

## **Testimony of Lora J. Leavy**

### **Before the District of Columbia Tax Revision Commission Public Hearing June 24, 2013**

I am a fairly recent federal FERS retiree and a 47-year resident of the District, and I derive over half of my retirement income from municipal bond interest. I am grateful to have this opportunity to submit testimony before the District of Columbia Tax Revision Commission concerning the impact of taxing the interest from out-of-state municipal bonds.

#### **Overview**

By way of a brief review, out-of-state municipal bond interest has historically been exempted from DC income tax despite sporadic efforts to reverse that policy. The most recent bond-tax saga began in May 2011, when the DC Council voted to begin taxing out-of-state municipal bond interest effective retroactively to January 1, 2011. Subsequently the effective date of the tax was postponed twice, and the Council ultimately voted to “grandfather” all bonds purchased before January 1, 2013. This spring, when it became obvious that the original budget shortfall that the tax was intended to address had never materialized, Mayor Gray proposed, and the Council provisionally approved, full repeal of the tax. (The second reading of the budget is scheduled for a vote on June 26.) I and a grassroots assemblage of other seniors who had joined forces to contest the tax breathed a collective sigh of relief, but we all agreed there would be great value in sharing some of the facts we’ve learned with the Commission in hopes that it will advise against imposing a bond tax in the future.

In this testimony, the consequences of a municipal bond tax are discussed in the context of the Commission’s stated objectives, four of which have direct applicability.

#### **Objective: Provide for Fairness in Apportionment of Taxes**

A bond tax is inherently unfair because it falls disproportionately on middle-income seniors and retirees. There has been a perception among some Councilmembers and social justice advocates that only the very wealthy own municipal bonds. This belief is refuted by 2009 IRS data showing that approximately 50% of municipal bond investors across the country had federal adjusted gross incomes (AGI) below \$100,000 and that 75% earned less than \$200,000. Locally, 2010 data released by the District’s Office of Revenue Analysis showed that of the approximately 18,000 DC taxpayers who reported some amount of tax-exempt income, 65% had AGIs between \$50,000 and \$200,000. Given the District’s higher income levels and higher cost of living relative to the nation as a whole, AGIs in this range would not be atypical for single or joint filers reporting income from pensions, social security, and IRA withdrawals augmented by a small amount of taxable interest and dividends.

That seniors are the principal owners of municipal bonds is supported by 2010 IRS data, which indicates that 60% of interest income from tax-exempt bonds is reported by those over the age of 65. AARP, in a 2011 letter to the Council, estimated that up to 75% of DC bond investors “could be AARP members and/or persons of retirement age.” Although precise statistics have eluded this researcher, it is conventional wisdom that municipal bonds are largely held by an older demographic that regards them as the gold standard for a safe, fixed-income retirement strategy.

There are a number of reasons why municipal bond ownership continues to appeal to retirees and those approaching retirement age:

- Municipal bonds pay reliable fixed interest.
- Municipal bond prices generally fluctuate less than stock or corporate bond prices.
- Interest is exempt from federal taxation and, when issued by the state of residence, from state taxation as well, resulting in a tax-equivalent yield that in most instances outpaces inflation.
- Except in the rare case of a default, a municipal bond will repay its par value at maturity.
- Many bond owners appreciate that their money is lent to a local or state government for projects that make life better for the average person.
- In recent years, municipal bonds have outperformed other traditionally low-risk investments such as bank CDs and Treasury notes.

For District investors, the historically tax-free status of all municipal bonds made them an especially appealing proposition and has led many to make them the cornerstone of their retirement investment strategy. In my own case, it was largely based on the estimated income stream from tax-exempt bonds that I decided I could retire at age 65 and remain in this city. Therefore, if the District were to begin taxing out-of-state bonds, it would not only be targeting seniors and retirees—it would also be punishing those that it had implicitly encouraged to make such investments.

