

SMALL BUSINESS TAX SIMPLIFICATION

A Report to the Governor



Suzan DelBene, Director – June 29, 2011

EXECUTIVE SUMMARY

This report was developed in response to Executive Order 10-05, which charged the Department of Revenue (Department) with exploring, evaluating, and recommending tax simplification solutions to help small businesses by reducing the complexity of the state's tax system.

The Department has collected more than 1,100 comments, concerns, and suggestions from small businesses through outreach efforts.

From the majority of comments and concerns, the Department concluded that the greatest tax complexity problems faced by Washington's small businesses related to:

- Reporting business and occupation (B&O) tax.
- Reporting retail sales tax.
- Understanding the reporting and licensing requirements of multiple agencies.
- Understanding tax administration processes.

Outreach efforts

The Department used the following methods to solicit feedback and gather data:

- Face-to-face meetings across the state with small business owners, business associations, and tax practitioners.
- Surveys of small businesses.
- Face-to-face meetings across the state with city, county, and other local government officials.
- Survey and focus groups with the Department's front-line employees.

Small businesses' findings

Small businesses struggle with reporting B&O tax for two primary reasons:

- Many businesses have to report local B&O tax to one or more of at least 39 cities that impose and administer their own B&O tax.
- The state has a daunting 51 B&O tax classifications. A business must report under one or more classifications depending on its activity.

This creates complexity for small businesses as they attempt to distinguish different classifications, definitions, rates, credits, deductions, and exemptions. It also creates an extra burden to report and pay B&O taxes to multiple jurisdictions using multiple forms.

Small businesses face tremendous complexity with retail sales tax such as:

- Washington has 424 local taxing jurisdictions, each with a distinct reporting code and tax rate. When a transaction occurs, the business must be able to identify the correct local taxing jurisdiction to ensure the sale is coded properly and the correct amount of tax is collected. This information is subsequently reported on its returns.
- Businesses find it difficult to identify and apply deductions, exemptions, deferrals, and credits for retail sales tax.

Finally, small businesses struggle to understand which state and local agencies they must deal with as they navigate the complex maze of licensing and reporting requirements. They think of government as one entity and expect to be able to access information and fulfill their obligations through this entity.

Local governments' findings

Local governments provided feedback indicating that any tax simplification solutions must:

- Be revenue neutral (this was the top issue for local government).
- Allow for ongoing local authority and flexibility to:
 - Set tax rates.
 - Tailor deductions, credits, and exemptions to a specific city's tax base.
- Not impose greater administrative costs than what it takes for them to run similar programs today.

Department recommendation

Based on extensive feedback from small businesses, there is consensus that the top priority to simplify their tax burden is to have a single way to file taxes across the state. To meet this need the Department recommends centralizing administration of state and local B&O tax reporting as is done with sales tax reporting today. This would provide one of the greatest simplifications for small businesses with the least impact on local governments. The net result would be consolidated reporting of all state and local B&O and sales taxes.

The message from Washington's small businesses is clear: they want to do the right thing, but because of complexity and lack of uniformity across jurisdictions, they spend valuable time and money to understand what that is. By centralizing administration of state and local B&O tax reporting, Washington can relieve a significant burden for small business owners—freeing them to get back to the work of running their businesses.

In addition, the Department recommends continued work to address feedback on administrative processes and ongoing efforts to look at integration of state systems, working towards a goal of a single business portal for small businesses to use to interact with the state.

INTRODUCTION

Governor's Executive Order improving services to small businesses

Executive Order 10-05 – Improving the Way State Government Serves Small Business – was issued by the Governor on October 26, 2010. This Order outlines priorities to make it easier to do business in Washington State.

The Executive Order is focused on improving services for small businesses (businesses with fewer than 50 workers). While many items in this report pertain to businesses in general, the focus of the Department's efforts, as well as the feedback we received, is around tax simplifications that will directly benefit small businesses.

