D.C. Tax Revision Commission

MEETING MINUTES

Subject: D.C. Tax Revision Commission Meeting
Date: Oct. 21, 2013
Time: 3:00 p.m. to 6:00 p.m.
Location: Room W250 1101 4th Street, S.W. Washington, D.C. 20024

Members Present:

Anthony Williams	Mark Ein
Teresa Hinze	Kim Rueben
Fitzroy Lee	Ed Lazere
Catherine Collins	Stefan Tucker
Pauline Schneider	Nicola Whiteman

Staff:

Gerry Widdicombe	Steven M. Rosenthal
Ashley Lee	Richard C. Auxier

I. Call to Order (Commission Chair)

Mr. Anthony Williams, Chair of the D.C. Tax Revision Commission (the "Commission"), called the meeting to order at 3:20pm. He thanked the Office of Revenue Analysis (ORA) and the Office of Tax and Revenue (OTR) for their continued support of the Commission and its work. He also gave a special thank you to Ms. Pauline Schneider, who chaired the previous meeting while he was away. Mr. Williams announced that the Commission's next public meeting would be held on Oct. 30, 2013, from 3 p.m. to 6 p.m., in the same room (Room W250 1101 4th Street, S.W., D.C.) and that the focus of that meeting would be property taxes.

II. Approval of Minutes

The Commission postponed a vote on the approval of meeting minutes for a future meeting.

III. Deliberations: Business Taxes

Mr. Steve Rosenthal opened the deliberations with a presentation on D.C.'s businesses taxes. He noted the policy options being considered by the Commission were the result of a lot of hard work by staff, including Mr. Richard Auxier and Mr. Gerry Widdicombe. He also credited a report submitted to the Commission on business franchise taxes by Mr. Norton Francis.

Mr. Rosenthal stated that D.C. has made major changes to its business franchise taxes in the last three years, including adding a combined reporting requirement for multi-state businesses, a shift to a double weighted sales factor apportionment formula, and an increased minimum business franchise tax. He noted that D.C.'s economy is doing well compared with its neighbors, explaining that D.C.'s small business growth is higher than the national average and comparable to neighboring states. He also said that D.C.'s growth in employment, wages and business establishments has outperformed many of the adjacent counties in Maryland and Virginia, and that D.C. has a higher share of the U.S. and regional economy than it did in 1997.

Mr. Rosenthal noted that D.C. relies heavily on business taxes, but it receives far more revenue from commercial property taxes than business franchise taxes. Commercial property taxes would be discussed at the next meeting on real property taxes. He also explained that while the business franchise tax is a relatively small percentage of D.C.'s total tax revenue, many look to the franchise tax rate as a barometer of how competitive D.C. is in attracting businesses to the city.

Options No. 28 and No. 29: Eliminate the business and unincorporated business franchise tax or reduce the tax rate.

Mr. Rosenthal explained that option No. 28 proposed either eliminating the business and unincorporated business franchise taxes or reduces the tax rates from 9.975% to Maryland's rate of 8.25% or Virginia's rate of 6%. Mr. Rosenthal stated that D.C.'s business franchise tax rate is the highest in the region, and only two states have higher rates nationally. He said that one quarter of the businesses in D.C. pay the minimum tax, which was recently increased to $250 for businesses with gross receipts of $1 million or less, and $1,000 for businesses with gross receipts over $1 million.

Mr. Rosenthal relayed the comments of Mr. David Brunori, a commissioner who was unable to attend, that D.C.'s franchise taxes should be eliminated because they raise little tax revenue (8%) and send a negative signal to the business community.

Ms. Nicola Whiteman asked whether the revenue estimates produced by the Office of Tax and Revenue (ORA) reflected only the losses from repealing the franchise tax, or whether some consideration of the potential economic gains from implementing the proposal were incorporated.

Mr. Rosenthal called upon Mr. Fitzroy Lee, the Deputy Chief Financial Officer in the Office of Revenue Analysis, who confirmed that the analysis did not generate a dynamic forecast. He said the numbers do not anticipate a macroeconomic response. Mr. Lee explained that it is difficult to predict the effects of eliminating or reducing the tax, and that the economic literature does not suggest any kind of consensus, because the outcome depends on the specific circumstances facing individual jurisdictions.

