JOINT PUBLIC HEARING

BILL 15-180, “COMMUTER TAX ACT OF 2003”

AND

BILL 15-212, “DISTRICT GOVERNMENT NONRESIDENT EMPLOYEES TAX ACT OF 2003”

Before the

Committee of the Whole
Committee on Finance and Revenue
Committee on Government Operations
Subcommittee on Public Interest
Council of the District of Columbia

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Council Chamber

Testimony of
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Good morning, Chairman Cropp, and chairmen and members of the committees. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia. I am here today to testify on two bills: Bill 15-180, the "Commuter Tax Act of 2003," and Bill 15-212, the "District Government Nonresident Employees Tax Act of 2003."

Relationship to the Structural Imbalance

Before I begin my formal remarks concerning these two bills, I would like to make some introductory comments concerning the circumstances under which we are discussing them. As you know, Madame Chairman, I have long argued that the District faces a structural imbalance between our sources of revenue and our needs for public services. I have not, of course, been alone in raising this issue. Recently, the General Accounting Office (GAO) concluded, after a thorough study, that the structural imbalance indeed exists. The Commuter Tax Act bill would, if it could be enacted, make a significant reduction in that imbalance, and would place the District in the same position as other taxing jurisdictions that can tax income at its source.

The GAO report on this subject estimated that the structural deficit ranged from a low of $470 million to more than $1.1 billion a year, figures arrived at by combining estimates of the District's cost of providing an average state basket of services with estimates of revenue capacity. Economic changes have led other jurisdictions to begin identifying structural issues as well, and the District shares in the breadth and depth of problems facing most states and localities. In addition, however, the District's structural imbalance is extreme, driven by the unique set of services provided by the District and the unique set of restrictions that limit the District's revenue raising capacity. I have testified to these requirements and restrictions on several occasions before this Council and the Congress. In the District, we provide city services, state services, county services and even the services of a school district; we also provide public safety and public works services to the federal government itself. The provision of state-type services such as the Department of Motor Vehicles, the Department of Mental Health, the University of the District of Columbia, and the Department of Consumer and Regulatory Affairs costs us as much as $500 million a year. Public safety and public works services provided to the federal government cost us approximately $200 million a year.

We do all this with an artificially constrained tax base. We cannot tax the income of people working in the District and living elsewhere, a restriction faced by no state. A two percent commuter tax would raise approximately $540 million annually. Ironically, even if the District cannot tax income at its source, the District residents who earn income in other states are subject to tax in most of those states. Those District residents, including attorneys in firms with multi-state practices, then claim credits for those taxes against their District tax obligations.

To illustrate this point, let me cite the example of an attorney who is a District resident, who has a federal lobbying practice within the District, and who is a partner with a multi-state law firm. Even though this attorney works entirely on business activities here in the District, since his/her law firm files a "composite tax return" that lists 15 percent of the law firm's work as sourced in New York, that District resident partner is required to file a New York income tax return and to pay New York taxes on that 15 percent of his/her income. Under the District tax code, the lawyer gets a credit on his/her District income tax return for the amount of income tax paid to New York [Section 47-1806.04(a) of the DC Official Code].

Moreover, while states generally do not object to this operation of the "sourcing rule" due to the reciprocal nature of such income tax payments, the congressional restriction on District taxation of nonresident income means that the rule operates here as a one-way street. District residents' income is taxed by other jurisdictions under the sourcing rule, and the District provides a credit for such taxes paid. But the District receives no taxes from partners in the New York office of the multi-state law firm, even if that firm does a substantial amount of District-sourced business.

We cannot count on high-density real property to make up for our limited taxable property because of the height restrictions on District buildings. We cannot tax about 42 percent of the real property in the city, because that property is owned by the federal government, diplomatic missions, or international institutions. The District's biggest industry does not pay District taxes, but imposes costs on the city. The District, of course, enjoys the honor and privilege of being the nation's capital and economic benefits of being the seat of the federal government, but on balance the costs outweigh the benefits.

The existence of the structural imbalance does not mean, of course, that our budget is not balanced – quite the contrary. We have now had six consecutive balanced budgets, and the District's credit rating has been raised. But we have achieved that at considerable long-term cost: our debt is unusually heavy for a city or state of our size, our tax rates are among the highest in the region and the country, and our income tax rates for married taxpayers are 10-15 percent higher than Maryland and more than 50 percent higher than Virginia. Our pay scales for rank and file employees in some of our departments are not competitive, and some of our physical infrastructure is decaying.

The GAO also pointed out that a substantial structural deficit would still exist even as the District government improves the efficiency and effectiveness of its programs.

Reciprocity with Neighboring States

Let me suggest that reciprocity among surrounding jurisdictions is the key to an effective implementation of these bills in general and for voluntary compliance with them.

Tax reciprocity among states is a complex issue, often boiling down to whether or not two states have a similar number of residents commuting between them. The District does not have a "reciprocal agreement" with either Maryland or Virginia. In both states, the reference to the District in the statute is apparently attributable to the congressional prohibition restricting the District from taxing the income of Maryland and Virginia residents.