In the Executive Order, the Department is specifically charged with exploring, evaluating, and recommending tax simplification solutions as a way to assist small businesses, draw businesses to the state, and keep Washington competitive. The Order calls for a business process with findings and recommendations due to the Governor by June 30, 2011.

The complexity of Washington's tax system

Currently small businesses interact with state and local government in three primary tax areas: B&O tax, sales tax, and business licensing. Each of these areas has its own level of complexity.

B&O tax complexity

- At least 39 cities impose their own B&O taxes with variations in rates, exemptions, deductions, and thresholds.
- Washington has 51 different state B&O tax classifications that businesses report under, depending on their business activities.
- The business community has expressed its growing concern around the lack of uniformity between state and local B&O taxes, despite the 2003 Model B&O Ordinance legislation.

Sales tax complexity

- Washington's retail sales tax includes two rates: (1) a state rate of 6.5 percent, and (2) differing local rates that require the use of 424 distinct local taxing codes.
- The variable local sales tax rates, while providing flexibility to local governments, result in extensive tax administration costs for retail businesses.

Business licensing requirements

- Approximately 212 of the 280 cities in Washington require a business to obtain a license if it engages in business in the city.
- Fees associated with the business license vary from flat rate charges to fees based on some combination of employee count, square footage occupied, and business type.

The current tax system creates a significant burden on businesses, especially small businesses.

OUTREACH EFFORTS

The Department used multiple channels to solicit ideas and examples of tax simplification for small businesses, including:

- Face-to-face meetings across the state with small business owners, business associations, and tax practitioners.
- Surveys of small businesses.
- Face-to-face meetings across the state with city, county, and other local government officials.
- Survey and focus groups with the Department's front-line employees.

Small businesses meetings

The Director and other Department representatives attended meetings with:

- Small business owners, bookkeepers, and managers.
- Business associations, such as:
 - Independent Business Association (IBA).
 - National Federation of Independent Businesses (NFIB).
 - Washington Food Industry Association (WFIA).
 - Association of Washington Businesses (AWB).
 - Washington Retail Association (WRA).
 - Tax Executives Institute (TEI).
- Chambers of Commerce from across the state.
- Members of the Hispanic business community.
- Members of the Asian business community.
- Tax practitioner groups, such as:
 - Washington State Certified Public Accountants (WSCPA).
 - American Society of Women Accountants (ASWA).



Business survey

In early January, the Department launched an Internet web page that included a brief background of the project and an online survey. The page was launched when our monthly, quarterly, and annual taxpayers came to the DOR website to file their returns. To boost response, the Department issued a press release, which was picked up by many media outlets.

Local government meetings

The Director and other Department representatives traveled throughout the state meeting with local government as well as with city and county associations. These meetings provided an opportunity to share the primary tax simplification ideas received from businesses and solicit information, perspectives, and concerns from local governments.

The Department held meetings in each of the following cities with local representatives including mayors, city council members, and finance and city managers.



The Department also met with:

- Association of Washington Cities (AWC).
- Washington Association of County Officials (WACO).
- Washington State Association of Counties (WSAC).

Department employees

The Department also turned to its front-line employees who work directly with businesses for feedback. A brief online survey was used to capture ideas employees hear from small businesses based on their experience with taxpayers. Employee focus groups were also held across the Department representing multiple divisions and specialties, especially those that work most directly with taxpayers. These employee conversations helped identify priorities based on direct experience working with small businesses.

SMALL BUSINESSES' FEEDBACK

While the Department received varied feedback from small businesses covering many areas and topics, comments and concerns fell into four main areas, specifically:

- Reporting B&O tax.
- Reporting retail sales tax.
- Understanding the reporting and licensing requirements of multiple agencies.
- Understanding tax administration processes.

Small businesses offered suggestions including:

- Offer one form to file and one place to go to report all business taxes.
- Reduce the number of sales tax rates and location codes.
- Reduce the number of tax classifications, exemptions, deductions, deferrals, and credits (B&O tax and sales tax) with a goal of lowering overall tax rates.
- Limit the number of times tax rates can change during a year.
- Offer one place to go for assistance with multiple state agency filing requirements.
- Continue to improve tax administration processes while not losing sight of efficiency and customer service.

