



VINCENT C. GRAY
MAYOR

August 3, 2012

The Honorable Anthony A. Williams
Chairman, D.C. Tax Revision Commission
1156 15th Street, NW, Suite 600
Washington, DC 20005

Dear Mr. Williams:

It is with great pleasure that I accept your invitation to meet with you and the D.C. Tax Revision Commissioners on August 6th to provide remarks during your public kick-off meeting. As you know, I am pleased to support the creation of a new Commission to review the current tax structure of the District of Columbia, and to propose revisions where needed to insure a robust, equitable, and competitive tax system in the District of Columbia.

As you know, the last Tax Revision Commission was created in 1996 by an act of the Council of the District of Columbia at a time when the District was overseen by the District of Columbia Financial Control Board, and our government was near insolvency. The Commission was convened to carry out an independent and comprehensive review of District taxes and revenues, and provide recommendations for a potential overhaul of the entire revenue system, with special attention to the underlying problems of the District's economy, which was recovering from a depressed economy and experiencing years of population loss.

The situation could not be more different today, as we convene another Tax Revision Commission. Today the District of Columbia economy, although recovering from the national recession, is stronger than that of its surrounding jurisdictions. Our population is growing by as much as one thousand residents a month, unemployment has been steadily reduced under my administration, and the housing market is recovering. We have just sent our 17th consecutive balanced budget to Congress, our fund balance has been stabilized and is now rising again, and we enjoy a AAA bond rating on Wall Street for our income-tax secured bonds.

The underlying task of this Commission is not a complete overhaul that will address a fiscal imbalance, but rather a review to insure that the District of Columbia tax code is suited to the needs of the city early in the 21st century.

As you know, one of the most important goals of my administration is to grow and diversify the District's economy in order to increase prosperity, expand the tax base, reduce our dependence on the federal government, and create more jobs. I believe that the ideas I am sharing with you in

this letter will further these goals by channeling the tax code into a tool for targeting economic sectors with growth potential. This will in turn allow the District to attract and retain a critical mass of emerging businesses in the New Economy we are seeking to build.

1. Examine the impact of additional methods to attract and retain technology businesses through the tax code

One of the most important policy goals of this administration is to attract businesses of the future – namely technology, health care services, and education services. A tax code that is in step with these economic development goals is important. I have already proposed some significant tax changes to make us more competitive in attracting and retaining high technology companies through Bill 19-747, the “Technology Sector Enhancement Act of 2012”. I would request that the tax revision commission examine whether there are other tax changes that would allow the District to be even more competitive at becoming a hub for emerging technology businesses.

2. Lowering the commercial property tax rate

Please examine the impact on revenue of reducing the District’s commercial real property tax rate from \$1.65 to 90 cents per \$100 of assessed value for the first \$3 million of assessed value, and from \$1.85 to \$1.10 per \$100 of assessed value over \$3 million, phased in over a period of five years (15 cents per year).

I am interested in determining whether, for many large downtown office buildings that have low vacancy rates, the District would recapture most or all of the tax revenue lost from the lower rate through increased assessed values. Many of these large downtown buildings operate through triple-net leases, and presumably, if tenants were paying less taxes through a rate reduction, building owners would increase rents back up to the market value of the leased space. This, in turn, would increase the economic value of the building, because the property could generate more rent. There might be a two-year lag on recouping revenue as assessed values adjust.

I believe a real property tax rate reduction could provide tremendous tax relief for small businesses and spur economic development in neighborhood corridors, where I believe it would be much less likely to see a corresponding increase in assessed values, particularly in corridors like Georgia Avenue that are still developing business capacity. A 90 cent commercial rate for the first \$3 million of assessed value, would make our neighborhood businesses far more competitive with businesses that may be located just across the District line for tax purposes. Since I would not expect to immediately recapture revenue from neighborhood commercial property, I would like an analysis of the revenue the city would be foregoing. In the longer term, I believe lowering this rate will encourage small business development and eventually result in higher revenues for the District in the form of sales and income taxes from our neighborhood businesses.

Alternatively, please provide an analysis of the impact of lowering the tax rate only in certain zones that are most in need of business development. Based upon our economic development priorities, we will provide you with a list of areas we believe should be considered. Moreover,

reductions could be limited to a specific period in order to realize the catalytic effect, and then revert to a higher rate.

