Part I

Summary Report

to the Mayor and Council of the
District of Columbia, June 1998

The District of Columbia Tax Revision Commission
1755 Massachusetts Avenue, NW, Suite 550
Washington, DC 20036

June 2, 1998

The Honorable Marion Barry, Jr., Mayor
Government of the District of Columbia
Washington, DC 20001

The Honorable Linda W. Cropp
Chairman, Council of the District of Columbia

Dear Mayor Barry and Chairman Cropp:

On behalf of the District of Columbia Tax Revision Commission, I am pleased to submit this summary report, *Taxing Simply, Taxing Fairly.* This report, which fulfills the mandate to the Commission as laid out in the *Tax Revision Commission Act of 1996*, recommends fundamental change in the District of Columbia's fiscal arrangements.

In reaching its recommendations, the Commission was guided by a straightforward set of principles. The District's tax system is an expression of community relationships between individuals and between the people and their government. That system should be easy to understand and manage, it should be fair to residents and businesses alike, and it should allow the District to create jobs and attract and retain residents. A review of the major recommendations shows how they are tailored to fit these principles.

If the District is to create a public sector climate favorable to job development, it must have a tax system that can generate revenues from businesses in a fair and neutral manner and simplify a very complex and capricious structure. It also should reflect benefits received. Accordingly, the recommended business activities tax is a revenue neutral replacement for four existing business taxes. The proposed business activities tax also is accompanied by a recommendation for a strategy to dramatically reduce commercial real property taxes.

The Commission also recommends making residential property taxes simpler and more equitable by making rates uniform for all residents and providing tax relief with a single program based on ability to pay. Accordingly, the owner-occupied rate and the rate on rental properties should be consolidated into one rate; and the existing *ad hoc* set of direct property tax relief programs should be consolidated into a single program directed to those who most need financial help to pay their taxes.

The Commission also recommends that residents calculate their District income tax liability using the taxable income amount from their federal tax returns. This change will greatly simplify the process of calculating tax liability, provide more generous standard deduction and personal exemption amounts that are indexed to inflation, and allow several thousand residents to stop filing tax returns.

Other recommendations propose taxing sales of tangible products to District residents the same regardless of whether they are sold remotely or by District-based businesses; taxing all equivalent utility services at the same rate; returning to annual assessments at an early date; and not adopting a split-rate property tax at this time.

As with any tax reform policy, individuals are going to find some points for legitimate disagreement. This is particularly true with recommendations such as these that change the distribution of taxes in important ways. While the Commission is confident of the merits of its recommendations, it recognizes that the next step is to have learned and open discussion of the issues. In a democracy, people must understand the changes that are proposed and weigh the pros and cons. As you proceed with this process, the members of the Commission will work with you in creating such an understanding and discussion.

Respectfully submitted,

Robert D. Ebel
Chair

Contents

Appendices

List of Figures

About the D.C. Tax Revision Commission

Creation of the D.C. Tax Revision Commission

The mayor and the District Council created the D.C. Tax Revision Commission in 1996 to recommend comprehensive changes in District taxes and other revenues. The law establishing the Commission, the "Tax Revision Commission Establishment Act of 1996," was effective June 13, 1996. The Commission is composed of 20 members, nine appointed by the mayor, nine members plus a chair appointed by the District Council, and an ex-officio member from the Office of Tax and Revenue. It began deliberations in September 1996 and has held 19 meetings, all of them open to the public. The Commission also held three public hearings at the beginning of its work.

The law creating the Commission assigned six duties:

1. To analyze the District's current tax system in terms of revenue productivity and stability, efficiency, equity, simplicity of administration, and effect upon the District's economy;
2. To propose innovative solutions for meeting the District's projected revenue needs while exploring possibilities for reducing general rates;
3. To identify economic activities that are either beneficial or detrimental to the District's economy and that should be either encouraged or discouraged through tax policy;
4. To recommend changes in the District's current tax policies and laws;

5. To establish criteria and a conceptual framework for evaluating current and future taxes; and
6. To conduct an analysis of a split-rate approach to real property taxation together with a recommendation as to how it could be structured with minimal effect on the average payer's taxes.

A small staff and several expert consultants performed the Commission's work. Completing this work will cost about $900,000. This amount includes a $50,000 grant from the Department of Housing and Urban Development for the Commission's studies of the District economy, with the balance coming from the District government.

Members of the D.C. Tax Revision Commission

Robert D. Ebel, *Chair*
The World Bank Group

Timothy C. Coughlin
Riggs National Corporation

Marie Drissel
Institute for Real Property Studies

Bert T. Edwards
Retired Partner, Arthur Andersen, LLP

Thomas Elzey
Howard University

Julia Friedman, *ex officio*
Office of Tax and Revenue

Richard Halberstein
Halberstein & Byrne

Jacquelyn Helm
Law Offices of Jacquelyn V. Helm

James L. Hudson
Offices of James L. Hudson

Iris J. Lav
Center on Budget and Policy Priorities

Rosemary Marcuss*

Walter Nagel
MCI Communications Corporation

*Resigned February 28, 1998

Jerome S. Paige
Information Resources Management College
National Defense University