Ms. Whiteman agreed that the effects of eliminating or reducing the tax are difficult to quantify given the numerous shifting variables, but commented that the projections ought to incorporate some consideration of the positive contributions to the economy that would result if the proposal were implemented.

Mr. Lee explained that the estimates are meant to give an idea of the effects of repeal within an order of magnitude, rather than a precise calculation. He said that any potential offset would not be incredibly high, and would therefore not appreciably affect the accuracy of estimates.

Ms. Whiteman added that perhaps, the Commission could see where revenue is coming in and out once it began to assemble all the bits and pieces.

Ms. Kim Reuben noted that D.C. is not allowed to tax income at the source, but wants to collect some tax for the cost of providing services to businesses. She suggested that the Commission consider conforming the business franchise tax rate to the top rate for the individual income tax rate.

Mr. Stefan Tucker said that he would like to understand the difference between the corporate franchise tax and the unincorporated business franchise tax. He noted that real estate developers are typically not D.C. residents, so eliminating the unincorporated business franchise tax would leave D.C. with no means of taxing them. He added that he would not recommend eliminating the tax altogether.

Mr. Ed Lazere commented that he agreed with Mr. Tucker and Ms. Reuben. He also suggested the Commission consider moving the unincorporated business franchise rate down to the top individual income tax rate of 8.95%.

Ms. Teresa Hinze inquired about the recommendations that the 1998 Commission made with regard to the minimum tax. Mr. Rosenthal explained that the recent increase in the minimum tax was based on gross receipts as opposed to income, with no complaints from the business community.

Mr. Mark Ein observed that investment firms, hedge funds, and private equity firms are discouraged from moving to D.C. by the unincorporated business tax. He added that but for the tax the many of these industries want to be in D.C. and could potentially bring other tax revenue with them. He pointed out that there are various exemptions for the unincorporated business franchise tax, and asked if investment firms could be added to that list. When asked, Mr. Ein also said that he could help to reach out to such firms and ask them to contact the Commission.

Mr. Williams said that in his view, D.C. is a peculiar entity economically and politically. He said studies that apply to jurisdictions and states don’t necessarily apply to D.C. Nonetheless, D.C. has come a long way in working with business, and that perhaps small signals like a reduction in the franchise tax would be a powerful indication to business investors.

Ms. Reuben voiced her agreement with Mr. Williams' recommendation that the rate be reduced.

Ms. Whiteman noted that eliminating the tax would send a strong signal to the business community. She suggested that the Commission consider phasing in a reduction in the tax rate to mitigate the loss in revenue.

Mr. Williams indicated that the Commission had exhausted its discussion of the first option and suggested moving on to option No. 30.

Option No. 30: Create a de Minimis Threshold for the Business Franchise Tax

Mr. Rosenthal explained that option No. 30 creates a *de minimis* threshold of $12,000 for the business franchise tax, so that businesses with small amounts of income are not subject to a minimum tax. He added that currently, while a small business that is organized as a corporation is subject to a minimum tax, unincorporated businesses with income below $12, 000 are not, and that this option would level the playing field. He also noted that New Hampshire and Florida have exemptions for businesses earning less than $50,000.

Ms. Schneider asked whether these were the only states with tax thresholds or exemptions.

Mr. Auxier answered that these were the only states he was able to find in his research through the Tax Policy Center.

Mr. Tucker asked if a business in New Hampshire with gross income of $50,000 plus $1 would pay taxes on the whole thing.

Mr. Auxier answered that the business would indeed pay tax on the entire amount, and that this would be the case in D.C. as well.

Ms. Reuben said that part of the reason why New Hampshire and Florida have explicit thresholds might be explained by the fact that they do not administer an individual income tax, which possibly compels them to administer their business taxes differently.

