D.C. Tax Revision Commission Policy Options

Policy Option #23: End the Exemption for Out-of-State Municipal Bonds

MEMORANDUM

Proposal: Eliminate the exemption for out-of-state municipal bonds
Tax Type: Income
Origin: Robert Buschman
Commission Goal: Broaden the tax base

Current Law

Interest earned by individuals, estates and trusts from out-of-state bonds is exempt from the D.C. individual income tax. Policymakers enacted a tax on interest income from all out-of-state bonds held by D.C. taxpayers (acquired after Dec. 31, 2012) but repealed the tax in August 2013.

Proposed Change

Remove the exemption for interest earned by individuals, estates and trusts from out-of-state bonds. Thus, only interest earned on D.C. bonds would be exempt from D.C. taxation. The exemption would grandfather out-of-state bonds acquired before the policy change.

Reason for Change

States typically exempt municipal bond interest to encourage investment in their bonds (or the bonds of a political subdivision). By exempting the interest on all municipal bonds, D.C. taxpayers effectively subsidize other state and local governments. Limiting the exemption to D.C. bonds would promote investment in the District.

Maryland, Virginia and virtually all states with an income tax include interest earned on out-of-state municipal bonds in taxable income. Utah has reciprocity and exempts the interest of bonds from states that allow an exemption for Utah bonds.

Pros

- Revenue gained from taxing out-of-state bonds could fund broad-based tax relief/cuts for D.C. residents.
- The exemption benefits a very small and specific set of taxpayers. Most investors in these bonds are relatively affluent.
- The proposal encourages residents to invest in D.C. bonds.

Cons

- Would negatively affect residents who want to invest in out-of-state bonds.
- The tax would fall disproportionally on seniors.
- D.C. has a limited supply of bonds to offer its residents

Revenue Impact

The Office of Revenue Analysis estimates that in the first year of implementation that removing the exemption for interest earned by individuals, estates and trusts from out-of-state bonds and income from a bond fund would raise $47,874,677 in new tax revenue (without the grandfather provision).