



A Margin Tax Would Make Washington's Tax Structure Only Marginally More Competitive

Briefly

A draft bill is being circulated that would replace Washington's business and occupation (B&O) tax with a margin tax. Like the B&O tax, a margin tax is a type of gross receipts tax. Unlike the B&O tax, the draft margin tax would allow the taxpayer to deduct the greater of (a) 30% of the taxpayer's total revenue, (b) a \$1 million standard deduction, (c) the cost of goods sold, or (d) compensation.

Gross receipts taxes fail several key principles of good tax systems, such as economic neutrality and transparency. Consequently, Washington and Texas (which currently has a margin tax that is the model for the Washington proposal) are ranked by the Tax Foundation as having, respectively, the fourth- and fifth-worst corporate taxes in the country.

In moving from the B&O tax to a margin tax, the state would be making only a marginal improvement in business tax policy. It would not make Washington's tax structure significantly more competitive, and it would create winners and losers in the business community.

If the personal income tax survives the ballot and the state Supreme Court, a corporate income tax could be an alternative option to the margin tax. Although that would also create winners and losers, it seems premature to change the business tax structure without considering it fully.

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Efforts to Change Washington's Business Tax Structure

Washington's B&O tax was enacted in 1935, after the state Supreme Court held that graduated income taxes are unconstitutional (WRC 2012a). The B&O tax is levied on gross receipts and businesses cannot deduct expenses. There are more than 50 tax classifications, with rates ranging from 0.138% to 3.3%. Activity-specific surcharges can increase the tax rate even further (e.g., to 9% for advanced computing businesses).

However, as we've noted, "Because the B&O tax is imposed on each business transaction, a single good can be taxed multiple times as it moves through a supply chain, a situation called 'pyramiding.' Because of pyramiding, the effective tax rate on final production is higher than the statutory rates charged at any one stage" (WRC 2017).

A similar issue occurs with intercompany transactions. As the Washington Department of Revenue (DOR) has written, "Intercompany transactions are generally eliminated from consolidated financial statements

to avoid misrepresenting the overall financial position of a group of closely-related affiliate entities. These intercompany transactions do not create additional wealth for the business enterprise. However, these transactions may still result in Washington tax liability” (DOR 2012). According to DOR, this characteristic of the B&O tax puts Washington in a “small minority of states” (DOR 2012).

In 2017, the Tax Structure Work Group was created by the Legislature to discuss “the advantages and disadvantages of the state’s current tax structure and potential options to improve the current structure for the benefit of individuals, families, and businesses in Washington state” (SSB 5883). In 2023, the Tax Structure Work Group recommended replacing the B&O tax with a margin tax (TSWG 2023). At the time, Washington did not have a personal income tax, so a corporate income tax was not considered a viable option. Legislation was proposed in Washington in 2023 to adopt a margin tax, but it did not advance (SB 5482).

According to the Tax Structure Work Group final report, “The margin tax shifts tax incidence away from small businesses” (TSWG 2023). Also, “While Real Estate, Rental, and Leasing sectors would experience the largest decreases in tax incidence, the Health Care & Social Services and Accommodation & Food Services sectors would experience the largest increase in tax incidence with the margin tax” (TSWG 2023).

How the Margin Tax Would Work

Texas currently has a margin tax, which it calls the Texas franchise tax. The Texas franchise tax is based on total revenue, and taxpayers are allowed to deduct 30% of revenue, the cost of goods sold, compensation, or a \$1 million standard deduction (TCO 2023).

The draft bill that is being circulated in Washington is based on the Texas franchise tax. The draft is not fully fleshed out, and many changes will likely be made before it is officially introduced. However, the broad strokes of the draft show how a margin tax would work.

First, the computation of taxable margin would begin with total revenue, which would be based on certain income reported on federal tax forms 1120 (for corporations) and 1065 (for partnerships). (DOR would be required to adopt rules to determine total revenue for other types of taxpayers.) Some exclusions are specified, both in general and for certain industries and activities.

Then, to determine the taxable margin, the taxpayer would effectively deduct the greater of: (a) 30% of the taxpayer’s total revenue, (b) a \$1 million standard deduction, (c) the cost of goods sold, or (d) compensation paid to officers, directors, owners, partners, and employees (limited to \$500,000 per employee). The taxable margin could not be negative.

The margin tax would be 1.75% times the taxable margin and at least \$250. However, there would be an “E-Z computation and rate,” in which taxpayers with total revenue of \$5 million or less would be able to elect to pay a 1.5% tax rate on total revenue, with no credits or deductions. (In Texas, the regular rate is 0.375% for retail or wholesale and 0.75% for other businesses. Texas’s E-Z rate is 0.331% and applies to businesses with up to \$20 million in revenue.)

