Testimony for the DC Tax Review Commission June 24, 2013 Public Hearing
Submitted on June 17, 2013
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Thank you for the opportunity to submit written testimony on why the Tax Review Commission should not recommend a municipal bond tax. My testimony will demonstrate how a DC municipal bond tax:

- Places Washington in a very poor position when compared to other jurisdictions;
- Creates a complicated, inequitable tax structure; and
- Contradicts the city's goals of promoting fairness and competitiveness.

A Brief History

Washington did not have a municipal bond tax until May 2011 when the Council, without hearings or testimony and as a trade for a much discussed higher marginal tax rate, overnight switched the higher tax rate with a bond tax to fund a revenue gap that never materialized. Those residents who became aware of the tax primarily through letters to the editor and listservs formed grassroots efforts, one of which I coordinate, to oppose the tax.

Throughout the summer of 2011, we met with Council members seeking change and in September 2011 the Council effectively delayed the tax by grandfathering bonds so that income from non-DC bonds purchased prior to January 1, 2012 would not be taxed. In 2012 this grandfathering was extended, making the tax effective on January 1, 2013. Grandfathering changed the projected revenues from the bond tax from a four year total of over $101 million down to a four year total of under $12 million (and with how funds were to be grandfathered possibly less than $6 million.)

This spring Mayor Gray asked for a full repeal of the municipal bond tax. On May 22 the DC Council approved the budget with the bond tax repeal; repeal is expected to be retained in the final budget after the second reading on June 18.

Comparing Washington DC with Other Jurisdictions

<u>Municipal Bond Tax Rules</u>

No state can tax bonds issued by a commonwealth, territory or possession of the United States ("territory bonds"). The seven states without state incomes taxes -- Alaska, Florida, Nevada, South Dakota, Texas, Washington State, and Wyoming – do not tax income from out-of-state bonds. One state, North Dakota, has an income tax but does not tax income from out-of-state bonds.

Utah, also with a state income tax, does not tax bond income from states that do not tax Utah bond income. Prior to 2011, Utah did not tax DC bond income. After DC's passage of a bond tax, Utah changed its rules to tax income from DC bonds purchased after the DC bond tax was effective. With repeal of the DC bond tax, Utah will once again not tax DC bond income, making DC bonds very attractive to residents of a state with a population that is 4.45 times DC's population.

However, Washington DC is a city and not a state, which is an important distinction. The number and type of municipal bonds issued in DC is very, very small. If DC residents must purchase DC bonds to obtain a local tax exemption, we will be unable to obtain diversification, exposing us to excessive risk (selection, liquidity, credit, and default) and extra costs. For these reasons alone, comparing DC's municipal bond options to those of states is like comparing apples to oranges. For an "apples to apples" comparison, Washington must be compared to other cities.

We have researched the income tax rules for cities and counties throughout the country, especially those with local income taxes. Our research indicates that none of these local jurisdictions imposes a special tax on income from municipal bonds issued outside of their borders. If DC taxes all bonds issued outside the city, it will be the only US local jurisdiction whose residents pay tax on income from all municipal bonds (other than territory bonds) issued outside its borders.

<u>Municipal Bond Volume and Diversification</u>

In 2012 there were only 15 bonds issued in Washington DC and there were no DC-only bond funds or money market accounts. All DC bonds are issued by a small number of issuers in one geographic city ranked 23rd by population. Thus, if a DC resident is limited to investing in only DC bonds to get the full value of a tax exempt bond, this resident has very little choice with individual bonds, has no choice if they want to invest in a bond fund or money market account, and is taking significant risk by investing in bonds issued in only one city by very few issuers.

The attached table shows the number of bonds issued in each state in 2012 and the number of bond funds and money market accounts. In the seven states with no state income tax and North Dakota, residents can buy every bond on the spread sheet and not pay any tax. For Utah, the tax exempt income on non-Utah bonds is from all bonds in the seven no-income tax states plus North Dakota, Indiana (pre-1/1/2012 bonds), and, with repeal of the bond tax, the District of Columbia.

For the remaining 41 states, their residents can invest in bonds in their state and not have to pay income tax. All states except Delaware offer more bond, bond funds, and money market options than DC. Regarding Delaware: according to 2013CityRating.com, their cost of living is 17% less than DC's; their top income tax rate is 3% less (2% less in Wilmington with its city income tax) than DC's; they have no sales tax (compared to DC's 6.5% tax); and their bonds are diversified with state-wide issues.