Option No. 31: Replace Business Tax with a Gross Receipts Tax

Mr. Rosenthal explained that Option No. 31 replaces most business taxes with a gross receipts tax (GRT). With a GRT, D.C. would benefit from having more latitude to collect revenue from non-residents who engage in a business, including lawyers, accountants, doctors, and other professionals currently exempt from the unincorporated business franchise tax. He added that rates could be set relatively low if this option were implemented, but pointed out that an argument against the gross receipts tax is that it is sometimes viewed as a turnover tax. He said that a GRT is essentially a tax on all income with no deduction for the cost of doing business, and that it creates tax pyramiding that some people find objectionable.

Mr. Rosenthal stated that Mr. Lee's group produced revenue estimates using both a tax base that excluded lawyers, accountants, and others that are currently exempt from the unincorporated business franchise tax, as well as one that included such professionals. Mr. Rosenthal commented that a wider base would allow tax rates to be set much lower, yet generate similar amounts of revenue.

Mr. Lee explained that the revenue estimates represent the tax rates that D.C. would have to impose to maintain revenue neutrality if it moved to a gross receipts tax. He added that ORA calculated estimates of what the tax would have to be if the base was $34 billion, $73 billion, or $110 billion. The estimate for a base of $34 billion excludes lawyers, accountants, and other currently exempt professionals, the $73 billion base includes these professionals, and the $110 billion base is intended to cover the outer limit of what ORA thinks could be included in the base.

Mr. Williams commented that a gross receipts tax seems fair because all businesses pay less. But he admitted that problems with such taxes had prevented D.C. from adopting them in the past.

Ms. Reuben said that D.C. is too small to administer a gross receipts tax, and pointed out that gross receipts taxes are hard to implement and lead to businesses changing locations She also noted that implementing a GRT could cause effects that the Commission is not anticipant. Ms. Reuben commented that she believed Mr. Brunori to be in agreement.

Mr. Rosenthal referred to an article from the University of Chicago for the proposition that one of the consequences of the gross receipts tax is a more vertical integration to avoid the cascading of taxes.

Mr. Williams noted that the GRT has many of the same issues as the “value added tax” (VAT).

Mr. Tucker commented that there is much more dynamism to a gross receipts tax than most people realize, and businesses could do something called “hotelling” to get around the tax. He said that it would be a major mistake for D.C. to think about a gross receipts tax, and that many surrounding jurisdictions would love it if D.C. implemented a gross receipts tax.

Mr. Lee pointed out that several neighboring jurisdictions have a gross receipts tax. He noted that there are not many manufacturing companies in D.C., so D.C. does not have a vertical integration issue to address with a gross receipts tax. He added that a VAT is easy to administer if the rate is low enough, which eliminates the disincentive effects. He suggested that the choice between a VAT, GRT, or any other tax requires a consideration of the nature of industries that D.C. has, as well as the rate that will apply.

Mr. Widdicombe said that Ohio, Virginia, and several other states have a gross receipts tax.

Mr. Lazere said that the issue is what the Commission wants to do about the businesses that are in D.C. that currently don’t pay taxes. He asked whether the Commission would change the base or allow professional service providers to become taxable.

Mr. Ein said that he did not have a strong view on this option, but reminded the Commission that D.C. implemented a gross receipts tax to pay for bonds used to build the ballpark

Ms. Schneider added that the costs were recovered rather quickly when D.C. instituted a gross receipts tax to pay the costs of the Verizon Center.

Mr. Ein said that D.C. has approximately 33,000 businesses, and only collects baseball tax from 3,000 of them.

Mr. Williams asked if Commissioners had any other questions on the GRT, and recommended moving to the next option.

Option 32: Expand Nexus from Physical to Economic Presence

Mr. Rosenthal said that there are a few steps for a business to calculate its D.C. business franchise tax, including whether the business has nexus with the District. Mr. Rosenthal explained that option No. 32 shifts from a physical test to an economic presence test. An economic test would make companies who make sales in D.C., but that lack a store or headquarters in the city, eligible for taxation. Mr. Rosenthal noted that the scope of the proposal, in terms of how many out-of-state companies would be affected is unknown since the number is almost impossible to determine accurately.

Mr. Tucker asked whether unincorporated businesses subject to tax under an economic nexus standard could argue that this is an invalid commuter tax. Mr. Rosenthal said that the District would be limited if a business were in a partnership form.

