Occupational License Tax:

Net Profits
vs
Gross Receipts

EQUITABLE TAXATION

How did we get here?

- Gross Receipts Tax - 1964
  - All “occupations” were taxed at different percentages of gross receipts (0.1%, 0.3%, 0.5%) based on the occupation. E.g., accountant, mason, carpenter, etc.
- Payroll Tax/Net Profits Tax – 1976
  - Employees pay 1% of gross wages
  - Businesses pay 1% of Net Profits

When the City of Georgetown first levied an occupational license tax in 1964, businesses and employees were lumped under one category called “occupations” and taxed equally on their gross receipts. All persons engaged in an occupation, trade or business in Georgetown paid 0.1%, 0.3% or 0.5% of gross receipts, depending on the type of occupation. In 1976, the City repealed the Gross Receipts tax and split the tax into a Net Profits tax for businesses and a Payroll tax for employees.

What's the difference?

Net Profits = Revenue *minus* expenses (wages, benefits, insurance, materials, taxes, utilities, depreciation, rent, etc.)

Gross Receipts = Receipts from the sale or lease of goods, services and property *minus* returns and allowances*

*(allowances are deductions to the original selling price when the customer accepts defective products)

Net Profits means a business's gross revenue minus its expenses. With a few exceptions, anything a business can deduct on its federal tax return can be deducted from its net profits return. Gross receipts means a business's receipts from the sale or lease of goods, services and property minus returns and allowances for defective products.

Apportionment

Net Profits Tax Owed = Total Net Profits x Apportionment x 1%

$$\text{Payroll Factor} = \frac{\text{Compensation paid within jurisdiction}}{\text{All compensation paid by business}}$$

$$\text{Sales Factor} = \frac{\text{Sales within jurisdiction}}{\text{All sales by business}}$$

$$\text{Apportionment} = \frac{\text{Payroll Factor + Sales Factor}}{2}$$

A business owes net profits or gross receipts taxes to a taxing jurisdiction based on the percentage of its business that is attributable to work done in the jurisdiction. This is calculated with a two-factor formula based on payroll and net profits. For businesses with only payroll or only sales generated in a jurisdiction, only one factor is used.

Key Concept:

Net Profits are calculated based on global business operations.

Hypothetical - **SuperWorldMart**

$100 Billion Worldwide Receipts

Businesses calculate net profits based on global operations in all jurisdictions, including other local jurisdictions, other states and other countries. Let's look at how this affects taxes owed to Georgetown: Let's say SuperWorldMart reports $100 billion in global profits for the year 2020. SuperWorldMart generated $50 million in sales in Georgetown, and about 0.05% of its global sales and payroll was generated in Georgetown. However, despite record U.S. sales, SuperWorldMart's spent $150 billion building facilities in the US, Europe and Asia, resulting in a global loss. SuperWorldMart reports global net profits of $0.00. Super World Mart owes Georgetown $0.00 in net profits taxes. Note that none of the construction expenses SuperWorldMart deducted directly benefitted Georgetown.

With a 0.1% Gross Receipts Tax

Expenses are not deducted under a gross receipts tax

Hypothetical - **SuperWorldMart**

$99 Billion Global Receipts
after returns and allowances

If Georgetown instead levied a Gross Receipts tax, SuperWorldMart's global construction costs would be irrelevant. Assume SuperWorldMart had global Gross Receipts of $99 Billion after returns and allowances and that 0.05% apportionment. That means SuperWorldMart had $49,500,000 in apportioned Gross Receipts and owes the City of Georgetown $49,500 in gross receipts taxes.

Net Profits Tax vs. Gross Receipts Tax

Analysis Methodology

- Compile info from the most recent complete year of net profits filings (2018) and enter every entity's reported gross receipts and net profits.
- Sample size: 4,261 entities: 1,017 with no apportioned receipts; 3,244 with apportioned receipts
- Determine the entities' apportioned gross receipts (apportionment % x total gross receipts) and sort the results by apportioned gross receipts.
- Divide the entities into 7 groups of apportioned gross receipts ranging from less than $50,000 to greater than $50,000,000.
- Separately sort the entities into industry groups for secondary analysis
- Perform various analyses on this data
- Use the data to compare current net profits tax to proposed gross receipts tax and develop key statistics

In an effort to analyze the equity and efficiency of Georgetown's net profits tax and compare it to a potential gross receipts tax, we looked at actual tax returns from the last complete tax year for the 4,261 business entities that filed a return. Roughly 3,200 of those returns had greater than zero apportioned receipts. We then sorted the business entities by apportioned gross receipts and divided the results into seven groups, with the smallest group having less than $50,000 in apportioned receipts and the largest having over $50 Million. Finally, we separately sorted the businesses by NAICS industry groups. Using this data, we performed several analyses to develop useful statistics.