Robert Pincus
Franklin National Bank

Robert Pohlman
Financial Consultant

Carolyn L. Smith
Coopers & Lybrand LLP

Stephen Trachtenberg
George Washington University

Sterling Tucker
Sterling Tucker Associates

Matthew S. Watson
Law Office of Matthew S. Watson

Joslyn Williams
Metro Washington Council AFL-CIO

Staff

Philip M. Dearborn
Executive Director

Stephanie Richardson
Research Assistant

Hanns Kuttner
Consultant

Carol S. Meyers
Consultant

Process, criteria, and conceptual framework

Research for the Commission was carried out by both its staff and outside experts. Eighteen separate reports and analyses were presented at the Commission's meetings. The reports examine the District economy, each of the major taxes, and the federal relationship with the District. (See Appendix A for a list of the researchers and their reports.) This Summary Report from the Commission contains a summary of the research findings and the Commission's recommendations. A full report of the Commission's work and research will follow at a later date.

At the start of its work, the Commission agreed upon the characteristics of a good revenue system and used these criteria to guide its actions. The six general characteristics are summarized below. See Appendix B for the entire Criteria and Conceptual Framework, which guided the Commission's work.

1. The tax system must be fair in apportioning tax burdens and consistent in its application.
2. The tax system must be easy for taxpayers to understand.
3. The tax rates and tax structure must be perceived by District businesses and individual taxpayers as a reasonable cost of locating in the District.
4. The revenue system should have as its primary purpose raising revenues from the city's overall wealth base to support required basic services.
5. The District government must have the ability to administer and enforce all parts of the recommended revenue system.
6. The District's revenue system must be viewed in conjunction with the federal revenue system.

Summary of Recommendations

Business Taxes

- Abolish the four existing business taxes: corporate income, unincorporated business, tangible personal property, and professional license fee (page 42).

- Enact a broad-based general business activities tax on value added (compensation, interest, and dividends) at a rate of 1.50 percent. This tax will replace the four existing business taxes and raise an equal amount of revenue (page 50).

Personal Income Taxes

- Use federal net taxable income to calculate personal income tax obligations, and enact a new revenue-neutral tax rate schedule (page 63).

Real Property Taxes

- Repeal the four existing property tax relief measures: the $288 homestead exemption, senior citizen exemption, general circuit breaker, and elderly and disabled circuit breaker (page 71).

- Enact a new circuit breaker that replaces the four existing property tax relief measures and provides the equivalent amount of total property tax relief (page 71).

- Consolidate the five real property tax rates to two by (1) reducing the rental residential rate to the owner-occupied rate and creating a single residential rate of 0.96 percent (page 71); and (2) combining the other three rates to a single commercial rate. Limit the commercial rate to no more than twice the residential rate (page 59). The $89 million required to accomplish this recommendation is not currently available.

- Do not impose a split-rate property tax (one with higher rates on land than on improvements) at this time (page 107).
- At an early date, return to annual assessment for all properties (page 103).
- Repeal the special statutory treatment of cooperatives and assess them on a fair market value basis (page 105).
- Reform assessment practices by (1) using all qualifying sales to calculate ratios and coefficients of dispersion; (2) reporting both the old and new methods of computation; (3) calculating and publishing price-related differentials in assessment ratios; and (4) not increasing assessments by a uniform multiplier (page 106).
- The Commission considered and rejected a proposal to require exempt nonprofit organizations to pay property taxes (page 97).

Taxing Sales of Goods and Services

- The Commission considered and rejected proposals to broaden the sales tax base by adding additional services or taxing food for home consumption. The Commission also considered and rejected proposals to make purchases by all nonprofit organizations subject to the sales tax and to eliminate the sales tax on Internet access charges (page 91).
- For purchases over the Internet, (1) treat electronic presence similarly to physical presence for determining whether the sale of a product is subject to the applicable sales tax; (2) do not determine a sale's tax status based on

the means of the sale; (3) apply the tax on the basis of the destination of the sale; and (4) tax sales at the point of final use (page 96).

- Enforce collection of sales tax on goods sold by federal entities and nonprofit organizations to nonexempt purchasers (page 95).
- Exempt manufacturing equipment from the sales tax to prevent tax pyramiding (page 94).

Utility Services Taxes

- Tax all functionally equivalent utility services at the 10 percent gross sales rate by (1) changing the statutory definition of "public utility services" in the D.C. Code to an enumeration of services taxed; and (2) requiring providers to concede nexus as a condition of market entry (page 101).
- The Commission considered and rejected a proposal to tax prepaid phone card use the same as long distance calls that are billed (page 103).

Recommendations to the Federal Government

- Lift the ban on the District's ability to tax nonresidents' income (page 80).
- Make an annual payment in lieu of property taxes to be used to reduce the District commercial property tax rate (page 80).
- Adopt a formula federal payment (page 81).
- Ensure that the District is compensated for Government Sponsored Enterprises' federal exemption from District business taxes (page 83).

Other Recommendations

- Reduce or eliminate earmarking of taxes where legally possible, and discourage future earmarking (page 108).
- Subject transactions involving cooperative housing units to recordation and transfer taxes (page 109).
- The Commission considered and rejected a proposal to subject nonprofit organizations to recordation and transfer taxes (page 97).

