the wholesaling tax classification. Many times transactions not subject to sales tax actually fall into the service and other activities classification, which has a rate about three times higher than the wholesaling tax rate.

**Sourcing and Apportioning Gross Receipts**
Sourcing (or situsing) gross receipts generated from services is difficult. In 2010, when Washington switched to an economic nexus standard for certain service activities, it also changed its sourcing of service revenues from the location where the service is performed, to a market sourcing technique. There is a series of cascading tests for determining how to source revenue to Washington with the first test being where the customer receives the benefit of the taxpayer’s service.8 The economic nexus test effectively made many businesses located outside of Washington subject to the B&O tax, even if they never physically enter the state. Coupled with unclear rules for sourcing revenue, many companies headquartered outside Washington that perform services for clients in Washington are currently facing controversial and often large tax assessments.

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7 Revised Code of Washington 82.32.730.
The United States Supreme Court has held that gross receipts taxes are “required to be apportioned to reflect the location of the various interstate activities by which it was earned.”9 After sourcing the revenue to Washington, a calculation is done to determine the Washington-sourced revenue as a percentage of total world-wide revenue of a similar service nature. The resulting single-factor apportionment percentage is then multiplied by the world-wide revenue (after certain other adjustments are made) to determine the Washington taxable gross receipts.

**Washington City Tax Classifications and Sourcing** – The classification and sourcing challenges also exist for city gross receipts taxes, and to make matters worse they are in many cases quite different from how the state handles these issues.

The Washington cities that impose their own independent gross receipts taxes also have multiple tax classifications, but there are far fewer than the state. If an activity falls into a specialty tax classification at the state level, it is likely that the same classification does not exist at the city level, in which case the more general tax classification would apply. For example, the gross receipts taxable at the state’s manufacturing bio/alcohol fuel B&O tax classification would be reported at a city’s manufacturing B&O tax classification.

In some cases the cities have additional tax classifications to contend with. The City of Seattle divides the state’s retailing classification into two separate classifications. The city’s retail sales classification applies to sales of tangible personal property to consumers, and the retail services classification applies to services defined by the city as retail sales (such as repair of tangible personal property). Some activities have entirely different tax classifications at the city level. For example, gross receipts earned by beauty salons and barbers are subject to the state’s service and other activities tax classification, while the City of Seattle subjects these gross receipts to the retail services classification, and not the city’s regular services classification.

Sourcing and apportioning gross receipts to a city is another unique challenge. At least sales of tangible personal property are sourced to the delivery location, similar to the state’s sourcing rules. However, service gross receipts are apportioned to the cities quite differently from the state’s methodology. Service gross receipts are sourced to the city if the customer location is in the city, or the income producing activity is predominantly performed in the city as determined based on costs of performance, or the activity is performed in the city, and the taxpayer is not taxable at the customer location. The payroll and sales factors are calculated separately then averaged to determine the apportionment factor to be applied against world-wide revenue of the same service nature after deductions are claimed.10

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10 Revised Code of Washington 35.102.130.
Determining the Reportable Gross Receipts - The amount of gross receipts reportable to the taxing jurisdiction is not as easily quantified as it may seem. Take for example a single legal entity with manufacturing facilities located both inside Washington and outside Washington which also performs consulting services. The gross receipts reportable in this situation include the value of the goods manufactured in Washington, regardless of where they are ultimately sold, plus the sales price of the products manufactured outside of Washington and delivered to Washington customers, plus the world-wide revenue from all consulting services which will be apportioned.

Nexus

Nexus is the link between the selling organization and the taxing jurisdiction. Without sufficient nexus, a governmental jurisdiction may not impose a tax on a company.

Most jurisdictions imposing gross receipts taxes have used a physical presence test for determining nexus. However, nexus can now be established even without physical contact with a taxing jurisdiction. Perhaps emboldened by the presumption that Quill’s physical presence nexus test only applies to sales taxes, Ohio adopted a hybrid economic and physical presence nexus bright-line test for its Commercial Activities Tax in 2005. Washington adopted a nearly identical nexus test in 2010, but only for certain gross receipts classifications involving various types of services. Washington expanded the economic nexus test to include wholesale sales in 2015. The bright-line test sets various thresholds, and exceeding any one of the thresholds will create nexus:

<table>
<thead>
<tr>
<th>Nexus Threshold Tests</th>
<th>Washington’s Threshold Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property in the state</td>
<td>$53,000 or more</td>
</tr>
<tr>
<td>Payroll in the state</td>
<td>$53,000 or more</td>
</tr>
<tr>
<td>Apportionable gross receipts sitused to the state</td>
<td>$267,000 or more</td>
</tr>
<tr>
<td>Total property, total payroll, or total gross receipts within the state</td>
<td>25% or more</td>
</tr>
</tbody>
</table>

It is interesting that this nexus test includes both a physical presence element with the property and payroll thresholds, and an economic presence element with the gross receipts threshold. It is even more interesting that the law, which added wholesale sales to the economic nexus threshold test, also changed the year in which the tax may become due. As of September 15, 2015, if any of these nexus threshold tests are exceeded in one calendar year, nexus is created for that year, but no tax is imposed until the following calendar year.12