Standard Measure

$$\frac{\text{Net Profits Owed}}{\text{Gross Receipts}}$$

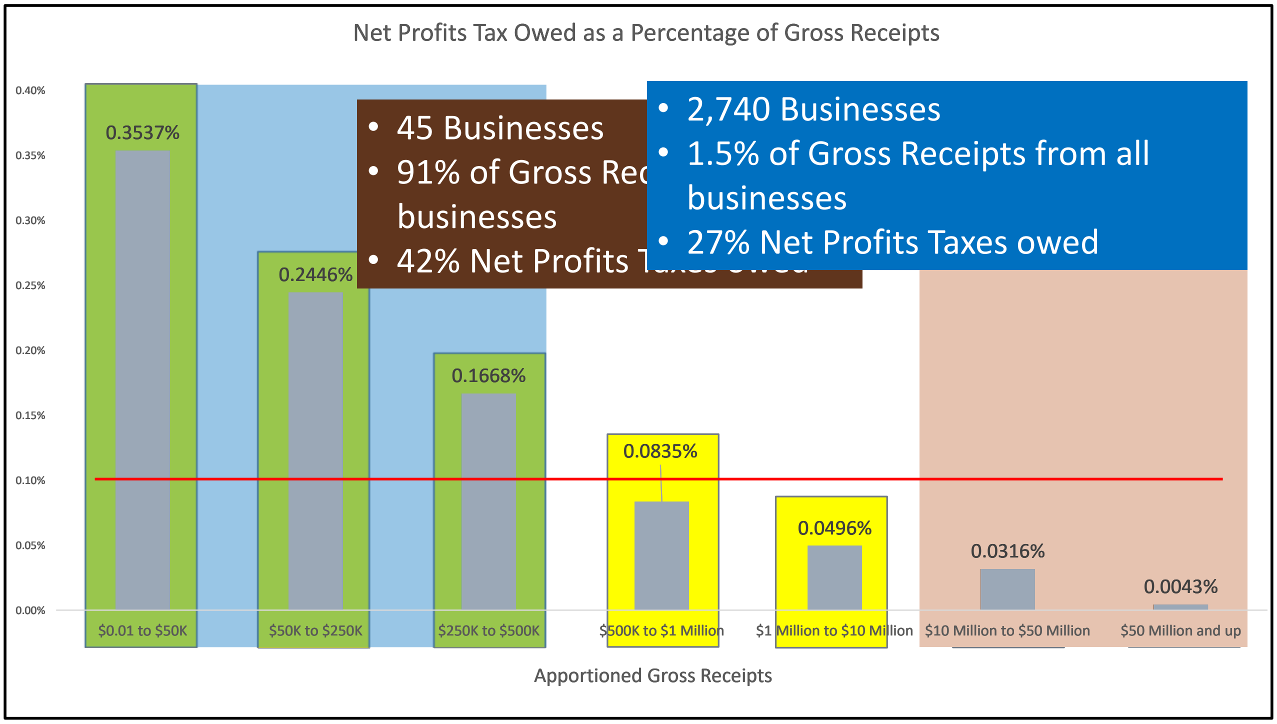
Throughout this exercise, we use a business's gross receipts (that is, the receipts from the sale or lease of goods, services and property) as the measure of how large or small a business is. Note that this, along with number of employees, is the standard by which the Small Business Administration measures business size. To compare tax burden among the various size entities, we divide the net profits owed by the business by its gross receipts.