Superseded Recommendations

The Commission was prepared to recommend additional changes. Each of these, however, has been rendered moot by one of the broader recommendations for change.

- Eliminate the notch problem of penalizing tax filers with incomes that are one dollar higher than the eligibility amount for the low income tax credit. This recommendation is superseded by the Commission's recommendation to use federal net taxable income to calculate personal income taxes, which eliminates the need for the low income tax credit (page 110).
- Correct the unrealistic depreciation schedules used for calculating taxable values for the personal property tax, particularly those for computer equipment. This recommendation is superseded by the Commission's recommendation to repeal the personal property tax (page 111).
- Make treatment of net operating losses in calculating corporate income tax conform with federal law. This recommendation is superseded by the Commission's recommendation to repeal the corporate income tax (page 111).

Introduction: A Time to Embrace Change

The District of Columbia is beginning to recover from a substantial financial and administrative crisis. Real progress will depend on changing course, not making minor adjustments and then reverting to business as usual. In short, this city must embrace change.

Members of the D.C. Tax Revision Commission welcome the opportunity to bring a fresh perspective to long-standing tax practices. Commission members believe the tax system is an expression of a relationship between the people and their government. Building on that public trust, the Commission devised strategies to ensure that the fiscal system serves the city well. The result is a range of recommendations: wholesale change for some elements, slight revisions for others, and no changes at all for those parts of the existing system that function effectively.

All decisions were guided by a straightforward set of principles: The District's tax system should be easy to understand and manage, it should be fair to both residents and businesses, and it should allow the District to attract — and retain — both businesses and residents.

In recent years, the tax and revenue system has developed in a piecemeal fashion as the government took small actions in response to specific concerns. The resulting tax system is burdensome and repetitive and would require reform even if the District had no visible economic problems. Moreover, in the 20 years since the last comprehensive review of the District tax code, the city's economic, demographic, intergovernmental, and political circumstances have changed dramatically. It is time to make the tax code fairer and simpler.

Commission members recognize that the District's problems have many causes unrelated to taxes, and that changes to the tax structure — no matter how significant — are only part of the solution; expenditures, management, and other issues also must be addressed. The recommendations in this report will help the District build on its progress and maximize its strengths. Implementing some of the recommendations may be challenging because they will substantially change the existing system and inevitably cause some redistribution of taxpayer burdens. Nevertheless, the Commission believes it is essential to make changes to improve the District's overall economy and thereby maintain, and advance, the city's recently improved, but still fragile financial health.

1. Background

Before considering specific recommendations, the Commission examined the District's economy, government finances, and tax structure. This chapter reviews its findings in these areas.

The chapter begins with a summary of the District's recent economic crisis and its current improved economic outlook. This review of the local economy also includes an analysis of the District's population decline and the Commission's analysis of how taxes relate to the changes in the economy and population.

The discussion then moves to the Commission's examination of government finances, including an analysis of the events that led to the financial crisis of the mid-1990s and current financial prospects.

The analysis continues with a review of the current District revenue structure and rates and an analysis of the unique and distorting role the federal government has played in their development. This section concludes by making the case for simplifying the tax structure.

The economy

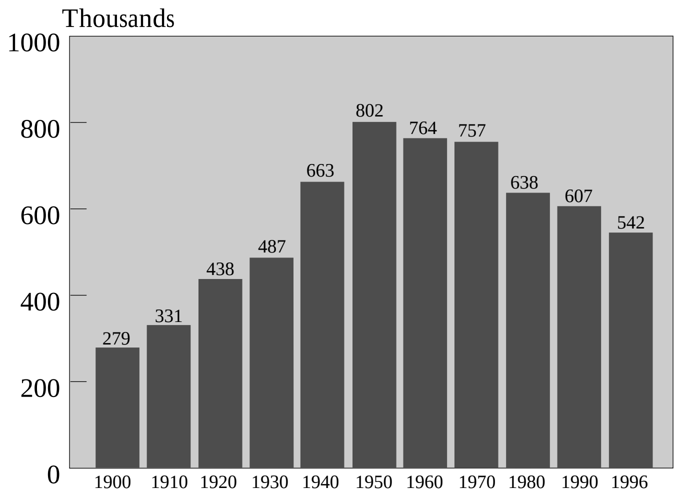
Economic crisis

In the early 1990s, the nation's capital was rocked by a depressed economy, severe population loss, and a government near insolvency.

