Testimony for the DC Tax Review Commission November 12, 2013 Public Hearing by Beth Marcus

Last June, at Mayor Gray's request, the DC Council revoked the 2011 municipal bond tax -- a tax that never actually went into effect due to annual grandfathering amendments. With this decisive action, the Council and the Mayor fixed the mistake made in May 2011 when, in a last minute deal without hearings or testimony, the Council substituted the bond tax for a tax on the highest earners.

The 2013 decision to repeal the bond tax was made after the Council and Mayor had the opportunity to hear from bond tax opponents -- a grass roots effort consisting primarily of senior citizens living in their retirement on their bond income – and the DC Fiscal Policy Institute (DCFPI), the only entity testifying for the bond tax. (In a November 3, 2011 letter to the Council, the DC branch of the AARP came out against the tax passed in May 2011.) However, although the DC government rightly put this issue to bed only a few months ago, Policy Option #23 raises the tax again.

On behalf of over 18,000 other DC residents with tax exempt income, I am testifying today to urge the Tax Review Commission to reject Policy Option #23. The written testimony I submitted in June, along with those from Neil Williams, Alma Gates, and Lora Leavy, provide the facts and rationale for no bond tax; I ask Commission members to please review these submissions. My testimony today focuses on the pros and the cons in Memorandum for Policy Option #23 in a way that will make clear to the Commission why, when taken together with our June testimonies, Policy Option #23 should be rejected.

<u>The Pros:</u>

"Revenue gained from taxing out-of-state bonds could fund broad-based tax relief/cuts for DC residents". The policy paper provides a revenue projection of almost $48 million for the first year of the tax that is based on a tax that is retroactive – a tax on income from non DC bonds owned prior to enactment of any tax. But the policy paper --and even those speaking to retain the tax during the 2013 Council hearings -- does not propose a retroactive tax, an egregious tax not enacted in any state. The policy paper proposes a tax that would apply to purchases made *after* the tax would be enacted, thus grandfathering income from current bond holdings.

So then what is the revenue projection for a tax like the one that is proposed in Policy Option #23? The Office of Revenue Analysis (ORA) gave us their projection in a March 28, 2013 memorandum to Council Chair Phil Mendelson on what revenue would not be received if the bond tax was repealed. The ORA projection for the first year of the proposed tax is $1.1 million -- not $48 million.

Even this estimate may be overstated because they appear to assume that DC bond investors will continue to act as they did prior to the bond tax which is not likely. In addition, as explained later in this testimony, because bond fund investors may not be able to identify income from bonds in the fund purchased after the tax is enacted, through no fault of their own, bond fund investors may not pay tax on non DC bonds purchased post-tax enactment in the fund. In this case, the projections will be

reduced significantly – possibly as much as 50% since, nationally, bond investors split fairly evenly investing in funds or individual bonds.

"The revenue benefits a very small and specific set of taxpayers. Most investors in these bonds are relatively affluent."
The vast majority of taxpayers have incomes that are significantly less than the $350,000 taxable income which is the income set by the Council in 2011 as a high income with the highest tax rate. Based on the 2011 ORA analysis of tax payers with tax exempt income, 64% have AGI from $40,000 to $200,000 and an additional 24% have AGI between $200,000 and $500,000.

Further, the final debate on the bond tax this year centered on a very small number of people with very large bond income, though whether this is from DC bonds which would not be taxable or non-DC bonds is not known. DCFPI wrote that there were 89 tax filers with bond income averaging $2 million; the Council's budget office said there were 16 people with bond income over $1 million and 139 people with bond income over $250,000. This is out of over 18,000 DC residents with bond income. Why penalize 99.5+% to go after less than 0.5%?

"The proposal encourages residents to invest in D.C. bonds."
In what bonds or DC only bond funds should we invest? There were only 15 DC bonds issued in 2012 and no bond funds or bond MMAs available in 2012 or any other year. And what about risk diversification? There is no geographic diversification offered with bonds issued in only one city and very little institutional diversification due to the limited number of bond issuers in DC.

Without a tax on non DC bonds, DC investors already invest in DC bonds and will continue to invest in DC bonds if the tax equivalent yield is competitive. However, yield is only one part of the equation; risk also must be considered. And because DC is just one city, investing only in DC bonds is a very risky venture due to the lack of geographic and institutional diversity. Thus, a tax on non DC bonds will not be enough to offset the other factors involved in bond purchase decisions.

<u>The Cons</u>
"Would negatively affect residents who want to invest in out-of-state bonds."
"DC has a limited supply of bonds to offer its residents."
I have combined these two cons because they are basically saying the same thing. The reason why residents invest in "out-of-state" bonds is because of how few bonds and how little risk diversification there is in a bond market consisting only of DC bonds. We don't *want* to invest in non DC bonds. What we want is to have equivalent tax exempt bond income, like state residents, that so many of us depend upon in our retirement. The only way to achieve this is to invest in non DC bonds.

