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The Honorable Anthony A. Williams, Chairman
Members of the District of Columbia Tax Revision Commission

Dear Chairman Williams and Members of the Commission:

Thank you for the opportunity to provide input to the D.C. Tax Revision Commission regarding potential changes to improve the tax structure in the District of Columbia. Because the Commission is charged with providing comprehensive recommendations to the D.C. Council and the Mayor, the following comments on behalf of the Council On State Taxation (COST) reflect the views of its member companies on a broad range of important tax issues, both on the multistate level and particular to the District.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Measuring the Business Tax Burden and Evaluating Competitiveness

One issue of critical importance in any tax revision study is to understand the contributions of business taxpayers in the context of the benefits those taxpayers receive from government. Each year, Ernst & Young, in conjunction with COST, estimates the total state and local tax burden imposed on businesses in each state and the District of Columbia. The following information is from our eleventh annual report, due to be released on July 15, covering Fiscal Year 2012.[1] We will provide a copy of this report to the Commission once it is finalized.

The report reveals that <u>in FY 2012, businesses paid $3.4 billion in District of Columbia taxes, representing 54.9% of all D.C. taxes paid, an increase of 6.2% over the prior year</u>. The national average for state and local tax burden paid by businesses

[1] For the prior year report, see Phillips, Andrew, Robert Cline and Tom Neubig, "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2011," July 2012, available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=81797.

is 45.2%. The District's total tax burden on businesses is among the highest in the country, when mineral-rich states are excluded. Property taxes make up the greatest percentage of state and local taxes paid by District businesses, at 50%, followed by excise taxes at 13.4%, individual income tax on pass-through business income and corporate income tax, at about 9.5% each. Sales taxes on business inputs is 8.9%. It is important to keep the relative burden of these taxes in context when discussing the contribution of "business taxes" to the General Fund.

Another important metric reflected in the report is the total effective business tax rate imposed on business activity in the District. This rate is measured by the ratio of state and local business taxes to private-sector gross state product, the total value of a state's annual production of goods and services by the private sector. The District's effective business tax rate is 4.8%, equaling the national average, but higher than its neighboring states, including Virginia (3.8%) and Maryland (4%).

Another critical issue to examine is the impact of state and local business tax systems on new capital investment, the cornerstone of state economic development. An April 2011 study, again by Ernst & Young in conjunction with COST, measures the competiveness of state and local business tax systems in terms of the tax burden on investments in new or expanded facilities.[2] The District of Columbia has the 50th highest effective tax rate (ETR) on new investment, when weighted either by capital investment (16.6% ETR) or by announced jobs (16.7% ETR). By comparison, Virginia ranks 6th (5.4% ETR) for capital investment and 10th (6.6% ETR) for jobs, while Maryland ranks 12th (6.3%) for capital investment and 25th (8.7%) for jobs.

Sales Tax: Avoiding Tax on Business Inputs

One common recommendation of tax restructuring efforts is to lower tax rates while broadening the tax base. The prime motivation behind this recommendation is to reduce, to the extent possible, economic distortions resulting from tax imposition. Unfortunately, when drafted into legislative proposals, this goal often translates to proposed imposition of sales tax on business purchases of goods and services. This creates a "tax on a tax" when the business sells its products to end consumers, creating pyramiding and transparency issues. Thus, such a tax on "business inputs" both defeats the purpose of the broad base by causing additional economic distortions and puts the adopting state at a competitive disadvantage.

COST has undertaken a study on the taxation of business-to-business sales.[3] This study reveals that expansion of the sales tax bases to include additional business-to-business sales of goods and services would result in the following:

- Significant tax increases would be imposed on businesses, often with 70% to 80% of the increased revenue derived from sales taxes on business input purchases.
- Companies would be encouraged to self-provide business services to avoid the tax imposed on additional services rather than purchasing them from more efficient service providers and paying tax. This would penalize firms that have been focusing on their core

[2] This study is available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=78442.
[3] Phillips, Andrew, Robert Cline and Tom Neubig, "What's Wrong with Taxing Business Services?," April 4, 2013, available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=83841.

businesses and turning to smaller businesses to provide non-core services.

- Companies subject to higher sales taxes on their purchase of additional goods and services would be put at a competitive disadvantage to many of their competitors in other states and in foreign markets. To the extent companies are limited by market competition in their ability to pass the additional sales taxes forward through higher prices, businesses would have a strong incentive to reduce investment and employment in the state.
- Sales taxes on business inputs result in hidden variation in effective sales tax rates due to pyramiding if the increased sales taxes are passed forward as higher consumer prices. This makes it impossible to determine who bears the burden of the sales tax and how the tax burdens vary by household income levels. As a result, it is difficult to design policies to offset this burden on lower income households.