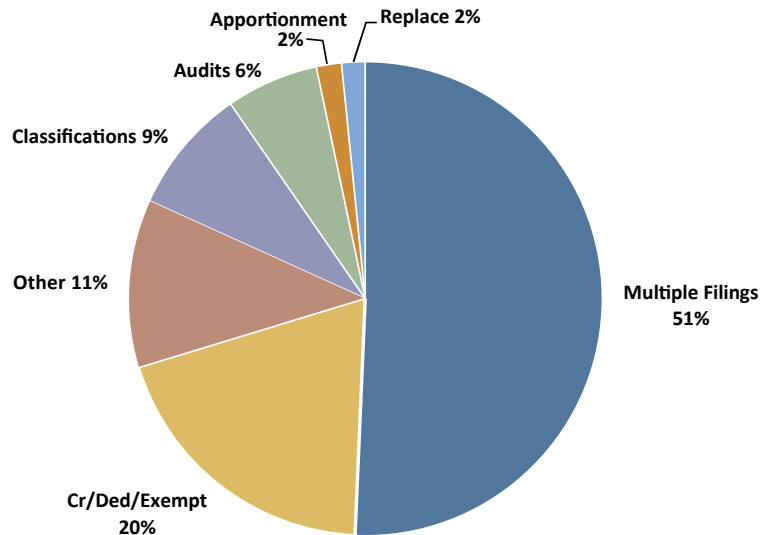


Reporting B&O tax

Small businesses shared many comments and concerns about reporting both state and local B&O taxes, including:

- The requirement to file B&O tax returns with multiple jurisdictions (separate forms).
- The number of classifications, credits, deductions, and exemptions.
- Other comments involved frustrations over:
 - Having a B&O tax when few states have this type of tax.
 - The fact that B&O taxes are based on gross receipts so they are due even if a business makes no money.
 - The belief that other businesses are not paying their fair share.
- The difficulty and burden of the audit process.
- Differing and complex definitions for both state and local B&O tax, including service apportionment.
- Replacing the current B&O tax with some other form of business tax.

Businesses' Comments about B&O Tax



Suggestions from small businesses for how to simplify B&O tax included:

- Pay all B&O state and local taxes to one place on one form.
- Lower rates and reduce the number of credits, deductions, and exemptions.
- Make definitions for state and local jurisdictions consistent, less complex, and less confusing.
- Reduce the number of state and local classifications.

“Don’t make me file with both the state and the city.... Have the systems talk to each other... Better yet, let me file both at the same time on the same website.”

— small business

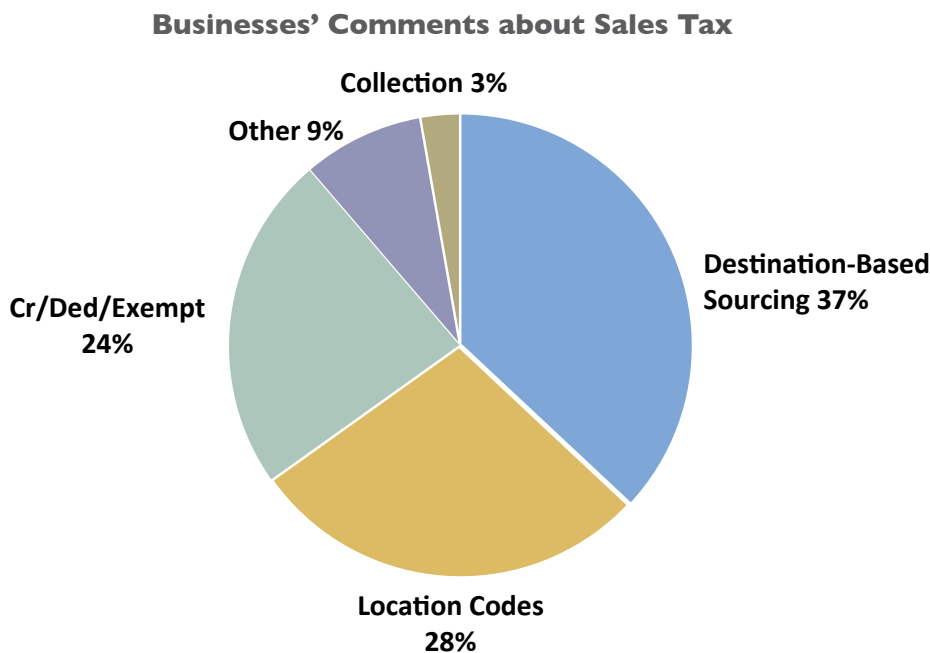
“Simplification means avoidance of complexity. Therefore a clear definition of the different categories or classes of business would help...”