If we lived in a state with geographic and institutional diversification and sufficient bond and fund choices, we would be able to create a tax exempt bond portfolio for our retirement income or find a bond fund that consisted only of our state bonds. But we live in a city comparable, for example, to

Baltimore, but without anywhere near the bond choices and diversification available to our Baltimore neighbors.

As noted, in 2012 there were only 15 bonds issued in Washington DC and there were no DC-only bond funds or money market accounts. All DC bonds are issued by a small number of issuers in one geographic city ranked 23rd by population. Thus, if a DC resident is limited to investing in only DC bonds to get the full value of a tax exempt bond, this resident has very little choice with individual bonds, has no choice if they want to invest in a bond fund or money market account, and is taking significant risk by investing in bonds issued in only one city by very few issuers.

My June testimony included a table showing bond issuances for the 50 states. Because DC residents can move to Maryland and Virginia and still enjoy the benefits of DC, comparing DC to Maryland and Virginia is especially relevant. The following table shows the difference in bond options whether you live in DC (one city/county-equivalent of 68 square miles) or in Maryland (24 counties and county-equivalents of 12,407 square miles) and Virginia (134 counties and county-equivalents of 42,769 square miles).

Jurisdiction	2012 Bond Issues	Available Bond Funds	Available MMAs
Washington DC	15	0	0
Maryland	97	45	1
Virginia	136	44	5

"The tax would fall disproportionately on seniors."

No one knows exactly what percent of the bond holders are seniors but we do know that 26% have pensions, though this doesn't include those without pensions (80% of private sector employees do not have pensions), those with any wage income, or those who are close to retirement and have created a bond portfolio for their retirement. Other estimates range from 50% to 75%. Whatever percentage one uses, the fact is that the percentage of bondholders who are seniors is significantly higher than 11.3%, the percent of DC's population who are seniors (less than the national 13%).

Municipal bonds are a common retirement investment tool. Why would DC intentionally enact a tax that significantly hurts seniors on fixed incomes who do not have wage income earning potential and who, especially today, are suffering from a decrease in income due to historically low interest rates?

Further, just last month, the Washington Post dedicated the Sunday magazine, along with follow-up articles, on the population increase in millennials who earn less than older residents and who, unlike seniors, are having young children who will soon be attending schools and using libraries, playgrounds, etc. Why would DC want to discourage seniors from living in/staying in DC when their use of public facilities is disproportionately less than their tax contributions, especially compared to those moving into DC?

A tax that disproportionately impacts a population that is already relatively small and may have greater mobility – not being tied to a job – does not encourage migration into DC; such a tax encourages

migration out of DC. Isn't it short sighted to pass a new tax that produces relatively little revenue but will discourage seniors from moving into DC and encourage seniors to leave DC?

Other Cons:

Policy Option #23 omitted several other critical cons to imposing a new bond tax. These include:

A bond tax would make DC less competitive than its surrounding jurisdictions.

The data provided above comparing DC with Maryland and Virginia vis-à-vis tax exempt municipal bonds demonstrates that anyone interested in investing in tax exempt bonds has exponentially more choices if they live in Maryland or Virginia, assuming that DC taxes non DC bond income.

A bond tax in DC would make DC the only city in the entire country that only exempts interest on bonds issued within its city.

We researched the income tax rules for cities and counties throughout the country, especially those with local income taxes. Our research indicates that none of these local jurisdictions imposes a special tax on income from municipal bonds issued outside of their borders. If DC taxes all bonds issued outside the city, it will be the only US local jurisdiction whose residents pay tax on income from all municipal bonds (other than territory bonds) issued outside its borders.

If non DC bonds are taxed, our advantage to sell DC bonds in the large Utah market will disappear.

Utah had a population that is 4.45 times DC's population which means it has a lot more people who could invest in DC bonds than DC has. Utah, which has a state income tax, does not tax bond income from states that do not tax Utah bond income. Prior to 2011, Utah did not tax DC bond income. After DC's passage of a bond tax, Utah changed its rules to tax income from DC bonds purchased after the DC bond tax was effective. With repeal of the DC bond tax, Utah will once again not tax DC bond income, making DC bonds very attractive to Utah residents. Doesn't it make more sense to open up the DC bond market to Utah's significantly larger population than to try to force DC residents to buy only DC bonds?

Not grandfathering bonds previously purchased would betray a trust and create an enormous burden; grandfathering the bonds creates a very complicated tax situation, especially for those with bond funds.

