D.C. Tax Revision Commission Policy Options

Policy Option #29: Eliminate the Unincorporated Business Franchise Tax

MEMORANDUM

Proposal: Eliminate the unincorporated business franchise tax
Tax Type: Business
Origin: Councilmember Jack Evans
Commission Goal: Competition and business growth

Current Law

An unincorporated business, including a partnership or a sole proprietor with more than $12,000 in annual gross income, is subject to the unincorporated business franchise tax (UBFT).

D.C. cannot tax non-resident unincorporated business income through its individual income tax—as all states with an individual income tax do. As a result, the UBFT fills a gap. The UBFT excludes professionals (such as doctors, lawyers, engineers, accountants and architects) or any other trade or business in which more than 80% of gross income is derived from the personal services actually rendered by the individuals or partners.

The tax rate for the UBFT is 9.975%; the same as the business franchise tax (BFT). Likewise, the minimum tax for the UBFT is $250 for businesses with gross receipts of $1 million or less and $1,000 for businesses with gross receipts greater than $1 million.

Maryland allows a credit for the D.C. UBFT for its residents, but Virginia does not. Virginia contends the UBFT is illegal because D.C. is prevented from taxing non-resident income.

Proposed Change

Eliminate the UBFT.

Reason for Change

The UBFT is an unusual business tax that undercuts D.C.'s ability to attract businesses. For example, the UBFT tax rate (9.975%) is higher than top individual income tax rate in D.C. (8.95%), so a business subject to the UBFT pays more than would a business that passes through its income to its owners. Furthermore, the disparity between D.C.'s UBFT rate and Virginia's individual income tax top rate (5.75%) is even larger than the disparity between the two jurisdictions business income tax rates. Some firms, such as investment advisement firms, also argue that this tax adds an additional layer of taxation not found in other jurisdictions—keeping such businesses out of D.C. as a result.

Pros

- Could encourage some unincorporated businesses to locate in D.C., which might increase business growth and employment.
- Would remove a double tax on income of D.C. unincorporated businesses that are owned by residents of Virginia.
- The current UBFT distinguishes non-service and service businesses which creates horizontal equity issues.
- Eliminating the UBFT would simplify D.C.'s tax system. D.C. residents would report that income directly on their individual income tax returns.

Cons

- Without the UBFT, D.C. could not tax the business income of unincorporated businesses owned by non-residents.
- Would put unincorporated businesses owned by D.C. residents at a disadvantage. These businesses would have to pay individual income taxes while competitors would collect tax-free business income. This could push D.C.-owned businesses out of the city.
- Eliminating the UBFT would reduce tax revenue.

Revenue Impact

The Office of Revenue Analysis estimates that in the first full year of implementation eliminating the UBFT would cost $152,000,000 in tax revenue.