Ms. Reuben commented that she was confused because no examples had been given as to who would be subject to the tax. Mr. Rosenthal answered that appliance deliveries could be taxable, or sales made on the internet by companies with affiliations in D.C. that help to sell its products. Such a company would be availing itself of D.C.'s market through the economics of its arrangement.

Mr. Rosenthal said that earlier Supreme Court precedent limiting the application of sales and use taxes with a physical presence standard under the Commerce Clause has not been extended to business franchise taxes and that many states are instituting an economic presence standard to be more aggressive.

Mr. Williams asked whether some of the states are treating digital presence as the equivalent of economic presence. He cautioned that, if such a recommendation were made, D.C. would be out in front of both other states and the courts.

Ms. Catherine Collins commented that if D.C. cannot currently tax partnerships that actually do have a presence in the District, then it cannot rightly tax lawyers whose clients are in D.C. when they are not.

Mr. Rosenthal said that tax could apply to any business, as long as it is not predominantly a service business.

Mr. Williams asked if there is any information that the Commission wanted to see on this topic.

Mr. Lazere said that the Commission would like to examine the negatives and positives of economic presence nexus.

Mr. Lee commented that it is hard to nail down who will be affected by this change.

Ms. Reuben suggested that perhaps D.C. should not push the envelope of what is constitutional.

Mr. Ein noted that this change may push lead some companies to end relationships and business activity in D.C.

Option No. 33: Adopt Single-Sales Factor Formula

Mr. Rosenthal explained that option No. 33 proposes adopting a single sales factor formula for allocating the tax liability for multi-state company in D.C. He added that, historically, three equally weighted factors (sales, property and payroll) have been used to determine taxable business income. He said that many jurisdictions have increased the weight given to. D.C. adopted a double weighted sales factor in 2011.

Option No. 33 would weigh only sales without considering payroll or property at all. Mr. Rosenthal added that since D.C. has an attractive customer base, the shift to exclusively sales would help export taxes to out-of-state companies and possibly encourage firms to locate in D.C. He also said that the revised apportionment calculation would result in more revenue to D.C..

Mr. Tucker commented that he supported this option because most companies that make sales in D.C. do not have property or payroll in the city.

Ms. Reuben said that she was not convinced a single sales factor because was best for D.C. because states that have previously adopted it usually are trying to protect and keep their manufacturing base. She cautioned that D.C.—lacking manufacturing—does not necessarily have the kind of economic activity that make this formula beneficial to other states.

Mr. Lazere said D.C.'s motivation is different from other jurisdictions but still beneficial. He asked if the tax might make revenue more volatile, though.

Mr. Rosenthal presented the hypothetical example of LL Bean, having only one store in D.C. He asked rhetorically, whether D.C. should tax a percentage on sales or shift to sales exclusively, and noted that weighing the physical store would produce a substantial undesirable outcome for D.C., because its affluent community causes LL Bean's sales in D.C. to be disproportionately large.

Mr. Ein said he was somewhat concerned that some stores (such as LL Bean) could be motivated to leave if such a proposal was adopted. But he was solidly behind the proposal if these fears are misplaced.

Option No. 34: Reduce the Capital Gains Tax Rate to 3% for Investors in High-Technology Firms

Mr. Rosenthal announced that option No. 34 reduces the capital gains tax rate to 3% for investors in Qualified High Technology Firms (QHTCs). He mentioned that Mayor Vince Gray previously requested that the D.C. Council include a reduction in capital gains tax rates as part of his economic development package. Mr. Rosenthal explained that the capital gains piece was stripped out of the legislation before it passed. The Council then requested that the Commission provide guidance on this proposal.

Mr. Williams said that the mayor had earlier requested that the process be expedited and made a priority, but the Commission had decided it lacked the resources and time to analyze this option outside of the established deliberative schedule.

Mr. Rosenthal commented that trying to target relief for QHTCs to investors is a difficult task, because solutions typically run the risk of being both over and under inclusive. He presented the counter argument that Virginia has a limited exemption that provides capital gains relief to QHTCs.

