



D.C. Tax Revision Commission

MEETING MINUTES—DRAFT

Subject: D.C. Tax Revision Commission Meeting
Date: May 6, 2013
Time: 3:00 p.m. to 6:00 p.m.
Location: 1101 4th Street, SW, Room W-250 Washington, D.C. 20024

Members Present:

Anthony Williams	Fitzroy Lee
David Brunori	Ed Lazere
Catherine Collins	Pauline Schneider
Tracy Gordon	Stefan Tucker
Teresa Hinze	Nicola Whiteman

Invited Speakers:

Norton Francis, Senior Research Associate, Urban-Brookings Tax Policy Center

Dr. Robert Buschman, Senior Research Associate, Fiscal Research Center, Georgia State University

Staff:

Gerry Widdicombe	Ashley Lee
Richard C. Auxier	Rick Rybeck
Mike Bell	Steven Rosenthal

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 3:05pm. He noted there was currently not a quorum, and therefore approval of the minutes from the April 15 meeting and other Commission business was delayed. Mr. Williams then announced that the meeting would focus on business franchise taxes and the individual income tax and noted all materials presented at the meeting are available on the Commission’s website, www.dctaxrevisioncommission.org. While no D.C. Councilmembers attended the meeting, Mr. Williams announced that Councilmember Tommy Wells is scheduled to appear at the May 20 meeting. He also took a moment to thank the Office of Revenue Analysis (ORA) and Office of Tax and Revenue (OTR) for their continued and excellent support of the Commission and its work.

II. Presentation: D.C. Business Franchise Taxes

Mr. Williams then introduced Mr. Norton Francis, a senior research associate with the Tax Policy Center and former director of revenue estimation at ORA, and his presentation on business franchise taxes in the District. Mr. Francis, after thanking Mr. Williams for his introduction, said he planned to discuss the D.C. business income tax system and how business income is taxed in other jurisdictions. He began by noting that, because D.C. is prevented from taking non-resident income, the city relies heavily on business taxes. In fact, business taxes account for more than half of all D.C. tax revenue. (Most of this, however, is commercial property tax revenue and not business income tax revenue). He said that business tax revenue in D.C. had rebounded post-recession, a reflection of both recent legislative action and economic growth.

Mr. Francis said the first step in business income taxation is identifying taxpayers—called “nexus.” The identification of taxpayers previously was limited to physical presence (ownership of property within a state) but recently expanded to “economic presence” (businesses offering services, even if they lack physical presence). Most states, including Maryland and Virginia, now use economic presence but D.C. continues to identify taxpayers by physical presence. Mr. Williams asked what state currently had the most expansive taxpayer identification. Mr. Francis said Oregon has a very broad definition, deeming any business with a connection to the state as creating nexus. In contrast, Alabama has a “bright line test” that requires a business to have a physical presence to gain nexus in the state. He said the internet is making identification very tricky, and that D.C. should consider moving to an economic test because—while the city has a lot of economic activity—it does not have a lot of business with physical presence.

Once taxpayers are identified, the second step is the treatment of the taxpayer. D.C. previously required separate entity reporting for a parent company and its subsidiaries but recently switched to combined reporting. Mr. Francis said the latter method discourages companies from tax planning and that about half of all states with business income taxes now use combined reporting. Mr. Williams asked why, if combined reporting increases the tax base and captures more revenue, all states don’t use combined reporting. Mr. David Brunori responded that companies, operating within a particular state, will ask their legislature not to implement combined reporting because it will increase their tax bill. He also noted that there are legal arguments about the use of combined

reporting. Mr. Francis then stressed that combined reporting is not merely a revenue grabber. For example, Maryland has studied combined reporting for years and found that the revenue change is mixed and small. The problem, politically speaking, is that there are “winners” and “losers” from this policy change. Specifically, the financial industry sees a larger tax burden while manufacturing is less affected. Related, D.C.’s revenue increase since the switch is in part a reflection of its lack of manufacturing.