The draft bill would allow businesses that are in an affiliated group and engaged in a unitary business to file combined group reports. Total revenue for each member would be added together. Then, a combined group would deduct either the group’s combined cost of goods sold, the group’s combined compensation, or \$1 million. By allowing reporting as a combined entity, the intercompany transactions issue discussed above would be eliminated.

The margin tax would be effective Jan. 1, 2028. However, under the draft, the margin tax would be phased in and the B&O tax would be phased out. A taxpayer's margin tax liability would be reduced by 80% for CY 2028, by 60% for CY2029, by 40% for CY 2030, and by 20% for CY 2031. Meanwhile, a taxpayer's B&O tax liability would be reduced by 20% in CY 2028, by 40% in CY 2029, by 60% in CY 2030, and by 80% in CY 2031. The B&O tax would be repealed Jan. 1, 2032.

The draft bill notes that it is the intent of the Legislature to maintain the advanced computing surcharge and specified financial institution surcharge "and apply these surcharges to the applicable margin tax base," but it's not clear how that would work in practice. The draft bill would provide a deduction from revenues in the amount of a capital gain that is subject to Washington capital gains tax, in order to avoid double taxation. However, there is no similar deduction or credit related to Washington's personal income tax, suggesting that this draft was developed before its adoption.

There is no fiscal note for the draft bill. However, with a tax rate of 1.75%, it would almost certainly reduce state revenues. The 2023 margin tax bill was meant to be revenue neutral for the state; to meet that mark, the tax rate was set at 3.1966%.

A Margin Tax—Like the B&O Tax—Would Violate Many Tax Policy Principles

There are five key principles of a good tax system: economic neutrality, administrative simplicity, stability, transparency, and fairness (WRC 2012b). Gross receipts taxes fail the economic neutrality, transparency, and fairness tests. For example, gross receipts taxes influence business decisions by favoring vertical integration, their costs are often hidden due to pyramiding, and they are imposed regardless of profitability. Consequently, as the Council on State Taxation writes of gross receipts taxes, "generally, such taxes should not be imposed on business" (COST 2009). As noted above, a margin tax is a gross receipts tax.

The Tax Foundation's 2026 State Tax Competitiveness Index ranks Washington as having the fourth-worst corporate taxes in the country (Fritts et al. 2025). Corporate taxes in Texas are ranked fifth worst. Washington ranks so poorly because the B&O tax is a gross receipts tax with no deductions for the cost of goods sold or employee compensation. Texas ranks almost as bad because it "offers a deduction for either the cost of goods sold or employee compensation but not both" (Fritts et al. 2025). Further, the Tax Foundation writes, "The margin tax is complex and burdensome. As a modified gross receipts tax, it applies to a firm's total sales with limited deductions, rather than being imposed on profits" (Fritts et al. 2025).

According to the Tax Foundation, states could improve their gross receipts taxes by allowing "deductions from gross receipts for employee compensation costs and cost of goods sold, effectively moving toward a regular corporate income tax" (Fritts et al. 2025).

A Possible Third Option

It may be the case that Washington has another option. Earlier this year, the state adopted a personal income tax (WRC 2026). If the personal income tax is upheld by the state Supreme Court, and not repealed by voters, it would open the door to a corporate income tax.

The 2002 Washington State Tax Structure Study Committee found, "Replacing the B&O tax with a corporate net income tax would eliminate the pyramiding of our tax system and the resulting non-neutral tax treatment of businesses" (WSTSSC 2002). Further, the 2023 report from the Tax Structure

Work Group found, “Across most sectors, business tax incidences would fall with a [corporate income] tax” (TSWG 2023).

Additionally, a corporate income tax would bring Washington in line with other states, improving our tax structure’s competitiveness. Washington is one of seven states with a statewide gross receipts tax (Mandal 2026). Forty-four states have a corporate income tax. (Delaware, Oregon, and Tennessee have both gross receipts and corporate income taxes.)

The revenues from a corporate income tax would be more volatile than revenues from the B&O tax (Watson 2019). The state has already introduced new volatility in the forms of the capital gains tax and personal income tax. Although volatile taxes make budgeting more difficult, strong budget rules—and higher reserve targets—can help manage revenue swings.

Comment

In moving from the B&O tax to a margin tax, the state would be making only a marginal improvement in business tax policy. It would not make Washington’s tax structure significantly more competitive, and it would create winners and losers in the business community.

If the personal income tax survives the ballot and the state Supreme Court, a corporate income tax could be an alternative option to the margin tax. Although that would also create winners and losers, it seems premature to change the business tax structure without considering it fully.

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