Key Statistic:

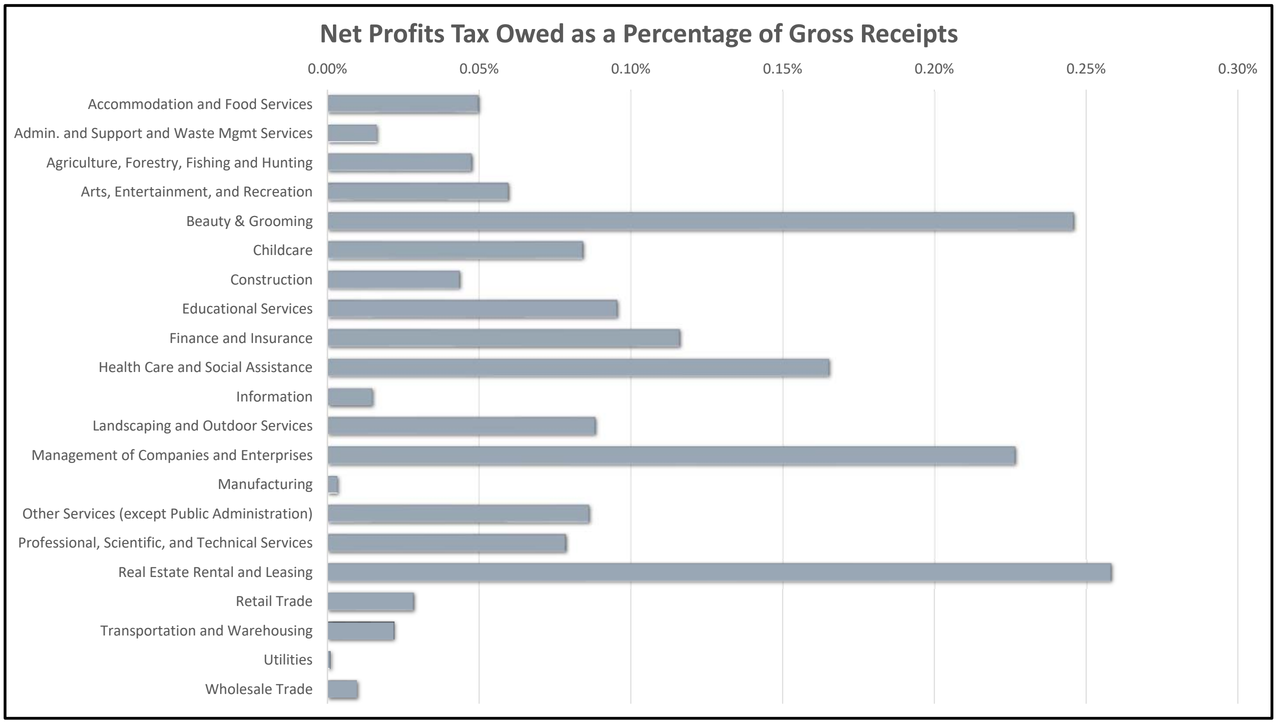
On average, the smaller a business is, the more it owes in net profits tax relative to its gross receipts.

(and vice versa)

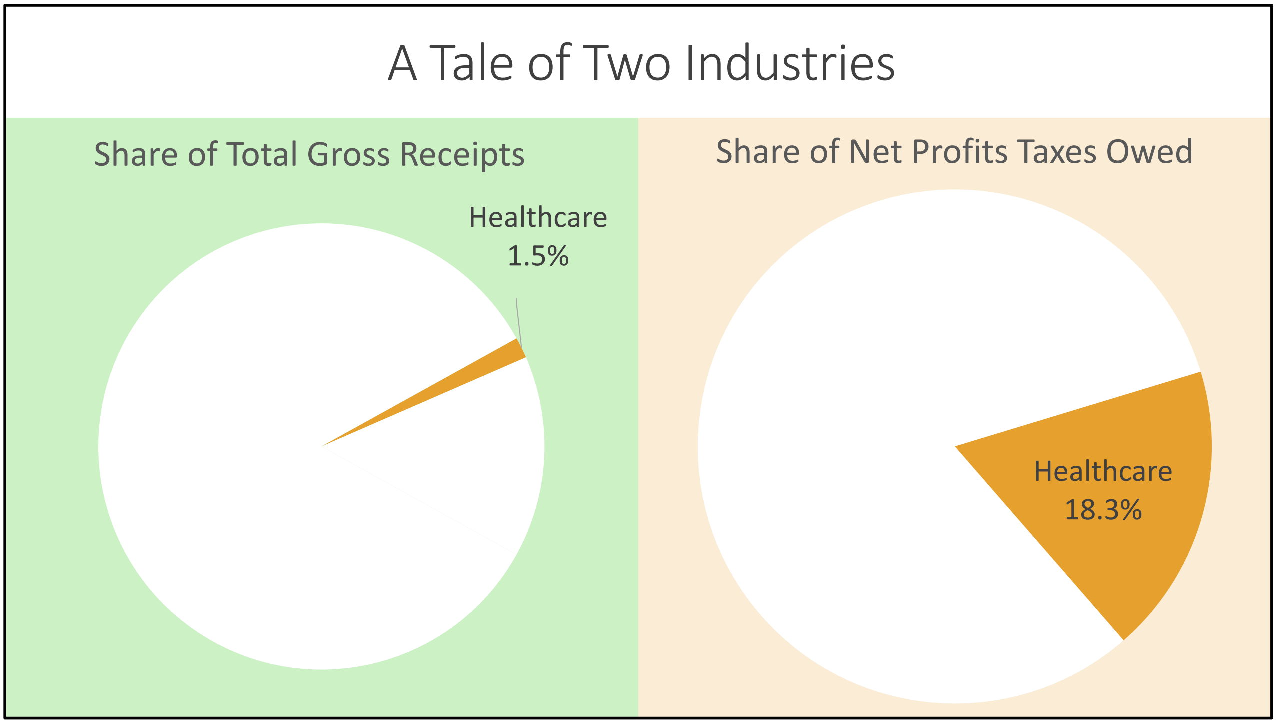
The most critical statistic we found was that, on average, the smaller a business, the more that business owed in net profits taxes relative to its gross receipts. Conversely, the larger a business, the less that business owed in net profits taxes as a percentage of its gross receipts.



