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The District of Columbia Considers Impressive Tax Reform Options

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Executive Summary

On February 12, 2014, the District of Columbia Tax Revision Commission submitted its recommendations for overhauling the District's tax system. The Commission, established in September 2011, had conducted dozens of meetings and hearings to develop its package of reforms, and the package as a whole received unanimous support from the Commission's members.[1]

The Commission concluded that the District's current tax system has three major shortcomings: (1) middle-class residents pay a relatively large share of their income in District taxes; (2) business taxes are too high; and (3) the District's tax base is too narrow. The Commission's recommendations seek to address these issues with reforms to the individual income tax, business taxes, sales tax, and estate tax. Taken together, the recommendations balance competing priorities to improve the simplicity, fairness, neutrality, and economic competitiveness of the District's tax system.

On April 3, D.C. Mayor Vincent Gray presented a budget proposal to the D.C. Council which includes two of the Commission's recommendations (adopting single sales factor apportionment and unifying tobacco taxes) and modified versions of two others (adding a 7.5 percent middle-income tax bracket and a business tax reduction from 9.975 percent to 9.4 percent) but did not include the rest.

1 The Commission's members were former Mayor Anthony Williams (Chair); David Brunori of George Washington University and editor at Tax Analysts; Catherine Collins of George Washington University; Mark Ein of Venturehouse Group; Teresa Hinze of Community Tax Aid; Ed Lazere of the DC Fiscal Policy Institute; Kim Reuben of the Urban-Brookings Tax Policy Center; Pauline Schneider of Ballard Spahr LLP; Stefan Tucker of Venable LLP; and Nicola Whiteman of the Apartment and Office Building Association.

Individual Income Tax

The Commission makes nine recommendations for reforming the District's individual income tax:

- Filing Statuses: Consolidate the District's eight filing statuses into five, matching the federal government.
- Joint Filers: Reduce the marriage penalty by creating separate tax brackets for married filers.
- Middle-Income Rate Cut: Add a 6.5 percent income tax bracket, reducing tax for those earning more than $40,000.
- Top Income Tax Rate: Reduce the top income tax rate from 8.95 percent to 8.75 percent in 2016 instead of the currently scheduled 8.5 percent.
- Tax-Free Income: Increase the standard deduction and personal exemption and adjust them annually for inflation.
- EITC: Increase the Earned Income Tax Credit (EITC) to 100 percent of the federal EITC for childless workers.
- PEP: Adopt a personal exemption phaseout (PEP) for high-income taxpayers.
- Remove unused credits: Eliminate the low income tax credit, District employee homebuyer tax credit, long-term care insurance deduction, and government pension exclusion.

Table 1 provides more detail on the Commission's recommended changes to tax rates and brackets, the standard deduction, and the personal exemption.

The District's income tax currently consists of four brackets: an initial bracket of 4 percent, with income over $10,000 subject to a 6 percent tax, income over $40,000 subject to an 8.5 percent tax, and income over $350,000 subject to an 8.95 percent tax. The rates apply to all tax filers, resulting in a significant marriage penalty for married couples. Neighboring Virginia imposes a top tax rate of 5.75 percent on income over $17,000 and middle-income taxpayers in neighboring Maryland counties pay a tax rate of 7.95 percent. Maryland and Virginia also have marriage penalties, although Virginia offers a credit designed to mitigate much of it.

Currently, income tax payers can itemize deductions or take a $4,100 standard deduction, plus exempt $1,675 of income per household member:

- A married couple with two children pays no tax on their first $10,800 in income.
- A single person with one child pays no tax on his or her first $9,125 in income

Table 1: DC Tax Revision Commission Recommended Individual Income Tax Changes

	Current Tax System	Commission Recommendation
Tax Brackets and Rates	4% for income above $0 6% for income above $10,000 8.5% for income above $40,000 8.95% for income above $350,000	For single filers: 4% for income above $0 6% for income above $10,000 6.5% for income above $40,000 8.5% for income above $60,000 8.75% for income above $200,000 For married filers: 4% for income above $0 6% for income above $10,000 6.5% for income above $40,000 8.5% for income above $80,000 8.75% for income above $350,000
Standard Deduction	$4,100 Itemized deductions phased out for taxpayers with income over $200,000 by 5% of AGI over threshold	$6,100 (single), $12,200 (married), adjust annually for inflation Itemized deductions phased out for taxpayers with income over $200,000 by 5% of AGI over threshold
Personal Exemption	$1,675	$3,900, adjusted annually for inflation Phase out for taxpayers with income over $150,000 (single) or $200,000 (married) by 2% for each $2,500 above threshold

Source: District of Columbia; D.C. Tax Revision Commission.

