

**WRITTEN TESTIMONY OF NEIL WILLIAMS
BEFORE THE D.C. TAX REVISION COMMISSION
PUBLIC HEARING
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**THE EFFECTS OF AN OUT-OF-STATE BOND TAX ON EQUITY,
COMPETITIVENESS AND EFFICIENCY**

The D.C. Tax Revision Commission has been asked to analyze how a new tax on the income from out-of-state municipal bonds (the "bond tax") might help to meet five important objectives. Three of these objectives would be most affected: (1) equity, (2) competitiveness, and (3) efficiency.

(1) Equity: Provide for Fairness in Apportionment of Taxes

D.C. residents have always relied on tax-exempt income from out-of-state municipal bonds since Home Rule. D.C. has repeatedly considered and rejected taxing this income even during times of financial hardship.

The bond tax would fall disproportionately on seniors, retirees and others on fixed incomes. In a 11-3-11 letter to all DC Council members, the AARP wrote that: "The AARP's research shows that up to three-fourths of these [municipal bond] taxpayers could be AARP members and/or persons of retirement age."

Seniors and retirees prefer municipal bonds to other investments because they are a conservative and dependable source of income. Historically municipal bonds have exhibited lower default rates and much higher recovery rates than corporate bonds. They also provide more diversification. The absolute size of the corporate bond market is larger, but the municipal bond market has about 50,000 issuers compared with only 3,000 corporate bond issuers. Treasuries now yield less than benchmark municipal bonds with similar maturities so retirees who rely on "fixed incomes" would also earn less.

About 18,000 D.C. filers receive income from municipal bonds. Only a few "high income" taxpayers as defined by the D.C. Council (i.e., income greater than \$350,000) would be affected by the bond tax.

- According to a 2009 IRS report (through Reuters) on all filers with income from municipal bonds, about 50% had adjusted gross incomes under \$100,000 and about 75% under \$200,000.
- According to a 2010 IRS report (through the D.C. Chief Financial Officer) on D.C. filers with income from municipal bonds, about 65% had adjusted gross incomes under \$200,000. The data on D.C. filers reflects the relatively high incomes and cost of living in D.C..

The tax exemption for out-of-state bonds has allowed D.C. investors to compete on the same playing field as those in the 50 states. Unlike any state, D.C. is a medium-sized city

that issues very few bonds and will never have a “single-state” bond fund. The bond tax would make D.C. residents second-class citizens.

The bond tax would exponentially increase the marginal tax rates of some D.C. residents. For example a D.C. resident’s total taxes would increase by as much as 42% if she gets 30% of her income from a portfolio of non-D.C. bonds purchased by her mutual fund after the grandfathering date.

There is no method of grandfathering the bond tax that would equitably protect all existing investments. D.C. taxpayers who invest directly in individual bonds would be treated differently than those who invest indirectly in bonds funds, although the source of their income is exactly the same. The D.C. Council would have to choose one of two options: (1) Grandfather investments that were “acquired by the taxpayer” (as in the Budget Support Act of 2011) or (2) Treat investment companies as “pass-through entities” for purposes of grandfathering (as in OTR Tax Notice 2011-06.)

- The first option would allow a retiree who acquired grandfathered bonds indirectly in bond funds to obtain tax-exempt income until those funds are sold; however a retiree who purchased grandfathered bonds directly would be unable to replace them with others if necessary in the future.
- The second option would allow a retiree who acquired grandfathered bonds directly to obtain tax-exempt income until those bonds are sold, called or mature; however a retiree holding grandfathered bonds in bond funds would very quickly lose that tax exemption because bond funds employ cash management strategies that greatly inflate turnover rates.

Because of the bond tax D.C. residents would have to either pay a large, unexpected tax on their retirement incomes or suffer from much higher risk, historically low yield and significant loss of principal. D.C. residents who sold and replaced their out-of-state bonds would suffer financial harm including federal tax liabilities, commissions, and markups that would more than offset any new revenue D.C. might gain. Replacing a long-term bond fund purchased 30 years ago could result in Federal and D.C. capital gains taxes of about 10 percent of principal, and markups on purchasing individual D.C. bonds could cost another 3 to 4 percent.

(2) Competitiveness: Make D.C.’s Tax Policy More Competitive With Surrounding Jurisdictions

In 9 states the income from out-of-state municipal bonds is not taxed. Seven states (AK, FL, NV, SD, TX, WA and WY) have no income tax. Two states with an income tax (ND for all states and UT reciprocally) do not tax the income from out-of-state bonds.

Because D.C. is not part of a state it would be the only local jurisdiction in the United States whose residents pay tax on all municipal bonds issued outside its borders. A state or municipality offers its bonds tax-free to encourage investment, and the remaining state or municipality reciprocates at its level of government as a courtesy. Fourteen states (AL, AR, CO, DE, IA, IN, KY, MD, MI, MO, NY, OH, OR, and PA) allow cities,

counties, and municipalities to levy their own separate income taxes in addition to state taxes; however none of these local jurisdictions taxes interest on bonds issued by their respective states.

