D.C. Tax Revision Commission

Dec. 18, 2013

Description of the Final Chairman's Mark

Make D.C.'s Tax System Fairer by Reforming the Individual Income Tax

D.C.'s tax system is generally progressive, especially compared to other state and local systems in the U.S. However, in the middle of the income range, families pay a relatively disproportionate share of their income in D.C. taxes. The Commission recommends increasing the progressivity of D.C.'s individual income taxes for the middle class.

Recommendation #1—Create a new tax bracket to relieve middle-income residents

The 8.5% tax rate on taxable income between $40,000 and $350,000 imposes a heavy burden on modest levels of income. To increase progressivity, the Commission recommends a new tax bracket for income between $40,000 and $80,000 at a rate of 6.5%. For single filers the 6.5% rate would apply to income between $40,000 and $60,000.

Recommendation #2—The top marginal individual income tax rate

The current top individual income tax rate of 8.95% expires on Jan. 1, 2016. Keep the bracket but permanently lower the rate 8.75%. Maintaining a 8.75% top rate preserves some of the progressivity of the proposed rate and bracket structure.

Recommendation #3—Raise the D.C. standard deduction and personal exemption to the federal levels

The Commission recommends raising D.C.'s standard deduction and personal exemption to the federal levels. As a result, the D.C. standard deduction would increase from $4,100 to $6,100 for singles and $12,200 for married joint filers. The D.C. personal exemption would increase from $1,675 to $3,900. The standard deduction and personal exemption are simple forms of tax relief for both taxpayers and administrators. All families would benefit from these extra deductions, but low- and middle-income families would benefit most.

Recommendation #4—Phase out personal exemptions for high-income earners

Create a phase out of personal exemptions that begins at $150,000 and reduces exemptions by 2% for each $2,500 in excess of the threshold. Do not change D.C.'s current phase out of itemized deductions.

Recommendation #5—Expand the Earned Income Tax Credit for childless workers

The Earned Income Tax Credit (EITC) is a vital tool to help low-income workers. D.C. currently supplements the federal EITC with a D.C. credit of 40% of the federal benefit. However, the federal and D.C. EITC offer relatively little assistance to workers who are childless. To help more, the Commission recommends increasing the D.C. EITC for childless workers to 100% of the federal credit.

Recommendation #6—Broaden the individual income tax base by eliminating expenditures

Increasing the standard deduction and personal exemption allows D.C. to broaden its tax base by eliminating four tax expenditures: the low income tax credit, the D.C. employee first-time homebuyer credit, the deduction for long-term care insurance, and the deduction for D.C. and federal government retiree pensions.

Recommendation #7—Simplify the system by conforming D.C.'s income tax filing statuses to the federal choices and creating a two-bracket system

The Commission recommends that D.C. adopt the federal filing options—which would reduce the number of options available for D.C. taxpayers from eight to five. Matching D.C.'s filing options with the federal options would simplify the D.C. tax code for taxpayers who would choose the same option for both their federal and D.C. forms.

Additionally, the Commission recommends that D.C. create separate brackets for married residents filing jointly and for single residents. Creating two bracket structures would help solve a potential "marriage penalty."

Create a More Competitive City that Attracts Business and Encourages Job Growth

Several members of our business community testified that D.C.'s business taxes are the highest in the region, and among the highest in the nation. The Commission recognizes the city has done relatively well over the past decade in growth in employment and population, but the recent retrenchment of the federal government warrants concern about the city's competitive position and highlights the importance of diversifying the D.C. economy. The Commission recommends several steps to lower these taxes.

Recommendation #8—Lower the business franchise tax rate

The Commission recommends lowering the District's business franchise tax (BFT) and unincorporated business franchise tax (UBFT) rate from 9.975% to 8.25%. As a result, D.C.'s business income tax rate would be the same as Maryland's rate (8.25%) and closer to Virginia's (6%). The Commission expects this large cut in business franchise taxes to signal that D.C. is "open for business."