**Objective: Broaden the Tax Base**

Keeping municipal bond interest tax-free in the District would work indirectly to broaden the tax base by providing a strong incentive for seniors and retirees to remain in the District. Conversely, imposing a bond tax would encourage many seniors to relocate. Recent migration statistics highlight why it is important for the District to retain the 11.3% of its citizens who are 65 or older and to attempt to increase the 2.2% of in-migrants who are in the 65-and-over age bracket.

As Figure 1 below shows, in 2011 the District suffered a net loss of residents to its immediate neighbors. This continues a longer-term trend in which slight gains from Virginia have been offset by losses to Maryland. The outflow to Maryland and Virginia is even more notable when it is considered that the 25,346 departures in 2011 constituted 53% of all moves from the District to other states.

	... Who Moved to DC	... Who Moved from DC	Net Gain/Loss to DC
<b>No. of MD Residents</b>	<b>14,129</b>	<b>18,492</b>	<b>-4,363</b>
<b>No. of VA Residents</b>	<b>7,975</b>	<b>6,854</b>	<b>1,121</b>
<b>Total</b>	<b>22,104</b>	<b>25,346</b>	<b>-3,242</b>

**Figure 1. 2011 Migration Flows between DC, MD, and VA by Number**  
 (Source: U.S. Census Bureau, 2011 American Community Survey 1-Year Estimates)

Perhaps more relevant to this testimony are the income levels of those migrating into and out of the District. As Figure 2 shows, District residents who decamped for Maryland or Virginia in 2010 reported higher federal AGIs than those who moved into the District from those states. By one estimate,

somewhere in the neighborhood of \$235 million of adjusted gross income was thereby lost to the District. And the 2010 losses are part of an even more precipitous five-year trend.

	... Who Moved to DC	... Who Moved from DC	Net Gain/Loss to DC (\$)
Average AGI of MD Residents	\$43,944	\$54,220	\$ (10,276)
Average AGI of VA Residents	\$61,147	\$90,523	\$ (29,376)

**Figure 2. 2010 Migration Flows between DC, MD, and VA by Income**  
(Source: U.S. Internal Revenue Service, SOI Tax Statistics)

In-migration from the rest of the nation tends to be similarly skewed toward the lower income brackets. For example, Census Bureau data shows that of those aged 15 and up who moved into the District from another state in 2011, just 5.8% had incomes of \$75,000 or more.

While it is difficult to quantify the tax contributions of the District's senior population, it may be useful to examine IRS data from 2011, which shows that DC filers who singly or jointly reported an AGI of \$75,000 or more represented 26.4% of all filers. However, those same filers constituted:

- 55.4% of those reporting some taxable IRA distributions
- 36.0 % of those reporting taxable pensions or annuities
- 43.6% of those reporting taxable Social Security benefits

While these tax characteristics are not incontrovertible proof of senior status, they strongly imply that the District's seniors make a disproportionately large contribution to the city's tax base. It would not be unrealistic to conclude that a tax directed at a time-honored investment strategy will encourage many seniors to flee the District—with the wealthiest among them being in the best position to make the move.

*But tax revenue from seniors is not all the District stands to lose.* In addition to paying income taxes, property taxes, sales taxes, gasoline taxes, utilities, and rents, seniors make scores of invaluable contributions to the city's economic, institutional, and cultural fabric. To name a few:

- They patronize local businesses and service providers
- They volunteer at homeless shelters, thrift shops, food banks, polling places, museums, libraries, and other social and civic institutions
- They donate to local charities
- They teach in schools, community centers, and places of worship
- They are the mainstays of historical societies and preservation organizations
- They provide childcare services to their families and their neighbors
- They support local sports teams
- They volunteer for valuable citizen science initiatives such as stream quality monitoring, tree inventories, and bird counts
- They are major supporters of arts and cultural institutions as patrons, donors, and volunteers
- They are politically active, both as voters and candidates