Another part of taxpayer treatment is apportionment. All states previously used a multi-state standard that equally weighed three factors (sales, payroll and property). But over the past 20 years many have moved to double weighing the sales factor or using just sales. The movement is spurred by tax planning: businesses are more likely to locate in a state that doesn’t use payroll or property in their apportionment. The District recently adopted double weighted sales because few businesses are physically located in the city. In fact, while most states lose revenue by emphasizing sales D.C. has experienced an increase.

Turning to rates, Mr. Francis noted the business franchise tax rate in D.C. (9.975%) is the highest in the region and third highest in the nation. But he stressed that rates do not tell the full story. In fact, the state with the highest top business income tax rate, Iowa, is given high marks by some “competitiveness” tests. Mr. Williams then asked why states don’t have uniformity on “treatment” and compete on rates. Mr. Francis answered that two forces are at work: the structure of businesses is evolving and states use “treatment” as an economic development tool. He added that tax credits are another economic development tool. But while many states have numerous credits D.C. only has four (and two are used by very few companies).

Mr. Francis closed his background presentation by noting D.C.’s system is somewhat different than others because it has an unincorporated business franchise tax. Other states tax also this income but do so through the individual income tax. D.C. has this particular tax because it is prevented from taxing nonresident income.

Before making his recommendations, Mr. Francis noted that D.C.’s business franchise tax has undergone major changes in the past three year, and that such changes resemble a reform package. In fact, many of the recent changes (combined reporting, double-weighted sales factor apportionment, and an increased minimum tax) were recommended by the 1998 D.C. Tax Revision Commission. Since these changes took effect so recently, however, there is little data available (for both the government and individual businesses) for analysis. Therefore, Mr. Francis advised it would be premature to change any of these policies at the moment. He also noted that D.C.’s economy is growing—both in sum and as a share of regional growth—and therefore the current business franchise tax system is not an impediment to growth.

Mr. Francis then made two concrete recommendations: 1) expand the tax base by asserting an economic presence for determining nexus; and 2) move to a single-sales factor, which he deemed the right fit for D.C.’s sales-based economy.

He also explained two options he was not recommending. One was a rate reduction. Mr. Francis emphasized working with the system and not just the rate. Still, a rate reduction will lead to a revenue reduction and the Commission must understand that creates tradeoffs (such as raising

taxes on commercial property or D.C. residents). He also did not recommend switching to a gross receipts tax. While this tax is advantageous because it's simple, D.C. must understand the effect it will have on individual businesses and the overall economy. For example, a gross receipts tax is typically an appealing option for manufacturing, a sector D.C. lacks.

After Mr. Francis completed his presentation, Mr. Brunori asked to list his objections to the corporate income tax, which included: it raises no revenue, it leads to tax planning (which results in businesses avoiding any tax liability), creates administration problems for government, and is overall "upside down" in efficiency. He also questioned why D.C. and other states tie the tax to sales (if the purpose is to link benefits and taxes) and the tax's progressivity (some of the burden falls on workers in the form of lower wages).

Mr. Francis responded that one reason D.C. has a business franchise tax is that—given federal restrictions—this is the only way to capture certain income. Also, since most workers in D.C. do not reside in the city the tax burden is lower for residents in D.C. than it is in other states with the tax. Furthermore, while the tax is admittedly complex, it raises a substantial amount of revenue for D.C. Ms. Tracy Gordon echoed this point, and stated that eliminating the tax would require finding substantial tax revenue elsewhere. She also noted that most businesses are far concerned with commercial property taxes than business income taxes—so eliminating this tax may not be the preferred reform. Mr. Francis and Ms. Gordon also discussed gross receipts taxes. Ms. Gordon expressed a concern for "pyramiding" and taxing business-to-business transactions. Mr. Francis replied that D.C.'s economy has less stages of production than most states (because it's service based); this is good for simplicity but possibly a problem for revenue.

After a question about a possible rate reduction from Ms. Nicola Whiteman, Mr. Francis explained that he had not seen much evidence that the current rate is turning businesses away from the city given D.C.'s economic growth. He also again stressed the need for the Commission to focus on the structure of the tax and not just the rate.