— small business

Reporting retail sales tax

A majority of comments and concerns regarding retail sales tax included:

- The first two categories of comments are basically two sides of the same coin:
 - Small businesses reported having difficulty changing from origin-based sourcing to destination-based sourcing as a result of legislation in 2008, as well as with the multiple sales tax rates many businesses now contend with.
 - Location code comments were about the difficulty of determining and reporting the location of transactions, as well as the corresponding local tax rates.
- Identifying and applying deductions, exemptions, deferrals, and credits is very complex.
- Other comments were about many narrow or specific sales tax issues, such as the different sales tax treatments of purchases by contractors and the rapid introduction and subsequent repeal of candy and bottled water sales taxes.
- The burden of collecting and administering sales tax is heavy. Small businesses say this often takes days to calculate in-house or costs them a significant fee to hire a tax professional to calculate for them.



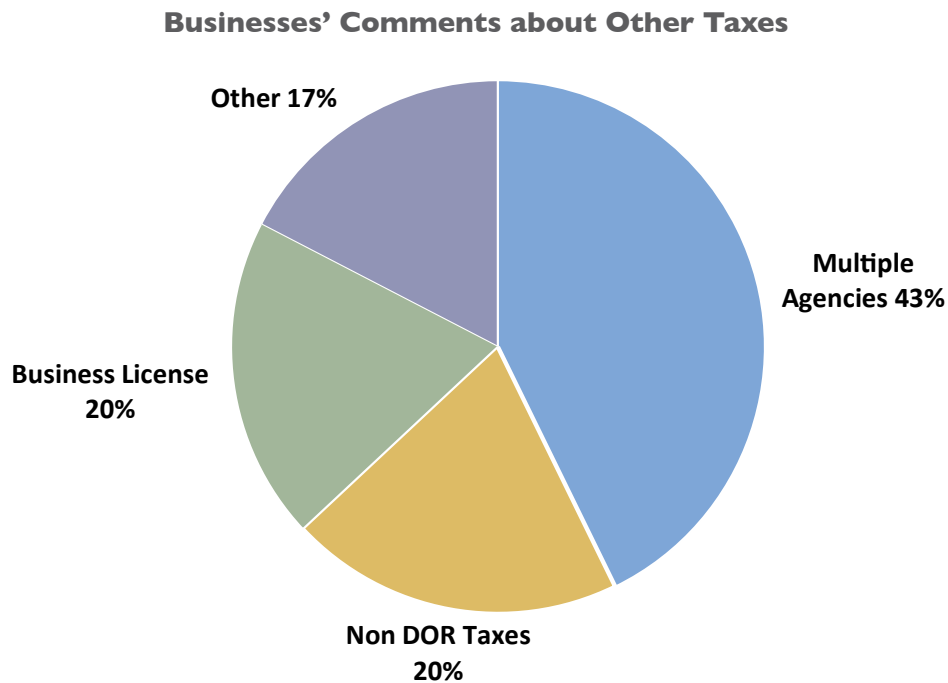
Suggestions from small businesses for how to simplify retail sales tax included:

- Fewer local sales tax rates, which could include:
 - One rate per county, or
 - A single statewide sales tax rate.
- Fewer location codes.
- Elimination or consolidation of exemptions, deductions, deferrals, and credits.