3. Certified Business Enterprise (CBE) property/income tax credits

Please consider whether it would be beneficial to provide a tax credit for District CBEs and the best method for ensuring the benefits of the credit reach the CBE. This would be easy for CBEs that own property, because it could be assessed as a credit against property taxes. For CBEs that rent space, it may, prove trickier, and I would ask that you examine the possibility of a tax credit against the CBEs franchise taxes.

Please consider the impact of this initiative at varying levels. In assessing the adverse revenue impacts of this initiative, please consider whether this would encourage additional firms who are not CBEs to seek such status merely for a tax break. Conversely, please consider the positive impact of this tax relief encouraging more CBEs to start-up or relocate to the District, thus increasing sales, franchise, and individual income taxes.

4. 401K pensions, retirement income, and estate tax relief

I have heard conflicting hypotheses over the years of whether reducing (or even eliminating) the District's 401K pension, retirement income, and estate taxes would increase or decrease the District's revenue. I heard from residents at the budget town hall meetings who suggested by lowering these tax rates we would have more high-income District seniors keep the District of Columbia as their principal residence, and would thus recoup more taxes. For instance, it has been suggested that by not taxing retirement income, we could actually recoup more from the investment income of seniors who would otherwise relocate to another jurisdiction as their principal residence. Similarly, if estate taxes are reduced, many believe that the District would see a revenue increase, because we would be drawing from a larger number of estates.

Conversely, others have argued that we would not recoup the revenue from reducing the rates, because many high-income seniors elect to keep the District as their primary place of residence for reasons other than taxes.

Please consider the appropriate taxation rate for maximizing District revenue. In this calculation please also consider how much we would lose from existing seniors in the District, versus the new revenue we would collect. It might also be helpful to examine the percent of residents we need to retain to make this initiative revenue neutral.

5. Pros and cons of taxing municipal bonds

When the Council first proposed a retroactive tax on all District Municipal bonds, I opposed such action, fearing that it would directly harm the investment District seniors had relied upon for their retirements. I eventually supported a compromise where existing out-of-state bonds would be grandfathered in tax-free, and out-of-state bonds would be taxed going forward.

However, I continued to hear many concerns that pooled bond funds made it almost impossible for residents to track which bonds were purchased before January 1, 2012. I thus proposed delaying implementation of this for another year in my Fiscal Year 2012 supplemental budget and listed it for permanent repeal on the revised revenue priority list of the Budget Support Act if revenue increased. The Council removed the one-year delay from the supplemental budget and lowered the repeal of the tax from #6 to #27 on the revised revenue priority list. I believe all policymakers would benefit from the commission's recommendation on the best approach to this.

In addition to the bond fund implementation challenges, fairness issues, and revenue implications mentioned above, there are other pros and cons to consider in analyzing this issue. For instance, by taxing out-of-state bonds competition increases for District bonds, but there is a question as to whether the District issues enough bonds to support the District resident investment community. Please examine both sides of this issue and provide a recommendation as to whether to tax all out-of-state bonds, tax no out-of-state bonds, or keep the existing situation that grandfathers out-of-state bonds purchased before January 1, 2012 as tax exempt.

6. Providing tax exemption/rebates to DC government employees possibly, in lieu of future salary increases to provide a more concentrated benefit to employees who live and pay taxes in the District of Columbia

Although the District is currently prohibited from imposing a commuter tax, even on its own District employees, please explore the legal possibility of the District providing an income tax credit to employees who live and pay taxes in the District of Columbia. If revenue were to increase to the point that the District could again consider employee raises above inflation, this credit could be negotiated in lieu of raises. The credit would provide a more concentrated economic benefit to District employees who reside in the District. It could also have the additional benefit of encouraging District employees to live in the communities they serve if the benefit was structured in that manner. The District would also clearly benefit by recouping more income tax revenue from its employees' salaries.

7. Lowering the corporate franchise tax

The District's corporate franchise tax is by far the highest in the region. Many have labeled this high tax rate an impediment for attracting and retaining businesses in the District, and have suggested that by lowering the rate, the District would eventually increase its tax revenue. I ask that you consider the revenue impact, both short and long term, of lowering the corporate franchise tax to various levels that are more in line with our surrounding jurisdictions.