Because Washington now applies this nexus threshold test to both the apportionable gross receipts from certain service activities and wholesale sales, it is very important for out-of-state based companies selling and delivering goods to customers in Washington

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12 Engrossed Substitute Senate Bill 6138 Section 204.
to determine the correct classification of the revenue derived from these sales. For example, an out-of-state company without a physical presence in Washington may not have bothered to determine whether the purchaser will resell the items because there is no requirement to collect sales tax, or even resale documentation, without physical presence nexus. However, now that wholesale transactions are subject to the economic nexus test, sellers will be required to pay B&O tax on taxable gross receipts earned in the year following the calendar year when the nexus test is first met. The seller will only know if it has gross receipts derived from wholesale transactions if the purchaser provides its Reseller Permit or other resale documentation. In this scenario, without receiving resale documentation and without physical presence, an out-of-state seller will likely presume it is not subject to Washington’s B&O tax.

**Washington City Nexus Compared to State Nexus** - Washington cities imposing a gross receipts tax still use a physical presence test regardless of the revenue classification. This can create confounding complexity when determining if a company must register and pay taxes to a jurisdiction. For example, assume a California-based company sells goods and its only activity in Washington is meeting with a prospective customer located in the City of Tacoma. In this situation, the California company has established a physical presence and, thus nexus with Tacoma, so the gross receipts from sales delivered to the customer in Tacoma will be subject to Tacoma’s B&O tax. However, it will not be known if economic nexus with Washington State has been created unless the customer provides the seller with its Reseller Permit, buys the goods, and the total amount of annual sales sourced to Washington are known. If the economic nexus threshold is exceeded, state B&O tax will not be due in that year, but will be due on wholesale sales delivered to customers in Washington in the following year.

**Deductions and Credits**

While the very nature of a gross receipts tax indicates the taxable amount is the gross sales price, most gross receipts taxes do at least allow deductions for bad debts, cash discounts, and returns because these deductions truly are a reduction of consideration ultimately received by the seller and are not a cost of doing business. Some of the more common deductions and credits are discussed below, but there are many others that are very specific, and it is well worthwhile to peruse the list of deductions available on Washington’s Combined Excise Tax Return. These standard deductions are generally the same for the cities. However, note that both Washington and the cities generally do not allow deductions for related party transactions, which can be an unpleasant surprise for unsuspecting affiliates and especially entities disregarded for federal income tax purposes.

**Bad Debts and Cash Discounts** - One challenge in claiming deductions for bad debts and discounts is that the deduction must be related to revenue previously reported and taxed.\(^{13}\) Bad debts may not be written off for a couple of years after the original transaction, and documentation that the specific individual transaction has been taxed may be difficult to find.

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\(^{13}\) Revised Code of Washington 82.04.4284.
Interstate and Foreign Sales - Washington takes the position that sales of goods originating in Washington must be reported as a gross receipt and a deduction may be claimed if the goods are delivered outside of Washington.\textsuperscript{14}

Credits for Multiple Taxation - Due to the unique nature of Washington’s taxation of specific activities, there are situations when the same revenue is subject to the gross receipts tax within Washington more than once. The manufacturing B&O tax is imposed on the value of a product manufactured in Washington, and the wholesaling B&O tax is assessed on the sale made for resale of the same product to a customer in Washington. In this situation, a credit in the amount of the wholesaling B&O tax is applied against the manufacturing B&O tax on the same item. In essence, this multiple activities tax credit is merely a means of eliminating double taxation on the same transaction. This credit may also apply in certain situations if gross receipts taxes are paid to jurisdictions outside of Washington. The cities also allow a credit if the same transaction is taxed by another city.

Conclusion
Gross receipts taxes are different from sales and income taxes and can be deceptively and frustratingly complex. The general formula for how to address gross receipts tax issues in Washington is:

1. Classify all revenues
2. Source/apportion the revenues to the jurisdiction
3. Determine if nexus exists with the jurisdiction for each revenue classification
4. Claim deductions
5. Determine the tax due by multiplying the appropriate rate by the taxable amount
6. Claim credits

Once you become comfortable using this formula to solve gross receipts tax problems, you might even come to enjoy working with the taxes because they provide a unique opportunity for a state tax specialist to learn a lot about a company’s activities. Determining the classification requires asking a lot of questions to gather information, and it is typically necessary to obtain copies of the seller’s contracts and invoices with the buyer to verify the nature of the activities generating gross receipts. Sourcing revenues to a jurisdiction is more of an art than science and is open to various interpretations. Deductions from gross receipts are rare but do exist, so this step should not be overlooked.

Washington’s B&O tax is the granddaddy of the gross receipts taxes. It has been around for more than 80 years in substantially the same basic framework, but it has

\textsuperscript{14} Washington Administrative Code 458-20-193.
become more of a patchwork quilt to fit specific needs. There is an abundant amount of interpretations and case law available to explore. City gross receipts taxes can be more annoying than painful due to the additional high level of administrative burden necessary for compliance relative to the small tax base and low tax rates. Most often companies not fully versed with the B&O tax do not pay enough and may learn the hard way when undergoing an audit.