Broad-based legislative proposals to tax business inputs this year have been rejected, including in Louisiana, Massachusetts, Minnesota, Nebraska, and Ohio. Expanding the sales tax to business inputs is simply bad tax policy, and the District of Columbia should do all it can to lower the amount of sales taxes borne directly by businesses.

Corporate Income Tax and Combined Reporting

The District of Columbia adopted mandatory unitary combined reporting, effective for the 2011 tax year. COST opposes mandatory combined reporting, as outlined in its policy statement[4] on this issue, because there is a significant risk that it will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity there. Further, combined reporting is an unpredictable and burdensome tax system. While COST continues to oppose this mandatory reporting method, we continue to recommend changes to the District's combined reporting regime to make it more equitable for corporate taxpayers.[5]

Specifically, COST recommends that the combined reporting law be amended to ensure there is no double taxation that will result from the intersection of the combined reporting regime with the existing unincorporated business tax. We understand that the 2014 Budget Support Act will include a provision referencing this issue and directing the Office of Tax and Revenue (OTR) to address the issue via regulation, and we have been working with the OTR toward this goal. COST also recommends limiting the OTR's discretion in including income and apportionment factors in the combined report, and that the OTR bear the burden of proof in making adjustments beyond the combined reporting rules laid out by statute. As a matter of equity, COST recommends removing limitations on credit and net operating loss utilization by combined group members (after all, combination of income is the foundation of this system, and there is no principled reason for restricting the utilization of losses and credits). COST also, as a matter of policy, opposes the expansion of the water's edge to foreign entities through the amorphous "tax

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[4] See COST Policy Position, Mandatory Unitary Combined Reporting, available at http://www.cost.org/uploadedFiles/About_COST/Policy_Statement/Mandatory%20Unitary%20Combined%20Reporting.pdf.

[5] See Testimony to the D.C. Council, Committee on Finance and Revenue, Regarding the 2014 Budget Support Act, April 30, 2013, available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=84090.

haven" designation or through otherwise reaching income and factors of foreign companies not conducting business in the U.S.

"Alternative" Business Taxes

A handful of other states have recently considered or enacted new business taxes that are based on some measure other than net income. These alternative-based taxes are generally derived from – or linked to – gross receipts. Gross receipts taxes are widely acknowledged to violate numerous tax policy principles, and for the reasons briefly discussed below, should not be the basis of tax restructuring in the District of Columbia.[6] Among the features of gross receipts taxes:

- Violates economic neutrality – A gross receipts tax interferes with private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. Most significantly, it establishes artificial incentive for vertical integration and discriminates against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.

- Anti-competitive – A gross receipts tax interferes with the capacity of individuals and businesses to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of a production chain within the state increases, so there is incentive to purchase business inputs from outside the state. It discourages capital investment by adding to the cost of factories, machinery, and equipment, and the disincentive increases as more of those capital goods are produced in the taxing state. This tax structure does not promote the growth and development of the state.

- Unfair – A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, depending on their profit margins. Low-margin firms will be at great disadvantage relative to higher-margin firms, regardless of their overall profitability. Many new and expanding firms have low margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

- Not transparent – A gross receipts tax is a stealth tax with its true burden hidden from taxpayers. Hiding the cost of government is inconsistent with efficient and responsive provision of government services and contrary to the fundamentals of democratic government.

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[6] See "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance" (January 2007), prepared for COST and the Tax Foundation by John Mikesell, professor of public finance and policy analysis and director of the Master of Public Affairs program at the Indiana University School of Public and Environmental Affairs. The paper is available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=67458.

Fair, Efficient and Customer-Focused Tax Administration

Regardless of the types of taxes utilized in any state's revenue system, taxpayers deserve fair, efficient and customer-focused tax administration. In COST's most recent survey of state tax administration systems, the District of Colombia scored a C+.[7] The District of Columbia could adopt several reforms that, while not impacting the fiscal health of the District, would result in a net gain through decreased compliance costs and an enhancement of the District's reputation as a fair and efficient place to do business:

- Provide for equalized rates of interest on overpayments and underpayments of tax. It is a simple question of equity that interest imposition not act as a penalty, but as a measure of the time value of money, *regardless of whether the state or the taxpayer holds the funds* at issue. For 2013, the interest rate on overpayments is 2% (previously 6%, simple interest). The interest rate on underpayments remains 10%, compounded daily. The District of Columbia has gone the wrong way on this issue, which will be reflected on the next COST Scorecard.
- Provide at least 60 days to protest an assessment, and preferably 90 days as recommended by the American Bar Association's Model State Administrative Tax Tribunal Act. Any protest period shorter than 60 days is unreasonable and could jeopardize a taxpayer's ability to fully respond to a proposed assessment. Currently, a taxpayer has 30 days to file a protest to a proposed assessment with the Office of Administrative Hearings.
- Provide an automatic extension of the corporate income tax return with the federal extension, and provide that that the state's return due date be at least 30 days after the federal due date or extended due date. The Office of Tax and Revenue has proposed regulations to allow a seven-month extension for combined filers.[8] This action should be applauded, and D.C. law should be amended to apply an extended due date 30 days beyond the federal due date for all corporate returns, without a separate D.C. extension request.
- Clearly define what constitutes a "final determination" of federal income tax that triggers the requirement to report the change to the District of Columbia, and allow at least six months (or 180 days) to file an amended return or worksheet to notify the District of such changes. Currently, District law does not define what constitutes a "final determination," and taxpayers have only 90 days after the federal change to provide a written report explaining the changes to the Audit Division of the Office of Tax and Revenue.