From 1990 to 1996, employment in the District declined from 687,900 to 623,000. From 1989 to 1995, unemployment

Figure 1

D.C. Population, 1900–1996



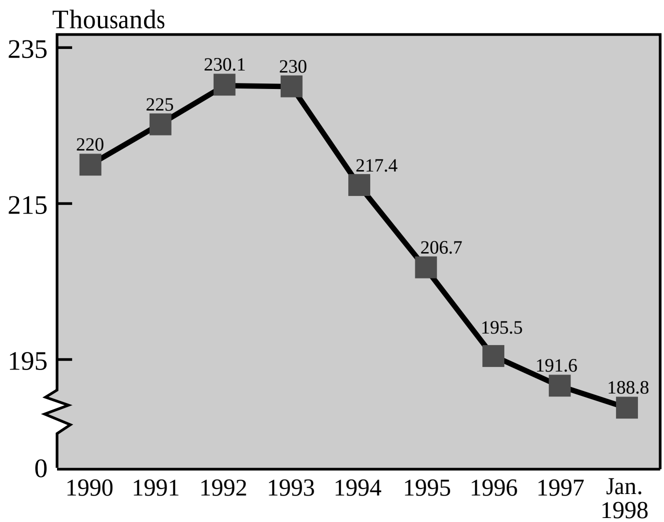
Source: Grier, George. *The Changing Population of the District of Columbia, 1991–1996.* A report to the D.C. Tax Revision Commission, November 1997.

rose from 5 percent to 9 percent, and commercial real estate values plummeted. In the 1990s, the District's population continued to decline as it had since the 1960s (Figure 1). From 1990 to 1996, the District lost 65,100 residents, or 10.7 percent of its population. Income tax filers decreased by 62,000 from 1989 to 1996. The District incurred an accumulated deficit that exceeded $500 million by 1996.

The District also was severely affected by federal agency reductions in payrolls and the District's own reductions in spending. The steep decline in federal government employment that began in 1993 contributed to the District's decline in

Figure 2

Changes in Federal Employment in D.C.
1990–1998



Source: D.C. Department of Employment Services.

employment (Figure 2). The rate of both resident and nonresident earnings growth also slowed in the 1990s (Figure 3).

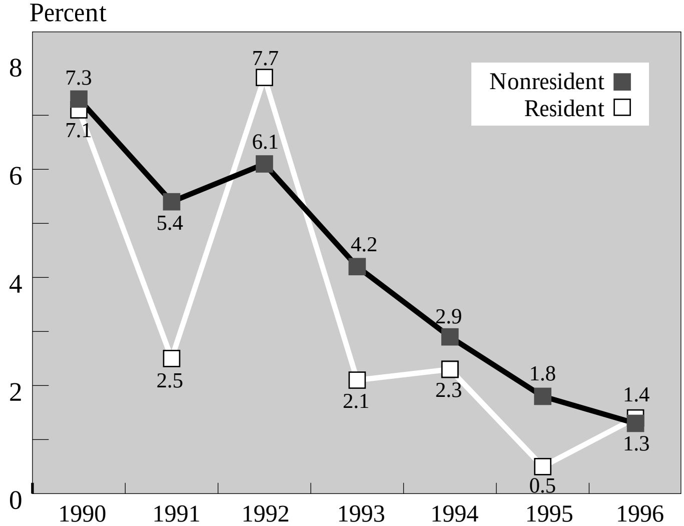
Potential for economic recovery

In coming years, the District economy should resume a positive growth rate as downsizing in the federal government reaches an end and other new initiatives are put into place.

The federal *Tax Relief Act of 1997* provides $1.2 billion in tax incentives over the next five years for businesses and residents (Appendix C). President Clinton has proposed $50 million in the 1999 budget to launch a new District economic development

Figure 3

Percent Change in Earnings of D.C. Residents and Nonresidents



Source: *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, October 1997.

corporation. In addition, the Commission's recommendations can lead to a fairer tax system that enhances tax certainty, stability, and economic efficiency and improves the District's ability to compete with neighboring jurisdictions. A solvent District government, the federal tax incentives, a new federally funded economic development corporation, and the tax restructuring proposed in this report all bode well for the image and future of the city.

A hopeful sign that improvement has started is a robust 7.0 percent growth in private sector earnings in the second quarter of 1997, as compared with the same quarter in 1996.

Figure 4

Percent Change in Federal Spending by Sub-State Area

1996–1997 Federal Fiscal Years

Type	District of Columbia	Suburban Maryland	Northern Virginia	Total
Grants	8.9%	18.1%	16.6%	11.8%
Salaries/Wages	2.6	2.1	-3.7	0.8
Payments to Individuals	1.1	13.9	18.2	14.3
Procurement	-8.7	2.1	11.1	4.5
Total	**1.9**	**6.8**	**8.8**	**5.6**

Source: *Consolidated Federal Funds Report,* U.S. Bureau of the Census, 1996 and 1997.

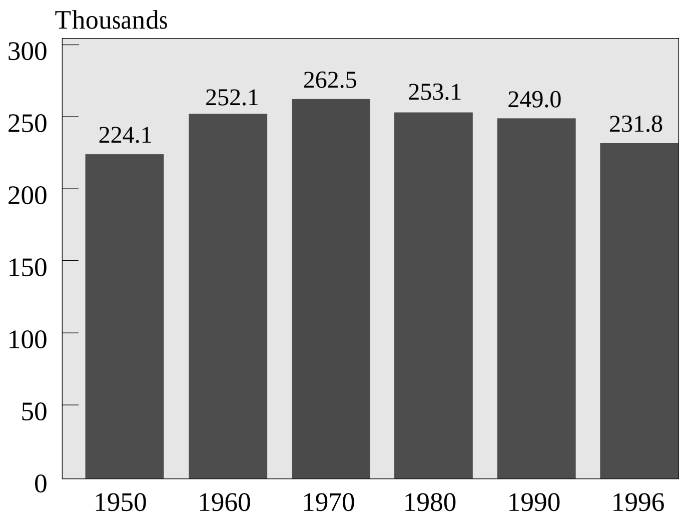
This increase in the District almost matched Virginia's 7.1 percent growth rate and exceeded both Maryland's 6.8 percent rate and the national 6.1 percent rate.