Confusion around reporting and licensing requirements with multiple agencies

In addition to improvements in reporting B&O and retail sales tax, businesses provided comments and concerns involving other topics, including:

- Filing requirements with multiple state agencies.
- Taxes not administered by the Department.
- Business license requirements in multiple locations.
- Other comments included those about the challenge of starting a new business and understanding government requirements.



Suggestions from small businesses for how to simplify confusion around reporting and licensing requirements included having one place to go for:

- State filing, rather than having to contact multiple state agencies.
- All state and local business licensing requirements.

“Make the due dates, penalty rates and interest rates the same for the Department of Revenue, Department of Licensing, Labor and Industries, and Employment Security Department.”

— small business

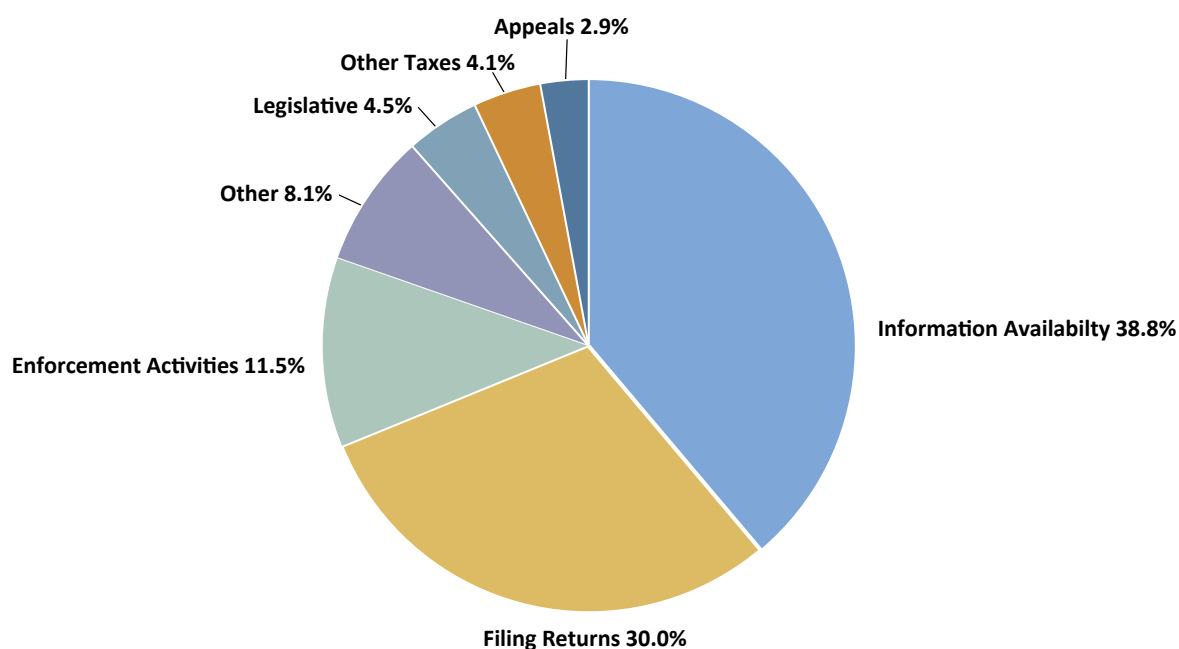
Improvements to tax administration processes

The Department received comments and concerns about tax administration processes and has already started addressing many of these comments.

The majority of the comments about tax administration processes were about:

- Information availability.
- Filing returns.

Businesses' Comments about Tax Administration Processes



Information availability

Small businesses shared concerns about information availability such as:

- Information is hard to find.
- More industry and tax-specific information should be available.
- Information on credits, exemptions, and deductions should be more apparent.
- More multilingual information is needed.



Suggestions from small businesses around information availability included:

- Tailor information to a businesses' activity.
- Create more industry and tax-specific guides.
- Make information on credits/exemptions/deductions more available.
- Provide more multilingual information.
- Make more Department determinations available and easier to find.
- Ensure consistency of information provided by staff, both on the phone and in person.
- Develop E-file customization enhancements.
- Make E-file more intuitive like over-the-counter tax reporting products.