Under the Commission's recommended system, the standard deduction will be raised to $6,100 for singles and $12,200 for married filers, matching the federal government. Additionally, the personal exemption will be raised to $3,900 per household member, again matching the federal government. Thus:

- A married couple with two children pays no tax on their first $27,800 in income.

- A single person with one child pays no tax on his or her first $13,900 in income.

This change, along with the new middle-income tax bracket and the reduction in the top tax rate, would result in almost all taxpayers seeing lower income tax bills. Table 2 reviews the change in income tax liability by seven hypothetical taxpayers. The most significant reductions occur for low-income workers and middle-income married taxpayers.

Table 2: Income Tax Liability for Seven Hypothetical Taxpayers under Proposed D.C. Tax Reform

	Van	Max	Jason & Nicole	Danielle	Laura & Jeremy	Sam & Ellen	Heidi & Bret
Filing Status	Single	Head of Household	Married	Single	Married	Married	Married
Income	$11,960	$23,920	$66,000	$75,000	$108,000	$360,000	$2,700,000
Children	0	1	2	0	1	0	2
Current D.C. Tax Bill	$175	($103)	$3,492	$4,650	$6,084	$26,429	$238,275
Proposed D.C. Tax Bill	($487)	($490)	$2,092	$4,061	$4,736	$25,914	$233,375
Dollar Change	($662)	($387)	($1,400)	($589)	($1,348)	($515)	($4,900)
Percentage Change	(378%)	(376%)	(40%)	(13%)	(22%)	(2%)	(2%)
Maryland Tax Bill	$354	$68	$3,859	$5,298	$6,397	$25,548	$221,607
Virginia Tax Bill	$236	$393	$2,979	$3,743	$4,798	$18,059	$143,911

Source: Tax Foundation calculations for tax year 2013. Assumes taxpayers with income below $75,000 take the standard deduction and taxpayers with income above $75,000 itemize at amounts based on IRS data: Danielle itemizes 6 percent of her income, Laura & Jeremy 16 percent, Sam & Ellen 11 percent, and Heidi & Bret 7 percent. Maryland taxpayer lives in Montgomery County and tax bill includes 3.2 percent local income tax. Proposed D.C. tax bill incorporates recommended changes to middle tax bracket, top tax rate of 8.75%, increased standard deduction and personal exemption, phaseouts of deductions and exemptions for high-income taxpayers, and increased EITC for childless workers.

The Commission considered but rejected a number of income tax proposals. A proposal to add more high-income tax brackets was rejected because they would exceed those of neighboring Maryland and widen the gap with Virginia. A proposal to further reduce the top income tax rate was rejected due to high revenue loss. A proposal to tax non-D.C. state bonds was rejected because the D.C. Council had recently voted against that approach.

Business Taxes

The Commission made four recommendations with respect to the District's business taxes:

- Reduce the District's franchise taxes (corporate income tax and tax on unincorporated businesses) from 9.975 percent to 8.25 percent, equal to Maryland's 8.25 percent rate and closer to Virginia's 6 percent rate.
- Expand the unincorporated businesses tax's current personal services exemption to include investment funds, which are effectively nonexistent in the District due to the tax.
- Adopt single-sales factor apportionment.
- Impose a "local services fee" of $100 per employee per year on all non-governmental employers with five or more employees, to collect some revenue from commuting employees exempt from D.C. tax.

A proposal to eliminate business taxes was rejected due to high revenue cost, as was a proposal to adopt a gross receipts tax due to a high rate being needed and the likelihood of negative economic distortions. Proposals for targeted business tax incentives were also rejected.