The District's fiscal year 1997 budget surplus, based in part on a healthy 4.1 percent growth in revenues, adds to the hope that improvement is underway.

This improvement, however, depends in part on whether the federal government stabilizes its activity in the District; recent figures show that the federal government continues to be a drag on the local economy. For example, the District's overall earning increase for the year ending in the second quarter of 1997 was a low 3.8 percent — despite private sector growth — because of a 0.3 percent drop in government earnings in the District. Also in 1997, federal government's procurement spending in the District declined while federal procurement spending in the suburbs increased (Figure 4).

Figure 5

Number of Households in D.C.
1950–1996



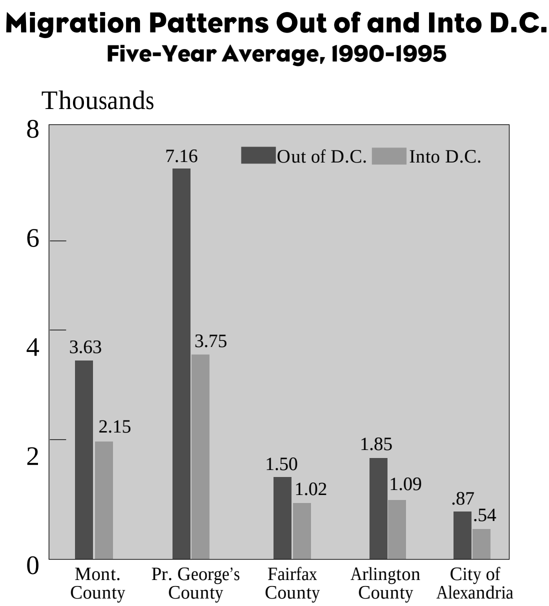
Source: Grier, George. *The Changing Population of the District of Columbia, 1991–1996.* A report to the D.C. Tax Revision Commission, November 1997.

The District's population loss: A major concern of the 1990s

The Commission focused special attention on population loss because of the resulting lost personal income taxes. As only residents pay personal income taxes, population losses can cause a significant decrease in revenues. Loss of households, moreover, is potentially more damaging than simple loss of population; households represent a taxpaying unit that contributes both property taxes and income taxes.

While the District has been losing population since the 1950s, the loss is attributable primarily to smaller family size

Figure 6



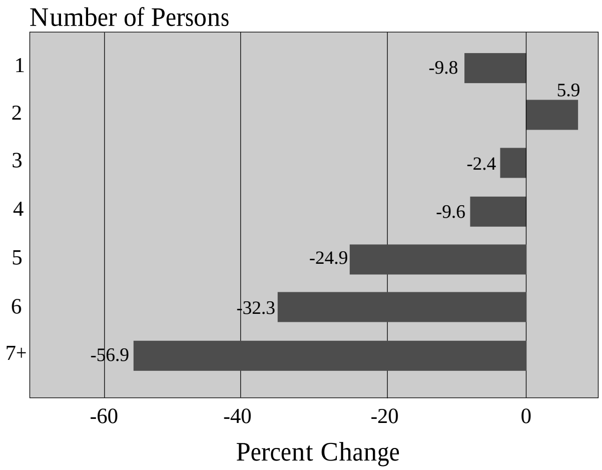
Source: Strauss, Robert. *The District of Columbia's Individual Income Tax.* A report to the D.C. Tax Revision Commission, December 1997.

rather than fewer households; family size decreased from an average 3.19 in 1950 to 2.27 in 1990. The number of households declined slightly in the 1970s and 1980s, but overall from 1950 to 1990, population declined 24 percent and households increased 11 percent. From 1990 to 1996, however, the District lost 17,200 households in addition to losing population (Figure 5).

In considering changes in households, it is important to recognize that the loss is a net difference between those moving into the city and those moving out. When the Commission examined migration patterns in the Washington area, it found

Figure 7

Change in D.C. Household Size Categories
1990–1996

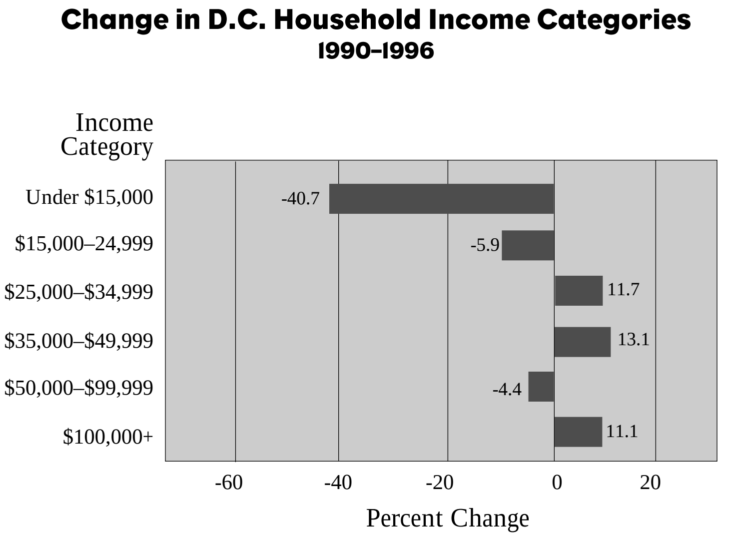


Source: Grier, George. *The Changing Population of the District of Columbia, 1991-1996.* A report to the D.C. Tax Revision Commission, November 1997.