The bond tax would make D.C. less attractive than surrounding jurisdictions for those with investable assets. It would treat D.C. residents differently than state residents because the tax would apply to all bonds issued outside the city. D.C. should properly be compared with other local jurisdictions such as Baltimore County. It includes a larger city with more diverse general obligation and revenue bonds of various durations, but residents don't pay tax on the obligations of MD or any MD subdivision.

D.C. residents cannot obtain adequate diversification of risk with D.C. bonds alone. According to the Municipal Securities Rulemaking Board (MSRB) 2012 Fact Book, D.C. has relatively few securities available for purchase as measured by unique trades, all trades, or par value. For example, the average daily number of unique securities traded for D.C. was far less than for states that tax out-of-state bonds, high tax states (such as CA, NJ, and NY), and surrounding jurisdictions (MD and VA.) In 2012 D.C., MD and VA issued 15, 97 and 136 bonds respectively. D.C. also does not have a single-state bond fund but MD has 45 and VA has 44.

There is no evidence that the bond tax has increased demand for D.C. bonds or improved their ratings or prices. The bond tax had not taken effect in 2012 and investments in out-of-state bonds made before 12-31-12 had been grandfathered. Therefore D.C. residents did not buy D.C. bonds in 2012 in order to avoid the tax but actually had an incentive to buy individual out-of-state bonds that would remain tax-exempt in the future. D.C. only sells bonds to brokers/dealers so there is no way for anyone to determine if D.C. residents are holding them either directly or indirectly. According to the Securities Industry and Financial Markets Administration Municipal Issuance Survey, the total municipal issuance, both short- and long-term, reached \$402.0 billion in 2012, a dramatic increase from \$342.0 billion in 2011. The increase in sales of D.C. bonds in 2012 was consistent with these national trends including the need to refinance existing debt and was unrelated to the upcoming bond tax.

The bond tax would affect D.C. residents, not the institutional investors who dominate the market for D.C. bonds. Wealthy D.C. residents who hold bonds directly are a very small part of the D.C. bond market and an even smaller part of the national bond market. Nationally about a third of all municipal bonds is held by investment companies such as banks and insurance companies for reasons unrelated to the local tax exemption. Another third is held by mutual funds, closed end funds, UIT's and ETF's for whom adequate diversification is critical.

(3) Efficiency: Modernize, Simplify, and Increase Transparency in D.C.'s Tax Code

Taxpayers, financial institutions such as mutual funds, and the Office of Tax and Revenue would be unable to understand and reliably determine the percentage of income received from bonds that were grandfathered. There would be no straight-forward

“footnote” from financial institutions as the Office of Tax and Revenue has predicted. Even the largest mutual funds such as Vanguard and Fidelity have never provided such extensive grandfathering information to their clients. Other types of investment companies, such as UIT’s that hold a fixed unmanaged portfolio and closed-end funds that hold a limited number of shares, present many complications that make such reporting infeasible. ETF’s that track a municipal bond index, either with or without leverage, do not actually hold these bonds so this calculation would not be meaningful for them.

Compliance and administration of the bond tax would impose a costly regulatory burden on thousands of individuals, estates, and trusts as well as the D.C. government. The bond tax is so complex and confusing that it would create a bookkeeping and accounting nightmare for everyone. OTR Tax Notice 2011-06 anticipated this problem when it proposed to shift the burden of proof to the taxpayer. The Office of Tax and Revenue intended to presumptively deny the grandfathering of any income unless the taxpayer can obtain convincing “written or electronic substantiation” from each financial institution involved. Complying with this regulation would be a vexing problem, especially for taxpayers who hold bonds indirectly.

The bond tax would produce far less net revenues for the General Fund than the Office of Tax and Revenue expects because it will alter taxpayers’ behavior in many unintended ways.

- Revenues from income taxes would decrease when D.C. residents replace some non-D.C. bonds with tax-exempt bonds from the U.S. Treasury or Commonwealth/Possessions/Territories.
- Even assuming that D.C. residents decide to replace all their out-of-state bonds with D.C. bonds as advocates of the bond tax hope, D.C. would still lose the same amount of tax revenue as before. The tax-exempt income would just come from another source.
- Revenues from estates would decrease when D.C. residents move elsewhere rather than pay new taxes on old investments.
- Similarly revenues from property taxes would decrease when residents of MD, VA and other states who hold substantial amounts of their own state’s bonds are discouraged from moving into the city.
- Because OTR Tax Notice 2011-06 treats investment companies as “pass through entities,” D.C. residents would still be able to purchase non-D.C. bonds indirectly after the grandfathering date and avoid at least a portion of the bond tax.
- Utah, with a much larger population than D.C., would stop exempting D.C. bonds from state taxation reducing the overall demand for them.