Those businesses that generated less than $50,000 in apportioned gross receipts paid net profits taxes that averaged 0.35% of their gross receipts. As the size of the business increases, the amount it owes in net profits relative to its gross receipts becomes less. Those businesses that generated more than $50 Million in apportioned gross receipts paid an average net profits tax that was just 0.0043% of its gross receipts. That means the smallest businesses in Georgetown, on average, paid 81 times more net profits taxes relative to their gross receipts than the largest businesses. A common gross receipts tax rate levied by cities is 0.1% of gross receipts. Notice that smaller businesses are paying, on average, significantly more than they would pay under a 0.1% gross receipts tax, and large businesses are paying less. The 45 businesses that had over $10 million in apportioned gross receipts accounted for <u>91%</u> of total apportioned gross receipts of all businesses but account for only <u>42%</u> of Net Profits taxes owed. Conversely, the 2,740 businesses with less than $500,000 in apportioned gross receipts account for only <u>1.5%</u> of total gross receipts of all businesses but account for <u>27%</u> of net profits taxes owed.

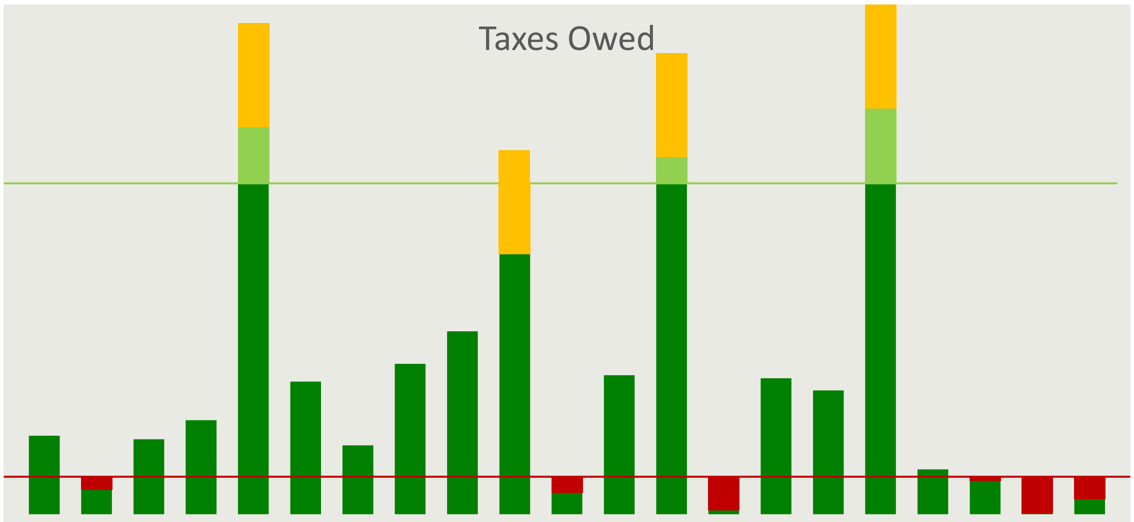


Net Profits taxes owed varies greatly industry to industry.   Industries such as Beauty, Healthcare and Real Estate bear a disproportionately high net profits tax burden, while industries such as manufacturing, trade and information bear proportionately little net profits tax burden.