that most people who left the District went to the Maryland suburbs, but that a large number of people also moved into the District from those same suburbs (Figure 6).

The number of households also changes because of the merging or division of households that remain in the city. For example, between 1990 and 1996, there was almost a 10 percent drop in one-person households, two-person households increased about 6 percent, and all other household sizes declined (Figure 7). It seems likely that a number of the lost one-person households simply became two-person households. The Commission can only speculate about the reasons for these changes.

Figure 8



Source: Grier, George. *The Changing Population of the District of Columbia, 1990-1996.* A report to the D.C. Tax Revision Commission, November 1997.

Poor households, whose members are not major taxpayers, account for a large proportion of the District's decline in number of households. Between 1990 and 1996, the District lost 23,800 households with incomes under $15,000, which is more than 40 percent of the households in that bracket in 1990. Middle- and high-income households — those with incomes between $25,000 and $50,000 and those with incomes greater than $100,000 — increased over the same period (Figure 8).

An analysis of who paid personal income tax between 1989 and 1995 shows a similar pattern. During that period, the District lost 37,150 or 35 percent of taxpayers who earned less than $15,000. While many of the low-income households may have left the District, it also is likely that many of them moved into higher classes of household income.

The decrease in households from 1990 to 1996 resulted in a net decline of 17,400 children, or a 15 percent reduction to 96,800. The percentage loss of children was only slightly greater than the overall 11 percent drop in population. While many speculate that the District's population loss is attributable to its bad schools, 68 percent of those households that moved to Washington's suburbs had no children.

The role of taxes in the District's economic decline and loss of population

A critical component of the Commission's work was examining changes in the District's economy and identifying the reasons for those changes. Of particular importance is whether taxes caused the deterioration in employment and population and the accompanying poor revenue performance of the 1990s and whether reductions in tax rates would improve the outlook for the future.

The Commission explored the effect of taxes on population, employment, retail sales, and property values. Its conclusion: Taxes may have had some adverse effects on individual business decisions, but the evidence in recent years points to nontax reasons for the District's lagging economy. Therefore, while this report identifies some taxes that should be eliminated or reduced to improve the District's economy, the Commission does not believe that such reductions should be made at the expense of vital services needed to keep the District attractive to residents. Specific conclusions for each of the four areas — population, employment, retail sales, and property values — follow.

Population

The Commission examined population change across the Washington metropolitan area from 1969 to 1994 using middle-income taxpayers as a representative population. The Commission did not discern any change caused by the income tax rate, the residential property tax rate, or the general sales tax rate. (Other taxes borne by households, such as the gross receipts tax on utility services or the selective sales tax rates were not included in the study.)

The principal population decline was in low-income households, which are least affected by income taxes. In addition, the only class of households that grew between 1990 and 1996 — middle-income households — should be the most sensitive to income tax rates. Studies of where households moved provide additional evidence: Income tax filers who left the District for the suburbs between 1989 and 1996 went overwhelmingly to Maryland and not to Virginia, despite the lower income tax rate in Virginia and comparable tax levels in Maryland.

The Commission concluded that while the reason for loss of population in the 1990s cannot be clearly identified, there is no evidence that suggests tax policies were to blame. The loss of population, moreover, was not accompanied by a substantial loss in related tax revenues. The District lost $60 million in annual revenue over five years due to population decline, and this loss equals only 2.3 percent of the District's 1996 local revenues. The $60 million results from lost income tax and sales tax revenues. Income tax revenues would have been $39 million higher over the five-year period if every District resident who paid taxes in 1989 stayed in the District through 1995. Sales tax revenues would have been $21 million higher had the number of households not declined.

Employment

Looking at taxes on businesses, the Commission found statistical evidence that the business personal property tax had a significant negative effect on job growth. The sales tax may have had negative effects on employment growth. The sales tax appears to influence employment growth in the services sector, and the personal property tax affects the retail trade and construction sector. In the service sector, a 1 percentage point decrease in the sales tax, which would reduce District revenues by $50 million, was estimated to increase the service employment growth rate by 4.0 percentage points in the following year. A 1 percentage point decrease in the personal property tax rate (currently 3.4 percent in the District) would increase growth in retail employment by 2.6 percentage points in the following year and decrease District revenues by $18 million.