Mr. Ed Lazere then asked about the new minimum business franchise tax and what type of follow-up research Mr. Francis was proposing. Mr. Francis said it's important to discover who the taxpayers were in 2010 and who the taxpayers were in 2012, learn who (post policy change) were the winners and losers, and see how individual companies are handling apportionment. This data will most likely not be available until 2014, though.

Mr. Fitzroy Lee asked about the experiences of other states that have switched to combined reporting. Mr. Francis said there is typically a one-year increase in revenue (as the tax base expands) but that after that the rate of revenue growth is little different from separate reporting.

After another discussion about the purpose and goals of business franchise taxes, Mr. Lazere emphasized the benefits of exporting the tax. If the business franchise tax were eliminated the burden would be shifted to D.C. residents, which he said made little sense with respect to both policy and politics. He concluded by asking why change was need if D.C. has a strong economic tax base and evidence suggest the tax does not distort economic activity.

Mr. Brunori agreed with Mr. Lazere's political assessment, but argued the tax was still poor fiscal policy. He asserted that the exported tax gives residents more government services than they are willing to pay for. Mr. Francis noted that one benefit D.C. pays for is support the federal government, and therefore it makes sense to export some of that burden.

At the conclusion of this discussion, with no further questions, Mr. Williams thanked Mr. Francis for his testimony and his work for the Commission.

III. Presentation: D.C. Individual Income Tax

Mr. Williams then welcomed Mr. Robert Buschman, a senior research associate at Georgia State University, to discuss the individual income tax with the Commission. Mr. Buschman began his presentation by thanking the Commission for their invitation and ORA for their assistance with his report. He then stated the focus of his presentation was equity—both horizontal and vertical.

Before discussing the tax, Mr. Buschman contrasted D.C.'s demographics with its neighbors, Maryland and Virginia. By comparison, D.C.'s population has a larger share of high-income households, fewer married households and fewer households with dependents. He also discussed population migration. While the 1998 Tax Revision Commission was concerned with residents leaving the city, D.C. has seen strong population growth over the past five years. Within the region, more have moved from Virginia to D.C. than reverse, but the opposite is true with respect to D.C. and Maryland. There is evidence of high-income residents moving from D.C. to Virginia, though.

As for D.C.'s income tax system, it ranks high (when compared with states) in revenues measured per capita and as a percentage of income. The system is also one of the most progressive in the nation. Specifically, it is very progressive from low- to middle-income families but less so between middle- and high-income families. The D.C. income tax is also relatively less complex than others, with fewer credits and adjustments than most states. On a related topic, Mr. Buschman noted that D.C. is considering removing its exemption for out-of-state municipal bond interest. He said that while only one other state has this exemption (North Dakota) a few other states, such as Utah, have reciprocal agreements with neighboring states. He also noted that recent changes to the D.C. income tax—the phase out of deductions for high income earners and the new top marginal rate of 8.95%—have only increased the effective tax rate for high-income taxpayers.

Mr. Buschman then began to outline his recommendations for improving the D.C. individual income tax. His first set of options were designed to engender a simpler system. They included: eliminating or consolidating redundant filing options (specifically related to domestic partners); eliminating the Earned Income Tax Credit (EITC) for non-custodial parents (fewer than 10 claim this credit); eliminating gross-income subtraction for long-term care insurance premiums; and eliminating the District/federal survivor's benefits exclusion. None of these recommendations were modeled but their revenue effects were predicted to be minimal.

His next five options were premised on eliminating horizontal inequity in the D.C. system: elimination of the District employee first-time homebuyer credit (and instead supply it via employee benefits); elimination of the \$3,000 exclusion for District/federal retiree pensions (possibly making it available for all or no senior income); elimination of the low income credit (few

claim it and most that do don't have enough income to benefit from the nonrefundable credit); elimination of the homeowner and renter property tax credit (provide such relief elsewhere); and adding a limited exclusion for long-term capital gains.

Mr. Buschman's next set of recommendations were created as a framework for a larger reform discussion. His proposal was to eliminate itemized and standard deductions, because they distort horizontal equity and behavior, and instead increase the personal and dependent exemptions. Additionally, he proposed adjusting D.C.'s tax brackets—both tax rates and income threshold. While he presented and modeled particular changes, he said this was less a specific recommendation than a demonstration of how the Commission can propose reducing the effective tax rate for many low- and middle-income households. Mr. Buschman then presented information on the effects of his policy changes, both with respect to the tax liabilities of D.C. families and D.C.'s tax revenue.