To see an example of an inequity in net profits taxes, look at the difference between these two signature industries. Manufacturing businesses accounted for 83.9% of the apportioned gross receipts for all industries combined but owed only 20.3% of the net profits taxes due to Georgetown. Healthcare businesses accounted for only 1.5% of the gross receipts for all industries combined but owed 18.3% of the net profits.

Great flexibility



Now let's talk about ways a gross receipts tax could be implemented and how it would affect the city and its businesses. Cities have great flexibility in establishing a gross receipts tax and have a variety of tools that can shape the fairness and effectiveness of the tax. A cap on the total gross receipts tax owed by any business may be particularly important in a city where one or more business entities would bear a disproportionately high burden compared to all other taxpayers. A floor could also be employed to ensure that all businesses regardless of size pay a minimum fee for the purpose of conducting business in the city. In Georgetown, there are almost 900 businesses that would owe less than $10 in gross receipts taxes. A city could also choose to enact different tax brackets, similar to federal income taxes, applying higher rates to business with higher gross receipts. Of course, a city could combine some or all of these tools.

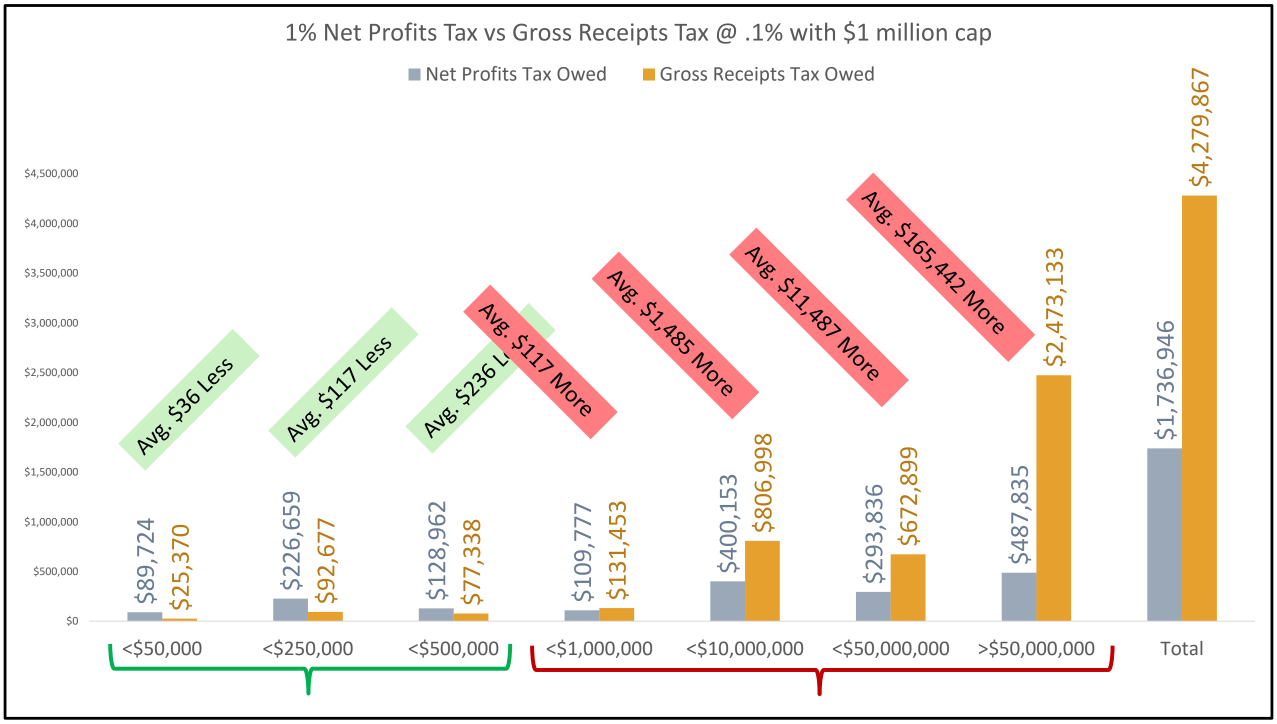
Change to a Gross Receipts Tax

	Taxes owed based on data from 2018 tax returns		
	Owed	vs. 2018	vs. 10 Year Avg.
Net Profits tax owed at 1%	$1,736,946	--	($847,576)
Gross Receipts at 0.1% with a $1,000,000 cap.	$4,279,867	$2,542,921	$1,695,345
Gross Receipts at 0.1% with a $2,000,000 cap.	$5,279,867	$3,542,921	$2,695,345
Gross Receipts at 0.2% with a $1,000,000 cap.	$7,559,734	$5,822,788	$4,975,212
Gross Receipts at 0.2% with a $2,000,000 cap.	$8,559,734	$6,822,788	$5,975,212

Combining some of the tools we just discussed, let's look at the revenues a hypothetical Gross Receipts tax would generate. Based on the returns data from 2018, businesses owed Georgetown $1.7 million in net profits taxes. Over the last 10 years, the city has averaged $2.5 million in adjust for inflation net profits tax revenues. If the city had a flat 0.1% gross receipts tax with a $1 million cap, only one business would have its tax capped, and all businesses would owe $4.3 million in gross receipts taxes. Increasing the cap to $2 million would still affect only one entity and the tax would generate an additional $1 million. At a 0.2% gross receipts rate with a $1 million cap, still only one entity one entity would have its taxes capped. All businesses would owe $7.5 million in gross receipts taxes. Again, increasing the cap to $2 million would have affected only one entity and would generate additional tax owed of $1 million.