The Commission's analysis did not determine the effects of the higher commercial property tax and corporate income tax rates. Another study, published by the Brookings Institution, found that the difference in the commercial property tax rate between the District and surrounding jurisdictions may have had a negative effect on the District's share of the region's employment. In the study, a $0.10 decrease in the commercial property tax, currently $2.15 per $100 of assessed value, was estimated to lead to 7,000 more jobs in the District within five years.

Retail sales

The Commission is concerned about the decline in the District's retail activity and considered whether the sales tax rate played a role in that decline. There has been a dramatic, consistent decline in the District's share of retail sales in the metropolitan area. The District's share of regional retail employment declined from 34.1 percent in 1969 to 14.4 percent in 1994. From 1982 to 1992, retail sales fell from 16.1 percent to 11.9 percent in 1992. The decline in sales affects all types of retailing, but is less pronounced in eating and drinking establishments, gas stations, and drug stores. Retail employment relative to population is lower in the District than it is in the rest of the region.

Key questions are whether the District sales tax rates caused the large declines in sales and retail employment and whether lower tax rates would reverse the pattern. The Commission concluded that the District's loss of population better explains the trend in retail employment than do differentials in sales tax rates, although one study suggests that a 1 percentage point decrease in the rate might produce a 4 percentage point increase in the growth rate of employment in the retail sector in the following year.

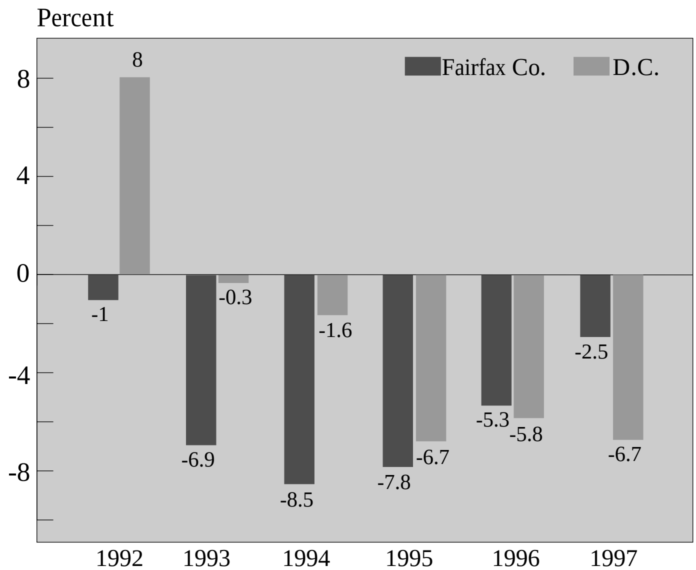
The analysis does not indicate whether the trend of retail activity moving out of the District to the suburbs can be reversed by lowering tax rates. However, shopping habits are formed over many years, and it is unlikely that more favorable tax rates would have an immediate, noticeable effect on the location of retail activity.

Property values

The sharp decline in assessed value of land and buildings in the 1990s appeared to be attributable to national and regional declines in property values and not to District tax policies. For example, in 1995, the District's worst property-tax year of the 1990s, the city's property tax base declined 6.7 percent. Fairfax County experienced an even higher 8.5 percent decline in 1994, its worst year (Figure 9).

Figure 9

Changes in Property Tax Values
D.C. and Fairfax County Compared



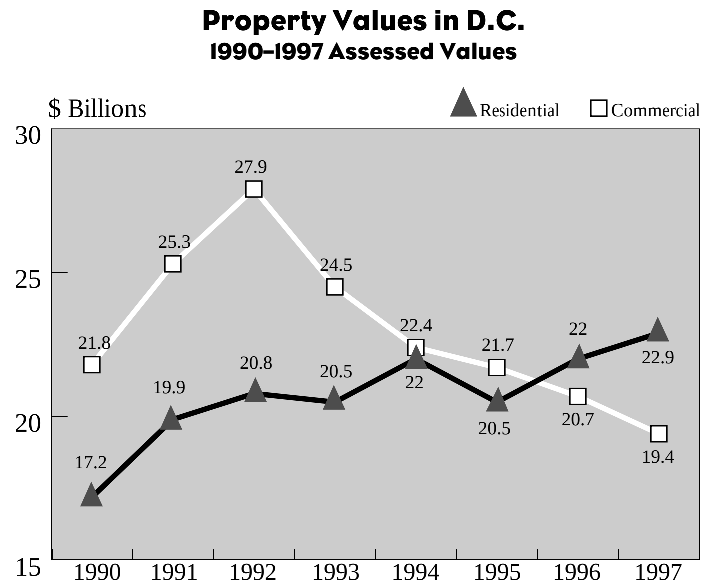
Source: D.C. and Fairfax County Comprehensive Annual Financial Reports.