Filing returns

Small businesses shared concerns regarding filing returns such as:

- E-file.
- Tax return forms.
- Filing frequencies.
- Reporting requirements.

Suggestions from some small businesses for improving the process of filing returns included:

- Tailor E-file to be industry-specific.
- Provide a more generic form for businesses with multiple activities.
- Provide an interactive Q&A tax form that will prompt taxpayers for the appropriate information depending on their situation.
- Provide more advanced notice of filing frequency changes for taxpayers.

Other categories small businesses commented on included:

- Enforcement activities – interactions with the Department for tax discovery, payment plans, and documentation.
- The refund process – time it takes to receive a refund and the documentation necessary.
- Tax dispute settlements – need for more information about the process.
- The Department's involvement in the legislative process – drafting of legislation, fiscal notes, and the implementation of new legislation.
- Other taxes administered by DOR – complexity of other taxes – such as forest tax, cigarette tax, fuel tax, litter tax, leasehold excise tax, and property tax.
- The appeals process – timeliness and issue resolution.

LOCAL GOVERNMENT FEEDBACK

What we heard from local government

Local government representatives generally supported the idea of centralized administration of B&O tax reporting. Discussions typically revolved around the fact that sales tax is collected for local governments and distributed by the state, and this process functions well. There was also general acknowledgement that centralization would be simpler for small businesses.

Local governments pointed out the following benefits of centralized administration

- Potentially reduce cities' administrative costs.
- Allow cities that cannot afford administration to have the option of enacting a local B&O tax.
- Increase statewide economic data.
- Reduce cities' employee workloads.
- Potentially increase enforcement and broaden compliance resulting in higher revenues.
- Eliminate redundant processes.
- Provide an opportunity for state and local government to look at tax structure, reporting, etc., holistically.

Priorities for all local governments

- Must be revenue neutral (this was the top issue for local government).
- Any solution should not impose greater administrative costs than what it takes for them to run similar programs today.
- Allow for ongoing flexibility and authority to:
 - Set tax rates.
 - Tailor deductions, credits, and exemptions to a specific city's tax base.

Additional feedback from local governments

In discussions with local governments, they stated that any type of central administration would need the:

- Ability to protect current and future funding levels and expenditures and provide local governments with the:
 - Ability to verify data for their locality.
 - Assurance that collection and enforcement activities will happen on their behalf (many cities currently can't afford an enforcement function).
 - Assurance that fund transfers would be timely.

- Ability to retain local authority and flexibility to:
 - Approve licenses.
 - Audit businesses in their city.
- Assurance that a central system can handle differences between the state and the various cities such as:
 - Thresholds.
 - Definitions and application of the law.
 - Deductions, credits, and exemptions.
 - Interest and penalty provisions.
 - Treatment of nonprofits.
 - Reporting frequencies.
 - Capturing different levels of business detail.
- Assurance that centralization won't force cities to enact a local B&O tax.
- Assurance that smaller cities will have a voice and that the larger cities won't drive the requirements of an integrated system alone.
- Ability to maintain local administration. This has been raised as a significant issue from the five largest cities that impose a local B&O tax: Bellevue, Bellingham, Everett, Seattle, and Tacoma. These cities have been exploring a way to develop a common portal so they can share administration of local B&O taxes.



DEPARTMENT RECOMMENDATION

Department's primary conclusions and recommendations

Based on extensive feedback from small businesses, there is consensus that the top priority to simplify their tax burden is to have a single way to file taxes across the state. Small businesses want:

- Consistent classifications and definitions across jurisdictions.
- As few rates and location codes as possible.
- Ability to customize the form they file (or have it customized for them) so that it only represents the information and fields relevant to their business.

Meeting their needs will require a multi-step plan to integrate systems and present a unified interface to businesses. It is also clear that small businesses do not differentiate between state and local filings. They see them all as a government driven administrative burden and want us to work together to provide uniformity and consistency whenever possible.