Because DC residents can live in Maryland and Virginia and still enjoy the benefits of DC, comparing DC to Maryland and Virginia is especially relevant. The following table shows the difference in bond options whether you live in DC or just over the District line in Maryland and Virginia.

Jurisdiction	2012 Bond Issues	Available Bond Funds	Available MMAs
Washington DC	15	0	0
Maryland	97	45	1
Virginia	136	44	5

Also, regarding geographic diversification opportunities, DC is only one city/county equivalent of 68 square miles. Maryland and Virginia, respectively, have 24 and 134 counties and county-equivalents and 12,407 and 42,769 square miles. If you live in Montgomery County, you can buy a bond issued in Baltimore or Ocean City or in Garrett County to the west or Worcester County to the east. If you live in Arlington County, you can buy a bond issued in Richmond or in Norfolk or Lee County all the way to the south and the west. The states also issue bonds that are tax exempt for their residents.

Complicated and Inequitable Tax Structure and Treatment

In September 2011, the Council stopped the bond tax from being retroactive. No jurisdiction had ever enacted a retroactive tax because the results are so egregious. Grandfathering, however, creates, effectively, an inequitable situation among bond investors and makes it so that DC may not even be able to fully administer the tax, unless DC treats the two different kinds of bond investors differently.

Bonds within funds are traded constantly. In addition, bonds, whether in funds or individually owned, are called frequently. In order just to maintain a portfolio – a fund or individually owned - new bonds have to be purchased.

Taxing bond investments post-grandfathering is not simple, especially with bond funds. Bond fund owners can figure out the percent of income from each state and DC but they don't know when the bonds were purchased. If a bond fund investor doesn't know what non-DC bond income is from bonds purchased after a grandfathering date, DC can't fairly enforce this tax on a fund investor. Individual bond investors, just to maintain their portfolio after grandfathering, can technically figure out what income comes from non-DC bonds purchased after grandfathering.

The Office of Tax and Revenue Tax Notice 2011-06 treated bond funds as "pass-through entities" and required taxpayers to obtain "written or electronic substantiation" that bond income was tax exempt. As noted above, for a bond fund investor, this proof doesn't exist since the documentation they receive on non-DC bond income does not provide the date the bond was purchased. The bond tax doesn't simplify the DC tax code; instead it complicates it significantly by putting in place a tax that is virtually impossible both for the bond fund investor to comply with and the DC government to enforce.

The result may be that bond fund investors, through no fault of their own, end up not paying tax on non-DC bond income for bonds purchased after the grandfathering date. This means that, when the bond tax was still in the process of becoming effective, only individual bond investors, acting like their own fund managers and reinvesting money they received from calls on the same bonds, were, unlike a fund investor, able to pay tax on the income off of the same new bonds that both they and the fund manager purchased.

Because of the differences in the practicality of identifying income of bonds purchased after the grandfathering date, a municipal bond tax effectively creates two tax structures based solely on what form a DC resident chose to buy bonds – through funds or with individual bonds. This would mean that whether or not you paid tax may be decided solely on how difficult it is to do your taxes and how difficult it is for DC to enforce the tax.

Promoting Fairness and Competitiveness

Who Is Hurt By A Municipal Bond Tax

A tax that disproportionately impacts residents who are in one age group is not fair and this is the impact of a municipal bond tax in Washington. With the bond tax, seniors are disproportionately hurt.

Seniors are already a smaller percent of the population in Washington than nationally: 11.3% of the total population in Washington compared to 13% of the national population. Perhaps this is because, according to the March issue of *US News and World Report*, Washington is one of the 10 worst cities in the country for retirees because of the high cost of living and the high taxes (and this did not include the bond tax.)

Municipal bonds are a common recommended investment for retirees:

- *AARP*, April 18, 2012: "Municipal bonds rank high on the list of investments that financial planners recommend to people who are nearing --- or who've reached – retirement."
- *The Wall Street Journal*, April 19, 2013: "Do municipal-bond funds make sense in retirement accounts?....for the taxable portion of one's savings, muni-bond funds can be an attractive alternative to money-market funds and certificates of deposit."
- www.newretirement.com: "Retirement Tips – Income, Public Works and Security: "Municipal bonds can offer calm and retirement security in the financial storm."