8. Coordinate with the 5-Year Economic Development Strategy Advisory Group to examine how to more fairly tax business

One of the primary – and most controversial – recommendations of the 1998 Tax Revision Commission was to abolish the District’s four business taxes and replace them with a business activities tax. The reasons for this recommendation included a lack of uniform taxation among different types of businesses under the current tax structure, as well as the revenue instability of profits taxes generally. This recommendation was never acted upon; however, recently we have implemented franchise tax reforms, including apportionment using a double-weighted sales factor, and combined reporting, that were considered by the previous Commission. As the Commission reviews taxation of businesses in the District of Columbia, several issues should be considered:

- **Competitiveness** - Whenever a business tax policy change is considered, the first topic raised is the District’s relative competitiveness with surrounding jurisdictions. Although I recognize the difficulty in measuring tax competitiveness, and understand that other factors (e.g., centrality, regulatory burdens, and skilled labor supply) impact business location decisions, the relative tax burden of any changes in business taxation should be considered. Additionally, the Commission could examine whether certain targeted types of businesses may be attracted or retained through unique tax treatment.
- **Fairness** - The District of Columbia faces a unique challenge in its pursuit of a fair distribution of taxes – namely, the inability to tax income at its source (or, as more commonly known, the prohibition to enact a ‘commuter tax’). Although most often raised as a concern with individual income taxation, the problem has a profound impact on the taxation of businesses as well -- particularly in the service industries that tend to be organized as partnerships and unincorporated businesses, and are taxed via the personal income tax. This issue is a primary contributor to the uniformity problem alluded to above. Solutions to mitigate this problem would not only contribute to a more fair tax system, but to a stronger tax base as well.

9. Examine Tax Expenditures

Tax abatements, exclusions, exemptions, deductions, credits, and other preferences are often used in the District of Columbia to promote the policy goals of the government. There are currently 229 separate tax expenditures included in the District of Columbia tax code: 111 as a result of District of Columbia conformity with Federal individual and corporate income tax law; and 118 specific to District law. Over time, as the tax code has evolved, multiple tax expenditures have been enacted to address similar or identical policy goals.

For example, according to the Office of the Chief Financial Officer, the four policy areas with the largest number of federal conformity tax expenditure provisions are economic development (27 tax expenditures), income security (15), education (12), and health (11). The four policy areas with the largest number of local tax expenditures are housing (26 tax expenditures), economic development (24), social policy (14), and income security (12).

Many of these tax expenditures were enacted decades ago, while others are more recent; however, a close look at the efficacy of each, with a view toward simplification or consolidation where needed, would be useful.

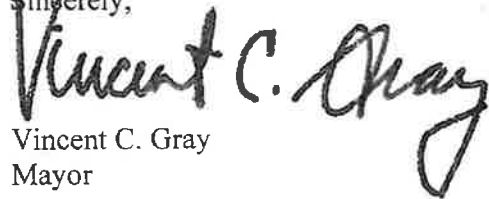
For example, The Homeowner and Renter Property Tax Credit -- informally know as a property tax "circuit breaker" -- was enacted in 1977 to limit property tax exposure for low-income, elderly and persons with disabilities -- regardless of whether they own or rent -- by providing a tax credit for assessed property tax via the D.C. income tax administration. The credit is currently available to eligible District households with income of no more than \$20,000 annually, and has a maximum value of \$750 per household. Neither the annual income threshold nor the maximum credit value has been adjusted for inflation in the 35 years since the credit was implemented, although a recent piece of legislation (B19-164) was drafted in part to address this issue.

However, given the myriad other income and housing support tax provisions that have been enacted since implementation of the circuit breaker, and given a potential fiscal impact that could range anywhere from \$5 million to \$20+ million, B19-164 may need revisions. In particular, the question of whether this reform might be paired -- and paid for -- by simplifying and consolidating many of the tax relief provisions that are targeted to the senior citizens, persons with disabilities, and low-income households for whom this reform bill was drafted. This is just a single example of an area in which the DC tax code might be updated to increase efficiency and simplicity.

Please consider the best method of simplifying D.C. tax expenditures in a way that is both simpler and fairer.

In closing, I would like to thank all of the Commissioners who have agreed to provide their time and talents to the residents of the District of Columbia. I would especially like to thank you, Mr. Williams, for agreeing to Chair the Commission, and provide the leadership that such a task will require. I look forward to the work of the Commission, and its independent recommendations for a stronger, more efficient, and equitable tax system for the District of Columbia.

Sincerely,

A handwritten signature in black ink that reads "Vincent C. Gray". The signature is written in a cursive style with a large, looped "G" at the end.

Vincent C. Gray
Mayor