Sales Tax

The Commission made four recommendations with respect to the District's sales tax:

- Raise the sales tax rate from 5.75 percent to 6 percent, returning the rate to where it stood prior to October 2013 and matching the 6 percent sales tax rates in Maryland and northern Virginia.
- Expand the sales tax to consumer purchases of certain services: construction contractors and other construction-related services, storage of household goods and mini-storage, water for consumption at home, barber and beautician services, carpet and upholstery cleaning, health clubs and tanning studios, car washes, and bowling alleys and billiard parlors.
- Instruct taxpayers to pay use tax—a tax on the purchase of an item upon which sales tax has not been paid—on the income tax return, including an estimated use tax table to simplify recordkeeping.
- Replace an array of taxes on non-cigarette tobacco products (chewing tobacco, smokeless tobacco, snuff, and roll-your-own tobacco) with a single excise tax of 80 percent of the wholesale price, equivalent to the $2.50 per pack cigarette tax rate if it were expressed as a percentage of wholesale price.

The Commission rejected further increases in taxes aimed at non-residents (18 percent parking tax, 14.5 percent hotel tax, 10 percent rental car tax, and 10 percent meals tax), as they would discourage business growth and job creation. The Commission also rejected a proposal to tax groceries and prescription drugs, citing other states' practices. A proposal to adopt an "Amazon tax" on online sellers was also rejected as likely to be challenged in court and unlikely to produce much revenue.

Estate Tax

The Commission recommended recoupling the District's estate tax exemption level with the federal government exemption level, thus increasing the estate exemption from $1 million to $5.25 million and adjusting it annually for inflation. The Commission also recommended a simplified rate structure that maintains the top rate of 16 percent while reducing the number of brackets from 21 to three. Maryland and New York this year passed similar laws recoupling to the federal estate tax exemption.

The Commission rejected a proposal to eliminate the estate tax, citing revenue loss and skepticism about whether elimination would impact migration. Virginia does not impose a state-level estate tax, although Maryland does.

Property Tax

The Commission rejected a number of property tax proposals. A proposal to reduce residential property tax rates was rejected because they are already the lowest in the region. A proposal to reduce high commercial property taxes ($1.85 per $100 in value, compared with $1.22 to $1.42 in Maryland and $1.00 in Virginia) was rejected due to high revenue loss and because a franchise tax reduction would have greater impact. A proposal to tax land at a higher rate than buildings was rejected because no other major city does so. A proposal to reduce the District's deed and recordation taxes (which range from 2.2 percent to 2.9 percent) was rejected due to skepticism that it would have an effect on transactions.

Revenue Impact

Table 3 illustrates the revenue impact of the Commission's recommendations, which would reduce annual revenue by approximately $52 million to $74 million out of the District's $7 billion annual budget.

Table 3: Projected Revenue Impact of D.C. Tax Revision Commission Recommendations

(millions of dollars)

Recommendation	FY 2015	FY 2016	FY 2017	FY 2018
Income tax changes (create middle-class tax bracket, increase standard deduction, increase personal exemption, expand EITC, and other changes)	-$124.8	-$103.7	-$109.0	-$111.8
Reduce business tax rate from 9.975 percent to 8.25 percent	-$57.0	-$59.9	-$62.6	-$65.4
Adopt single-sales factor apportionment	+$20.0	+$21.0	+$22.0	+$22.9
Impose $100-per-employee local services fee on non-governmental employers	+$45.0	+$45.5	+$45.9	+$46.2
Raise sales tax rate from 5.75 percent to 6 percent	+$20.5	+$21.3	+$22.1	+$23.0
Expand sales tax to select services	+$28.2	+$29.3	+$30.4	+$31.5
Add use tax collection to income tax form	+$1.0	+$1.0	+$1.1	+$1.1
Unify taxation of tobacco products	+$7.0	+$6.9	+$6.8	+$6.6
Total Revenue Impact	-$74.0	-$52.5	-$57.3	-$59.6

Source: D.C. Tax Revision Commission.

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