Mr. Ein asked whether option No. 34 would only provide tax relief to D.C.-based investors. Mr. Rosenthal said that was indeed the case.

Ms. Reuben asked what happens when an investor lives in Virginia and invests in a D.C. firm. Mr. Rosenthal stated that the location or relocation decision might be determined by one's tax liability. Ms. Reuben asked how this relief would interact with other rules and limitations on the District's ability to tax individuals located outside D.C. Mr. Rosenthal responded that in Virginia, the entrepreneur would not pay the tax, but a Virginia resident who invests in his company would pay. He explained that the QHTC rules are designed to encourage both investors and QHTCs to locate in D.C.

Mr. Ein said that option No. 34 would catalyze an ecosystem that is nascent and growing, and would help D.C.'s economy going forward. He added that "angel investors" would have more incentives to reach back and help small companies.

Ms. Whiteman suggested that the Commission aim to use tax policy to spur economic development.

Mr. Lee responded that that D.C. has more startup companies than Maryland and Virginia by multiple counts. He D.C.'s amenities make it attractive to the QHTC crowd. He suggested that the tax factor may not a big influence on these companies' decisions about location.

Mr. Ein commented that getting angel investor financing is one of the biggest issues that startups face. Therefore, option No. 34 would make an incremental difference and would help the sector grow.

Ms. Hinze raised the concern that such targeted policy could lead to tax planning, with firms both taking benefits from D.C. and cashing out other income in other jurisdictions.

Mr. Lazere said that D.C. has no shortage of generous policies for QHTCs. He explained that under current laws, QHTC are exempt from business franchise taxes for five years in addition to various credits. He pointed out that Virginia's policy for angel investors is much more modest, and that the Commission does not know how much it will cost D.C. to institute this particular option. Mr. Lazere concluded that in his opinion, money up front is much better than money at the end, and recommended something more like what Virginia does.

Ms. Reuben added to Mr. Lazere's point, saying that she sees two different sets of people who invest, angel investors who are generally wealthy and the employees who are given stock options when businesses go public. She was unconvinced tax breaks motivate either group.

Mr. Tucker said anyone looking to avoid capital gains taxes would move to Florida and not Virginia. He warned competing with Virginia could lead to a "slippery slope" and revenue losses.

Mr. Williams summarized that the Commission heard issues of timing, targeting, relationship etc., and could return to the discussion during future deliberations. He asked that the record reflect that the Commission applauds the mayor's efforts to provide incentives to attract QHTC businesses and to expand and diversify D.C.'s economy.

Option 35: Provide Certified Business Enterprises a Property Tax Credit

Mr. Rosenthal explained that option No. 35 originated in a letter from Mayor Gray, who suggested that the Commission think about ways to incentivize small and local businesses in D.C. He added that the Commission picked the amount of credit to apply, because Mayor Gray did not issue a detailed request, and that the Commission suggested a property tax credit because it would be easier to administer.

Mr. Rosenthal pointed out that certified business enterprises (CBEs) are currently only beneficial for government contracting. He described a prior definition of CBEs that required minority ownership, among other characteristics, and said that the scope of what a CBE is has been expanded. He acknowledged that providing a tax credit could greatly increase the number of CBEs and therefor the impact of the credit on tax revenue.

Mr. Tucker raised a concern that the property tax incentive might be inappropriate because many small business are renters. Mr. Rosenthal said that the Commission could go back and create an income tax credit. Mr. Auxier cautioned that the property tax credit would be far simpler to administer.

Ms. Hinze said the fact that any business can register as a CBE makes this a very poor option.

Mr. Williams said there are probably more effective and efficient ways of assisting CBEs.

Option 36: Levy a Local Services Tax on Employers

Mr. Rosenthal stated that option No. 36 proposes levying a local services tax on employers. Similar taxes exist in Pittsburg and Denver. He explained that business would be taxed a small amount per employee ($50, $75, or $100) as compensation for the services that these employees receive from D.C. He added that this would allow the tax to avoid characterization as a commuter tax because it would not be on income. He noted that option No. 35 would raise a substantial amount of revenue compared with some of the other proposals that the Commission was considering, and that this was also a good way to collect something from currently non-taxed organizations operating in D.C.