At the same time local governments want to maintain their revenue streams and their authority for tailoring tax rates, exemptions, credits, and deductions based on their needs. The Department has evaluated the feedback and recommends that we develop a plan to provide an integrated state and local tax system with appropriate uniformity and consistency to meet the needs of small businesses.

Today, the largest number of additional forms and filings for small businesses are the result of separately administered local B&O taxes. In addition, research conducted by the Department to date supports small businesses' claims that there are many differences between state B&O statutes, the 2003 Model B&O Ordinance, and the reality of how local governments are administering B&O taxes today.

Therefore, the Department recommends centralizing administration of state and local B&O tax reporting as is done with sales tax reporting today. This would provide one of the greatest simplifications for small businesses with the least impact on local governments. The net result would be consolidated reporting of all state and local B&O and sales taxes.

Centralized administration of B&O tax reporting includes:

- One form to file and one place to go for information.
- Fewer reporting classifications that are uniform across all jurisdictions.
- Common definitions.

Additional Department recommendations

This recommendation does not address all of the issues brought up by small businesses regarding simplification. The significant number of sale tax rates and location codes is also a large source of complexity and small businesses would like to see rate consolidation. The Department does not recommend rate consolidation because of the negative impact on over 300 local taxing authorities including cities, counties, public transit districts, regional centers, public facilities districts, Sound Transit, the football stadium authority and on Washington's participation in the Streamlined Sales Tax and Use Agreement. Given potential federal legislation, it would be imprudent to make changes that would have to be changed to conform to future national policy. Small businesses want consistency and this would be inconsistent with that goal. One way to address the sales tax variability impact would be to limit the number of times a year that sales tax rates can be changed so that businesses only need to reprogram systems a limited number of times a year.

In addition to the recommendations above, the Department believes work should continue on integration of state systems working towards a goal of a single business portal for small businesses to use to interact with the state. This is consistent with the findings of the Department of Commerce regarding Item #8 in the Executive Order, which called for a complete study to identify and evaluate the current regulatory steps and processes required of small businesses. One of Commerce's initial improvement opportunities is the creation of a "My Account" single sign-on for businesses, which would simplify how small businesses interact with state agencies.

Improvements to tax administration processes

The Department will continue to improve administrative processes based on suggestions from small businesses.

To address information availability issues, the Department will develop and implement:

- Search engine enhancements to make searches more effective in finding the information taxpayers need.
- Ongoing website enhancements and usability testing.
- A North American Industry Classification System cleanup effort that will allow the Department to more accurately categorize taxpayers to ensure they receive appropriate information and education for their industry.
- New industry-specific guides.
- New web page on sales tax exemptions.
- More multilingual information and services.
- More partner relationships with ethnic organizations and associations.

To address issues around filing returns, the Department will continue to:

- Communicate the benefits of E-file and ease concerns of new online customers by offering tools and resources that answer their questions.
- Work on our training and rule-writing efforts to ensure consistency of information provided by staff both on the phone and in person.
- Promote good administrative practices when advising the Legislature on new tax legislation.
- Make user-friendly enhancements to E-file (i.e. select button for tax classifications customization).
- Offer more educational tools about tax forms, filing frequencies, and reporting requirements.

NEXT STEPS

With approval from the Governor's Office, the Department will move forward with the following items:

- Based on stakeholder feedback, develop specific proposals and timelines to create a single tax filing form starting with the consolidation of state and local B&O tax filings and administration.
- Continue efforts to support an internet business portal for the state, as outlined by the Department of Commerce in response to the Executive Order, and participate in development of a plan to integrate systems.
- Draft any required legislation and estimate any fiscal impacts.
- Develop a plan to introduce any initial legislation during the 2012 session.

By doing this work, Washington can relieve a significant burden for small businesses—freeing them to get back to the work of running their businesses.





6500 Linderson Way, SW
Tumwater, WA 98501

PH: 1 800 647 7706