No one knows what percent of the bond holders are seniors but we do know that 26% have pensions; this does not include those without pensions (80% of private sector employees do not have pensions) or those with any wage income. Other estimates range from 50% to 75%. Whatever percentage one uses, the fact is that the percentage of bondholders who are seniors is significantly higher than 11.3%. A tax that disproportionately impacts a population that is already relatively small and may have greater mobility – not being tied to a job – does not encourage migration into DC; such a tax encourages migration out of DC.

Financial Fairness

The final debate on the bond tax this year centered on a very small number of people with very large bond income, though whether this is from DC or non-DC bonds is not known. DCFPI, the lead voice against repeal, wrote that there were 89 tax filers with bond income averaging $2 million; the Council's budget office said there were 16 people with bond income over $1 million and 139 people with bond income over $250,000. This is out of over 18,000 DC residents with bond income.

While the Commission may be considering whether or not DC should tax those with such high incomes differently than it does today, the bond tax, with less than 1% of bond holders in this very highest income group, is not the tax to use for this purpose. Not only does it only impact a very few of these highest earners but it will negatively impact about 18,000 other people who, as demonstrated within this testimony, would be unfairly hurt by a bond tax.

Promoting Competitiveness

The announcement for the June 24 public hearing asks if the tax system encourages residents to locate to DC. A municipal bond tax would unquestionably discourage movement into DC and encourage migration to Maryland and Virginia:

- Retirees disproportionately invest in bonds; a bond tax would make Washington even more costly for these retirees who already live in one of the 10 worst cities for retirees.
- With a bond tax, DC would be the only city in the US with such a tax, making DC not competitive with other cities.
- States, including Maryland and Virginia, offer significantly more bonds, bond funds, and bond money market accounts and/or geographic and issuer risk diversification.

Conclusion

After two years of debate, Mayor Gray and the DC Council repealed the municipal bond tax which, though enacted, was never implemented for many of the reasons provided in this testimony. As this testimony demonstrates: a municipal bond tax would make DC much less competitive than other cities and states, discouraging migration into and encouraging migration out of the city; is unfair to DC residents, effectively making us second class citizens regarding municipal bond options; creates an inequitable and difficult tax structure; disproportionately impacts seniors; and does not support DC's needs now or in the future, because it produces very little tax revenue and affects only a few of the very highest earners. For all of these reasons, I ask the Tax Review Commission to follow the lead of Mayor Gray and the Council and reject a municipal bond tax.

Municipal Bond Tax: States and DC Comparison

States and DC	# Bonds Issued in 2012\1	Current No. of State Specific Bond Funds\2	Current No. of State Specific MM Funds\2
Alabama	223	3	1
Alaska	21	0 (no tax)	
Arizona	114	39	1
Arkansas	287	6	
California	738	237	68
Colorado	220	22	
Connecticut	167	28	9
Delaware	8	0	
District of Columbia	15	0	
Florida	247	25 (no tax)	7
Georgia	179	24	1
Hawaii	21	6	
Idaho	48	4	
Illinois	691	0	
Indiana	339	0	
Iowa	443	0	
Kansas	344	10	
Kentucky	267	21	
Louisiana	102	4	
Maine	40	1	
Maryland	97	45	1
Massachussetts	266	60	10
Michigan	394	40	7
Minnesotta	631	56	2
Mississippi	112	3	
Missouri	445	14	
Montana	46	1	
Nebraska	410	5	
Nevada	27	0 (no tax)	
New Hampshire	29	1	
New Jersey	393	75	14
New Mexico	64	7	
New York	893	190	56
North Carolina	122	39	4
North Dakota	113	1	
Ohio	424	51	20
Oklahoma	334	1	
Oregon	125	27	
Pennsylvania	654	91	13
Rhode Island	33	13	
South Carolina	112	12	

South Dakota	63	0 (no tax)	
Tennessee	155	13	
Texas	1354	2 (no tax)	
Utah	84	3	
Vermont	28	0	
Virginia	136	44	5
Washington	273	0 (no tax)	
West Virginia	27	5	
Wisconsin	625	11	
Wyoming	32	0 (no tax)	

1 - Thomson Reuters, Jan. 2013
2 - Data in black are from Bloomberg.com. Data in blue are from Bondfunds.com or individual fund websites.