Mr. Ein asked if the tax would apply to the federal government. Mr. Rosenthal said it would not.

Mr. Tucker said that some of D.C.'s biggest employers are universities and non-profit organizations that currently are not taxed. Such a tax would spread the burden to these organizations. He asked for examples of how the tax might affect such employers.

Mr. Ein cautioned that more studies are needed because the proposal is very broad. He acknowledged, however, that if the Commission reduces some business taxes it is also going to have to find revenue to finance some of these changes.

Ms. Collins asked if this proposal is intended to tax organizations not currently paying taxes, e.g., the nonprofits.

Ms. Whiteman said that the Commission should be transparent if their intent is to get more revenue from certain sources. She worried this tax could be a bad signal to the business community.

Mr. Lazere remarked that his concern is with the federal politics of such a tax, and that the Commission should think through whether the option is politically realistic.

Mr. Ein answered that the tax would be paid for by businesses, not by the employees, so he did not see any issue with regard to limitations on commuter tax. He raised the concern that D.C. might end up pushing workers into a part-time status as businesses seek to avoid the tax, and asked if the tax could be credited so that it only applies to those not currently paying taxes.

Option No. 37: Replace D.C. Water Pilot with a Water Utility Tax

Mr. Rosenthal said that option No. 37 replaces the D.C. Water PILOT with a Water Utility Tax. He explained that this would affect taxes on water or sewage. He said that D.C. Water is an independent organization not funded by the D.C. government. While water is provided exclusively to D.C. residents, wastewater treatment services are provided to select Virginia and Maryland residents.

Mr. Rosenthal noted that D.C. water is currently exempt from all property and transaction taxes, but that they impose service fees on D.C. customers to fund a voluntary payment to D.C. in lieu of taxes.

These payments amounted to $17 million last year. He noted that the service fees are akin to a tax, which is passed on to D.C. residents, but not to users in Maryland and Virginia.

Mr. Rosenthal explained that the tax imposed on D.C. Water under this option would be neutral, but would spread the burden to all users (including those in Maryland and Virginia) of D.C. Water. He added that D.C. Water is unique, in that it is not municipality owned, but that this independent entity is not being subjected to the rate structure.

Ms. Schneider stated that it is an overstatement to say D.C. Water voluntarily agreed to the PILOT, which was as she understood it, the result of contentious negotiations. She said that D.C. Water was once a D.C. government entity, but separated from the D.C. government in order for its finances to be viewed separately form the District's at a time of poor economic performance. She added that D.C. wanted to go to financial markets to finance improvements to the facilities, and created this entity pursuant to an interstate compact, which required congressional approval. These past agreements create significant hurdles to change.

Ms. Schneider said that the bottom line is that charges will inevitably be passed through to consumers, and that the Commission should look at this proposal very, very, carefully. She concluded by adding that though it was not necessarily impossible in her view, the Commission should look at all the facts before deciding on this highly sensitive, and highly political option.

Mr. Ein asked whether Maryland and Virginia residents have alternatives to the service they receive from D.C. Water.

Ms. Reuben commented that is unclear whether changing the fee from a PILOT to a tax would change which jurisdiction's residents have to pay the costs. She asked whether anyone could explain this.

Mr. Rosenthal answered that he was unaware of the authority by which D.C. Water passes PILOT onto D.C. residents, or how this would change if the PILOT were changed to a tax.

Mr. Williams said that D.C. Water provides two separate services, water exit and treatment, and water intake, and that there is a long history involving assistance developing water channels from the army core of engineers. He commented that the proposal would change the legislative overlay between intake and outflow, which would require a lot of heavy lifting to get through the legislature. He recommended that the Commission discuss a strategy if it was serious about the proposal because this is a complicated and delicate issue.

Mr. Lazere added, with all deference, that if D.C. residents are paying for a service and Maryland and Virginia residents are not, this is not fair. Mr. Ein agreed.

Mr. Williams said that this proposal would likely provide only marginal benefits and require a lot of political heavy lifting.

IV. Adjournment

Mr. Williams announced that the meeting was adjourned at 5:30 p.m.