No jurisdiction had ever enacted a retroactive tax because the results are so egregious. Grandfathering, however, creates, effectively, an inequitable situation among bond investors and makes it so that DC may not even be able to fully administer the tax, unless DC treats the two different kinds of bond investors differently.

Bonds within funds are traded constantly. In addition, bonds, whether in funds or individually owned, are called frequently. In order just to maintain a portfolio – a fund or individually owned - new bonds have to be purchased. However, taxing bond investments post-grandfathering is not simple, especially with bond funds. Bond fund owners can figure out the percent of income from each state and DC but they don't know when the bonds were purchased. If a bond fund investor doesn't know what non DC bond income is from bonds purchased after a grandfathering date, DC can't fairly enforce this tax on a fund investor. Individual bond investors, just to maintain their portfolio after grandfathering, can technically figure out what income comes from non-DC bonds purchased after grandfathering.

When the bond tax was still "on the books", the Office of Tax and Revenue Tax Notice 2011-06 treated bond funds as "pass-through entities" and required taxpayers to obtain "written or electronic substantiation" that bond income was tax exempt. As noted above, for a bond fund investor, this proof doesn't exist since the documentation they receive on non-DC bond income does not provide the date the bond was purchased. The bond tax doesn't simplify the DC tax code; instead it complicates it significantly by putting in place a tax that is virtually impossible both for the bond fund investor to comply with and the DC government to enforce.

Because of the differences in the practicality of identifying income of bonds purchased after the grandfathering date, a municipal bond tax effectively creates two tax structures based solely on what form a DC resident chose to buy bonds – through funds or with individual bonds. This would mean that whether or not you paid tax may be decided solely on how difficult it is to do your taxes and how difficult it is for DC to enforce the tax. How is this equitable? How is this fair? How can this make sense?

Conclusion

After two years of debate, only a few months ago, Mayor Gray and the DC Council repealed a municipal bond tax just like the one proposed in Policy Option #23. They did this for reasons that include those in this testimony and the June testimonies by Neil Wiliams, Alma Gates, Lora Leavy, and me.

I urge the Tax Review Commission to reject Policy Option #23 -- a tax that significantly hurts seniors, makes DC non competitive with other jurisdictions, raises relatively little revenue, and creates a complicated and hard to enforce tax structure. Of all the taxes under consideration by the Tax Review Commission, the bond tax is perhaps the one most recently rejected by the Council and the Mayor after serious discussion and debate. By having this tax brought up one more time, DC residents, especially seniors, are being subjected to great uncertainty about their future and quality of lives in DC. It is time to close the books on this tax; it is time to make it clear that a bond tax is a bad tax for our city.

Subtitle (VII)(I) – Out-of-State Municipal Bond Tax Repeal Act of 2013

Background

This subtitle repeals[85] the tax on interest income earned on municipal bonds purchased after January 1, 2013.

Financial Plan Impact

Repealing the above-mentioned tax will reduce revenue by $1.1 million in FY 2013, $1.7 million in FY 2014, and $11.9 million over the FY 2014 through FY 2017 budget and financial plan period. The fiscal impact of the proposed subtitle is already incorporated into the proposed FY 2013 supplemental budget, and the proposed FY 2014 through FY 2017 budget and financial plan.

Estimated Fiscal Impact of Subtitle VII(I), Out-of-State Municipal Bond Tax Repeal Act of 2013, FY 2013 & FY 2014 - FY 2017 ($ thousands)						
	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	Four Year Total
Revenue reduction	($1,100)	($1,700)	($2,500)	($3,800)	($3,929)	($11,929)

Source: Office of Revenue Analysis estimates based on FY 2010 data on District taxpayers.

Subtitle (VII)(J) – Mandarin Hotel FY13 and FY14 Fund Transfers Amendment Act of 2013

Background

In 2002, the District issued tax increment revenue bonds for the Mandarin Oriental Hotel Project. This subtitle requires the Chief Financial Officer to recognize any tax increment above those amounts needed for debt service, as local revenue for Fiscal Years 2013 and 2014. The bond indenture allows for the return of any excess funds in the bond revenue account annually, on June 1.

Further, beginning in FY 2015, the subtitle requires the District to use excess tax increment revenue from the Mandarin project to prepay the Mandarin bonds in advance of their scheduled maturity.

Financial Plan Impact

The proposed subtitle increases the net tax increment available to the District's local fund by a projected $2.7 million in FY 2013 and $800,000 in FY 2014. Projected excess tax increment for FY 2015 through FY 2017 would be used to prepay Mandarin bonds in advance of their scheduled maturity. The impact of the proposed subtitle has been incorporated into the proposed FY 2014 through FY 2017 budget and financial plan.

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[85] By amending Section 47-1803.02(a) of the D.C. Official Code.