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[7] Lindholm, Douglas L. and Fredrick J. Nicely, *"The Best and Worst of State Tax Administration: COST Scorecard on Tax Appeals and Procedural Requirements,"* February 2010, http://www.cost.org/WorkArea/ DownloadAsset.aspx?id=75910.

[8] Office of Tax and Revenue, Notice of Proposed Rulemaking, Notice ID: 4405854, 6/14/13.

- Finally, while the District of Columbia has an independent appeals forum (the Office of Administrative Hearings), ALJs are not required to have tax expertise. Further, while there is no bond or prepayment requirement for appeal to the Office of Administrative Hearings, tax together with penalties and interest must be posted for an appeal to the D.C. Superior Court.

COST also scores states on their property tax administrative practices (D.C. received a C- on this scorecard grading).[9] While some of the categories carry-over from the administrative practices scorecard (for example, the interest rate disparity noted above), there are many categories particular to the property tax. Given the importance that property taxes represent (50% of all business taxes paid in the District), it behooves the District to adopt fair and simplified property tax administrative practices. Some of the more glaring deficiencies in the District's property tax administrative law are outlined below:

- Allow at least 60 days for the initial appeal deadline. Taxpayers seeking to file a property tax appeal should have at least 60 days from the formal written notice of the assessed value on the disputed property (ideally, the time period should be 90 days, as provided in the Model State Administrative Tax Court Act of the American Bar Association). The District provides until April 1 (approximately 30 days from the notice of assessment) for real property appeals, and 30 days from issuance of the notice of proposed assessment for personal property appeals.
- Provide *de novo* review on subsequent appeal. After an initial administrative review, subsequent appeals should be to an independent tax tribunal, and such review should be *de novo* (the record for appeal should not be set at the initial, non-independent hearing level). For personal property tax appeals in the District, such review on subsequent appeal is not *de novo*. (Real property tax appeals are *de novo*, however.)
- Allow ability to escrow or partially pay disputed tax. While for real property tax purposes in the District, tax does not have to be paid before appeal, for personal property tax purposes, tax, along with penalties and interest, must be paid before appeal.
- Provide neutrality between the residential and business property tax burden. To ensure neutrality, the property tax burden must be shared equally between business property and residential property. In the "Residential v. Business Property" component of COST's property tax scorecard, the District of Columbia received an F. The District's business property tax rates are higher than for residential property; residential property tax is capped; and residential property owners are provided with various deductions not available for business property, resulting in a significantly higher business property effective tax rate and exacerbating the already significant rate disparity.

Unclaimed Property Administration

While not a tax, unclaimed property has increasingly become relied upon by state governments as a revenue source. Of course, the goal of unclaimed property administration is to reunite the

[9] The Best and Worst of Property Tax Administration, May 2011, available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=78745.

property with its rightful owner. The increasing use of unclaimed property funds as general revenue points to abuses in the administration of unclaimed property that must be addressed if a state is to become more business (holder) friendly. On the last COST unclaimed property scorecard,[10] the District of Columbia received a C-. Two changes would dramatically improve the District's score and improve its reputation as a place to do business.

First, the District of Columbia should exempt business-to-business transactions from unclaimed property reporting requirements. Businesses are in the best position to determine whether another business holds their property, and they do not need the assistance of the state in making such determinations. Indeed, because businesses have the incentive, opportunity and wherewithal to collect what is owed to them, significant credit balances between businesses are inherently reconcilable.

Second, the District of Columbia should refrain from entering into any contracts with contingent fee auditors, and bar the use of such auditors in its laws (this should apply to tax purposes as well). The risk of abuse creates a perception of unfairness that colors holders' relationships with administrators and creates an atmosphere of mistrust that hinders compliance. Equally important, excessive payments to contingent fee auditors significantly reduce funds that would otherwise be available for the owners of the property or for the general revenue of the District.

Conclusion

Thank you for this opportunity to provide input on behalf of COST to the Commission regarding the improvement of D.C.'s tax laws. COST stands ready to assist the District in this endeavor, and we welcome any questions you may have regarding the issues raised in this testimony or any other issues of interest.

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[10] The Best and Worst of State Unclaimed Property Laws, January 2009, available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=71960.