Mr. Stefan Tucker began the Commission's larger discussion by noting that, in his experience as a tax lawyer, most high-income families do not leave D.C. for Virginia because of the income tax but rather because of the estate tax. He also noted that one reason D.C. exempts out-of-state municipal bond interest is because there is a limited supply of D.C. bonds for residents to purchase. Mr. Lazere added that the idea that families leave D.C. because of its income tax is not supported by the number of families moving from D.C. to Maryland (a state with similar if not higher income taxes). He said that points to other factors, particularly schools, as driving such migration. Mr. Gerry Widdicombe then noted that looking just at the region does not take into account all the migration to D.C. from the 48 other states. He said property owners have told him that most new D.C. residents are not from the Washington region. After a continued discussion on migration Mr. Widdicombe pledged to update the paper with national data.

Mr. Williams then asked about proposed federal tax reform that would limit deductions for state and local taxes, noting that such a limitation could severely affect D.C. taxpayers. Mr. Buschman said any plan to curb deductions will produce winners and losers, but again stressed his proposal is an effort to reduce horizontal inequity. Mr. Lee asked if middle-income families would be the hardest hit by limiting or ending itemized deductions. Mr. Buschman said middle income is where itemization begins but that high-income households universally itemize. Mr. Buschman also noted that D.C.'s current phase out of deductions still benefits those with more deductions. A hard deduction cap, in contrast, would do far more for horizontal equity. He also noted, however, that organizations such as charities and churches that benefit from deductions are sure to oppose any future limits on deductions.

Mr. Lazere then stated that the relatively high tax liability for middle-class families is most likely the result of applying the 8% rate on income above \$40,000—a rate he guessed is comparatively high for that level. He suggested lowering the rate for income in this range to smooth out the progressivity of the system. Mr. Lazere also noted that while the city's low-income tax credits are complicated and often counterproductive (as when they prevent taxpayers from claiming other and more favorable credits) that they are currently in place because D.C.'s standard deduction and personal exemption are so low. He favors eliminating the low-income credit for simplicity but advised the Commission to consider raising the standard deduction to compensate for a substantial loss of tax relief. Mr. Lazere then noted that D.C.'s multiple filing status—a target for simplification—allow some married couples to pay the top tax rate at \$700,000 of income and not

the intended threshold at \$350,000. Ms. Teresa Hinze added that the multiple filing statuses also force low-income residents (or volunteers assisting them) to do a lot of work attempting to discover what is the most beneficial filing status. Ms. Hinze also said she might favor the simplification of low-income and housing credits if such a change were coupled with an increase in the standard deduction and/or personal exemption. Mr. Buschman added that it is very common for states to have high standard deductions—and even higher deductions for seniors.

Mr. Williams then thanked Mr. Buschman for his time and his work for the Commission.

IV. Approval of Minutes

With a quorum now available, the minutes from the April 15, 2013 Commission meeting were approved without amendment.

V. D.C. Tax Revision Commission Business

Mr. Widdicombe proposed, and the commissioners supported, that relevant tax policy articles (both related to D.C. and national debates) be circulated by staff. He noted that circulated articles are for the benefit of the commissioners and are not an endorsement of any of the views expressed within. Mr. Widdicombe then announced that the staff is continuing its public outreach—having sent letters to each ANC group in the city—and is collecting participants for proposed public hearings in June and September. Mr. Widdicombe also announced that he recently had accepted an invitation to attend the fall meeting of the National Tax Association—an event that will feature many of the papers submitted to the Commission—to promote and discuss the work of the D.C. Tax Revision Commission. Finally, Mr. Widdicombe proposed two new projects/presentations: a study of competitiveness through case studies and an explanation of the ORA microsimulation model (used to forecast the fiscal effect of proposed tax changes).

VII. Adjournment

Mr. Williams called for adjournment at 5:15pm.