Recommendation #9— Exempt investment funds from the unincorporated business franchise tax

The current UBFT effectively precludes investment funds from operating in D.C. As a result, the UBFT prevents a potentially vibrant industry from developing in D.C. By adopting a "trading safe harbor", similar to New York City's (and the federal government's), investment funds would generally be exempt from the UBFT, which would make D.C. more attractive to investment funds and their advisers.

Recommendation #10—Shift entirely to sales to apportion business income to D.C. for taxation

Many multi-state companies sell to D.C. customers but relatively few companies locate in D.C. (or have property or payroll in the city). Using a single-sales factor formula would make D.C. more attractive to firms that seek to add property or payroll to their operations in D.C. Making this change also helps fund the significant reduction in business franchise taxes that the Commission believes are essential to making D.C. a more competitive jurisdiction.

Simplify the Estate Tax and Make D.C. a More Welcoming Place for Retired Residents

Recommendation #11—Raise the estate tax threshold to $5.25 million (federal level)

D.C.'s current estate tax is unnecessarily complex, with an outdated tax formula tied to an obsolete federal law. The Commission recommends conforming D.C.'s estate tax to current federal law, including an increase in the threshold for the estate tax from $1 million to $5.25 million, with inflation adjustments in the future.

Transition to a More Efficient Tax System by Broadening the Sales Tax Base

D.C. has a broader sales tax base than both Maryland and Virginia. But D.C. can further broaden its tax base, without hurting D.C.'s competitiveness.

Recommendation #12—Raise sales tax rate to 6%

The D.C. Council recently reduced the general sales tax rate from a temporary rate of 6% to a permanent rate of 5.75%. However, as of July 2013, Virginia raised its general sales tax rate to 6% in the Northern Virginia.[1] Maryland's general sales tax rate is also 6%. As a result, D.C. could raise its rate to 6%, without harming its competitive position regionally. Furthermore, the revenue gained from raising the sales tax rate to 6% would help fund the individual income tax relief for low- and middle-income residents.

Recommendation #13—Expand the sales tax to more services

The national and D.C. sales tax base has declined as consumers have increased the percentage of their income spent on services as opposed to goods. The Commission recommends D.C. broaden the services

[1] On July 1, 2013, the Virginia state sales tax rate increased from 5% to 5.3% and the jurisdictions of Northern Virginia added an additional 0.7% to bring the rate to 6%.

that are taxable in the city. The services chosen for taxation were selected by Professor William Fox, an expert on the sales tax who presented a paper to the Commission.

Recommendation #14—Add a use tax line to the personal income tax return

When D.C. residents purchase products remotely (e.g., online), they are required to remit use taxes. However, very few residents pay this tax—typically because they are unaware of their responsibility. A line on the income tax return would remind residents of their obligation.

Recommendation #15—Unify taxation of tobacco products

D.C. currently taxes cigarettes and other tobacco products (OTPs) at different rates. Some OTPs are not taxed at all. The Commission recommends broadening the definition of OTPs and taxing all tobacco products at the same rate. This would remove any incentive for consumers to purchase a low- or non-taxed tobacco product.

Ensure That All Who Benefit from D.C. Contribute to a Vibrant City

D.C. is not permitted to tax the income of non-residents. In addition, D.C. is home to many organizations (e.g., universities, hospitals and large non-profit organizations) that are exempt from property taxes as well as organizations that are exempt from the city's unincorporated business franchise tax because over 80% of their revenue is derived from personal services. These exemptions limit the city's tax base. This result is higher tax rates for D.C. residents and other organizations.

Recommendation #16—Levy a local services fee on employers

The Commission recommends levying a local services fee on employers to spread the tax burden more fairly. The fee would be imposed on the employer, who would pay $25 per employee (using the number of employees listed on their unemployment filings) every quarter. Employers with four or fewer employees would be exempt from the fee. The fee would be simple, transparent and would be commensurate with the benefits (e.g., police, fire, and ambulance protection) provided by the city to employees.