Change to a Gross Receipts Tax (cont.)			
	Taxes owed based on data from 2018 tax returns		
	Owed	vs. Net Profits	vs. 10 Year Avg.
Net Profits tax owed at 1%	$1,736,946	--	$2,584,522
GR – 0.1% capped at $100,000	$2,924,225	$1,187,279	$339,703
GR – 0.1% capped at $200,000	$3,385,411	$1,648,465	$800,889
GR – 0.1% up to $5M; 0.2% above $5M; $1 M cap	$6,295,329	$4,558,383	$3,710,807
GR – 0.1% up to $5M; 0.2% above $5M; $200,000 cap	$4,619,045	$2,882,099	$2,034,523

Continuing the analysis, if the city had a 1% gross receipts tax capped at $100,000, eight businesses would have their taxes capped and the tax would generate $2.9 million. Increasing the cap to $200,000 would cap the taxes of two businesses and generate $461,000 additional revenue. With a bracketed gross receipts tax at a rate of 0.1% for receipts up to $5 million, a 0.2% rate for receipts above $5 million, and a $1 million cap, those businesses would have paid $6.3 million in gross receipts taxes. If the cap is reduced to $200,000, eight businesses would have their taxes capped and the tax would generate $4.6 million.



Looking, for example, at a flat 0.1% gross receipts tax with a $1 million cap, businesses with less than $500,000 in apportioned gross receipts would, on average, owe less under a gross receipts tax compared to a net profits tax. Businesses with more than $500,000 in apportioned gross receipts will, on average, pay more under a gross receipts tax. Of the 3,244 business with apportioned gross receipts, 1,411 would have paid less under a gross receipts tax versus a net profits tax. Of the 1,803 business that would have paid more under a gross receipts tax, half would have seen an increase of less than $50 each. This analysis could be performed based on any particular gross receipts setup.

Other things to keep in mind…

- Smaller businesses tend to be local businesses, whereas the largest businesses are predominantly regional, national or global businesses.
- A Gross Receipts Tax is much easier for businesses to calculate and report. It is one simple formula. Calculating Net Profits Taxes may require detailed knowledge of federal tax law and often requires the services of an accountant.
- For the same reasons, a Gross Receipts Tax is far easier for the city to administer.
- A Gross Receipts tax puts businesses and employees on an equal footing, as both pay a tax based on income before any deductions.
- Over the last 25 years, employees have paid 74% of the occupational license taxes owed to Georgetown.
- 34 cities have enacted a Gross Receipts Tax.
- Only cities can levy a Gross Receipts Tax. Counties and schools cannot.

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