But tax compliance related to income tax is often dependent upon mandatory withholding and remitting of that withholding tax to the resident state. Where District residents are employed in Maryland and Virginia, the District is dependent upon the Maryland or Virginia employer's willingness to register with our Office of Tax and Revenue (OTR), to set up a withholding account, and to file employer withholding returns. Absent that voluntary withholding by the employer, the

District is dependent upon a resident filing estimated tax payments and filing an annual tax return with the District.

We have anecdotal reports that many Maryland and Virginia employers refuse to register with OTR for withholding and refuse to withhold District taxes. In all these cases, the employer generally withholds Maryland or Virginia taxes. Anecdotal evidence also indicates that many of these employees do not think they should have to pay estimated taxes to the District, since their Maryland or Virginia employer is withholding Maryland or Virginia taxes from their paychecks. This means that the District is then dependent upon the resident (1) filing a nonresident tax return with Maryland or Virginia for a refund of the withheld taxes, and (2) filing estimated tax payments with the District throughout the year. This is not only inconvenient for the District resident employed in Maryland or Virginia, but places an additional financial burden on the District resident and the District government, and can result in taxes not paid and returns not filed.

Provisions of the Bills

Now let me turn to the bills under consideration. These bills impose graduated taxes on wage and salary income of individuals who are employed in the District but live outside the District. The bills appear to be identical except that Bill 15-212 applies only to individuals who are employed by the D.C. Government, whereas Bill 15-180 applies to all employees who work in the District.

The bills are very simple. Each imposes a tax on the "salary and wages of non-resident individuals employed in the District" or "by the District Government." An individual's tax is determined by calculating specified percentages of "the taxable income." The percentages are: one half of one percent if the individual's taxable income is not more than $10,000, one percent if taxable income exceeds $10,000 but is not greater than $40,000, and two percent if taxable income exceeds $40,000.

The effective date provisions of the bills are also identical. Each would take effect on occurrence of the later of two events: (1) the passage of 30 days after the bill had been approved and published in the District of Columbia Register, or (2) Congress repeals section 602(a)(5) of the Home Rule Act, which prohibits the Council from imposing taxes on the income of non-residents. We interpret these effective date provisions to require that Congress take affirmative action to allow the Council to tax non-resident income before any individual would be required to pay the tax (or before any tax would be withheld based on this bill), regardless of when the Council passed the bills.

Revenue Effects of the Bills

To provide reliable revenue projections, we must know when the bills would be effective, which is contingent on congressional repeal of the commuter tax prohibition. Therefore, the revenue and cost estimates that I will give you are illustrative only, and cannot be used as projections that could be incorporated into the District's Multi-year Financial Plan.

Both bills impose a tax on "salary and wages" but determine the amount of the tax as a percentage of "taxable income." For our revenue estimates, we assume that this apparent distinction is not intended – that is, the tax would be calculated for each individual from that person's salary and wages sourced in the District without deductions of any kind. The bills make no provision for withholding of the tax by employers. Current District law expressly does not require withholding on non-residents' wage and salary income. Nevertheless, we assume, for these illustrative revenue estimates, that withholding would be required. This point should be clarified in the statute. (For example, the Philadelphia commuter tax law requires Philadelphia employers to withhold at the source of wages and income earned.) The legislation also should clarify the impact on self-employed individuals and independent contractors, whom we were not able to include in the fiscal impact calculation. We also assume that Virginia and Maryland would impose taxes at the same rates on District residents who work in those states, and that those commuter taxes would be credited against District residents' income taxes.

Assuming, again for illustrative purposes, that either bill would be effective for wages and salaries received after December 31, 2003, we estimate that the "Commuter Tax Act" would generate revenue of $1.916 billion for fiscal years 2004 through 2007; the more restrictive District Government Nonresident Employees Tax Act would generate revenue of $75 million over the same period.

Implementation Costs

The bills do not specifically provide that individuals subject to the tax would be required to file returns. However, since the tax is graduated – taxing at different rates depending on income – there would have to be year-end reconciliation and settlement for each affected individual. Therefore, we assume in our analysis that annual returns would be required. We estimate that about 20,000 District government employees would be affected by both bills, and that 480,000 other individuals would be affected by the Commuter Tax Act bill.

The Office of Tax and Revenue would have to design the appropriate forms and instructions, conduct suitable public education campaigns, and modify computer systems to deal with a new type of tax before its first filing season, which would begin under our illustrative assumptions about February 1, 2005. Also, OTR would have to design new withholding tables and associated instructions for non-resident individuals subject to the tax, and conduct suitable publicity and outreach among employers to implement withholding of the tax by January 1, 2004. The agency would be challenged to accomplish this by that date. Once the necessary forms and instructions, systems modifications, etc., had been completed, OTR would then have to process returns, maintain accounts, and answer taxpayer inquiries for an additional number of new D.C. taxpayers each year. If this legislation is enacted and becomes law, the total first year cost of implementation, including both developmental and ongoing annual activities, could range as high as 10 FTEs and $1 million.

Madame Chairman, this concludes my prepared remarks. I will be happy to answer any questions you or the other members may have.

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