**Objective: Make the District's Tax Policy More Competitive with Surrounding Jurisdictions**

If interest from out-of-state municipal bonds were taxed, DC bond investors would face virtually the worst investment climate in the country. The District's own bonds are too few in number and insufficiently diversified to safely compose more than a very small portion of an investor's portfolio. In all of 2012, the District issued only 15 bonds, whereas Maryland issued 97 and Virginia issued 136 (Thomson Reuters, January 2013). On the secondary market, the scarcity of DC bonds has driven up prices to the point where they are routinely offered at 10-15% above par, reducing their yields to almost nothing. The paucity of DC bond issues also means there is not and will never be even one single-state municipal bond fund for the District, whereas Maryland has 45 such funds and Virginia has 44. And finally, it should be noted that only a handful of other jurisdictions tax out-of-state bond interest at rates as high as the District's 8.5% or 8.95% rates. If the aim is to ensure that investment opportunities available to DC residents are competitive with those in neighboring states, the District would be best served by *not* taxing interest from out-of-state bonds.

**Objective: Modernize, Simplify, and Increase Transparency in the District's Tax Code**

Simplification would be the objective most negatively impacted were the District to impose a bond tax. As formulated by recent proponents, the tax would impose burdensome record-keeping requirements on investors and be virtually impossible for the city to administer accurately and fairly.

As an illustration, consider the recently repealed law under which investors' pre-2013 bond holdings were grandfathered. For DC investors who hold municipal bonds in a mutual fund, there is currently no way to determine the percentage of interest that was earned from bonds purchased on or after January 1, 2013. For tax year 2013, investors would need to know every interest payment made by every bond purchased by their fund(s) post-2012. Please note that the largest bond funds can hold *thousands of individual bonds*. Furthermore, given the common practice of bond funds to continue buying more of the same issues as they become available on the secondary market, it would be necessary to develop grandfathered vs. taxable proportions for the interest from such bonds. It is unlikely that bond funds would be willing or able to provide this level of detail to their shareholders. But even supposing, for the sake of argument, that this information could be made available, it would require investors to perform the types of calculations and analysis that they meant to avoid by investing in a mutual fund in the first place. I personally sold my holdings in two bond funds at the end of 2011 for fear of taking on this record-keeping nightmare.

For the approximately half of DC bond investors who hold individual bonds, all of the above considerations would hold true, albeit on a smaller scale. At best, very laborious record-keeping and highly complicated manual calculations would be required. For some investors, costly professional assistance would be mandatory. And due to the complexity of the calculations and the inability to foresee future redemptions and purchases, investors who make estimated quarterly tax payments would not be able to predict their tax obligation with any degree of accuracy. A large underpayment and associated penalty could very possibly be the result.

Some bond-tax proponents proposed that, due to the complexities noted above, those holding tax-free mutual funds purchased before 2013 be exempted from the tax in perpetuity, regardless of future acquisitions made by those funds. Meanwhile, those who directly bought the exact same out-of-state bonds that fund managers bought would be taxed. This provision would create a situation of *unprecedented unfairness*.

## **Conclusion**

To summarize, a tax on out-of-state municipal bonds would not support the Commission's stated objectives and would act in opposition to the Commission's three overarching questions:

1. *Does the tax system support the District's needs, both today and in the future?* At present, revenue from a bond tax is not needed. Were the District's finances to take an unfavorable turn in the future, a bond tax would still not be advisable because of its unproven revenue-raising capabilities and its disproportionate impact on the fixed incomes of seniors and retirees.
2. *Does the tax system encourage residents and businesses to locate in the District?* A bond tax would likely have the opposite effect on seniors and retirees, many of whom would seek to preserve their retirement income by relocating to lower-tax or no-tax states.
3. *Is the tax system easy and efficient to administer both from the perspective of taxpayer compliance and District enforcement?* Whatever the provisions of a bond tax, it would impose extremely confusing and burdensome reporting requirements on taxpayers and be virtually impossible to administer and enforce.

For these reasons, I strongly urge the Commission to reject a tax on out-of-state municipal bonds.

Continued

The Committee has also been informed that the Commission's findings  
should be taken into account in the future.

I have the honor to acknowledge the receipt of your letter of the 15th  
and to thank you for the information it contains. I am sure that the  
Commission will be able to take the necessary steps to correct the  
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