Government finances

Effects of the economy on District finances

The District's declining economy had a dramatic effect on District tax revenues. From 1991 to 1996, revenues from real estate property taxes decreased more than 22 percent, from $802 million to $624 million. Taxable values of commercial real estate, which peaked at $27.9 billion in 1992, dropped 30 percent to $19.4 billion over the next five years. Residential property values remained virtually unchanged from 1991 to

Figure 10



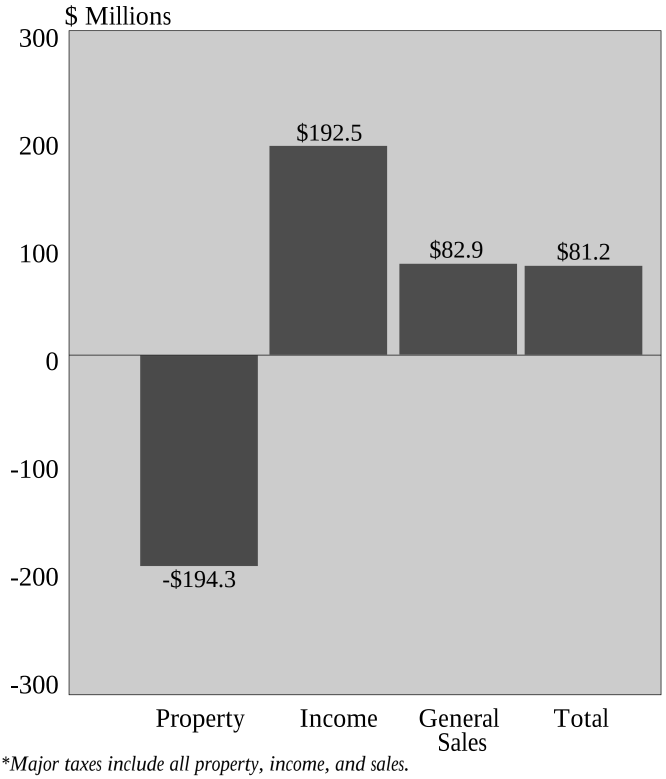
Source: D.C. Office of Tax and Revenue.

1995, and began an upward movement only in 1996 (Figure 10). Income and sales taxes grew about 12 percent from 1991 to 1996, but this growth was well below inflation and was barely adequate to offset the real estate decline over that period.

As a consequence, total District revenues from the city's three major taxes (real property, income and sales taxes) increased only $81 million or about 3.6 percent over six years (Figure 11). This increase in revenues was not even sufficient to pay the increased cost of long-term debt service, which rose $110 million during the same period. The District's management was unable to reduce other spending sufficiently to offset the inadequate revenue growth.

Figure 11

Difference in D.C. Revenues from Major Taxes*
1991 and 1997



Major taxes include all property, income, and sales.

Source: D.C. Comprehensive Annual Financial Reports.

As a consequence, the District's budget was unbalanced in 1992, 1993, 1994, 1995, and 1996. These imbalances led to an accumulated deficit of $518.2 million at the end of fiscal 1996.

Taking control of the finances

In 1995, the president and Congress addressed these severe problems by creating the District of Columbia Financial

Responsibility and Management Assistance Authority (control board) to oversee District budgets and ensure that expenditures were kept within revenues. At the same time, the mayor and District Council created the D.C. Tax Revision Commission to address failing revenues by analyzing existing tax laws and by proposing comprehensive reforms where necessary.

Today, the District's finances are beginning to improve, and the changes are due to a combination of factors, including improvements in the private-sector economy, the control board's expenditure policies, and an increase of 4.1 percent in 1997 revenues. In fiscal year 1997, the District's budget was in balance, and revenues exceeded expenditures by $185 million (Figure 12). This surplus reduced the accumulated deficit to $332.3 million. A similar balanced budget and reduction in the accumulated deficit is expected in fiscal year 1998. By the end of 1999, the District's accumulated deficit should be eliminated, and its operating budget should continue to be in balance.

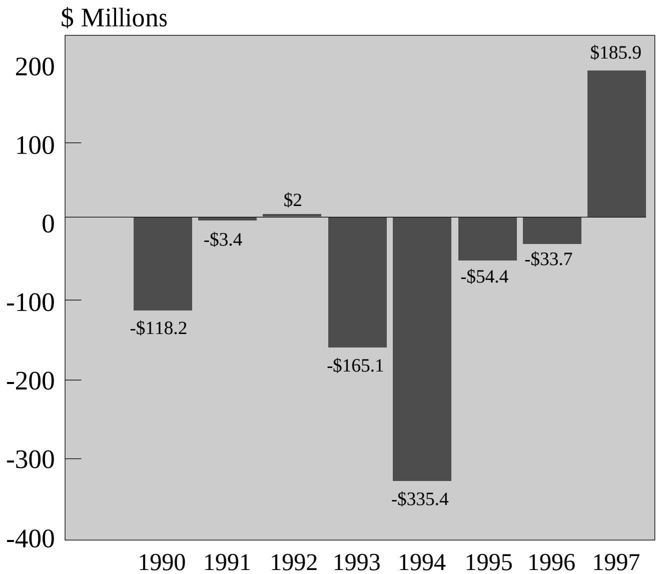
Tax structure and rates

Overview of the District's revenue structure

The District had 19 identifiable taxes in 1997 that include all the taxes typically used by state and local governments. The general sales tax and the real property tax each have five separate rates that are applied to different bases. If each rate is counted as a separate tax, there are really 27 different taxes. These taxes raised $2.6 billion in fiscal year 1997 (Appendix D). Nontax local general revenues added another $0.3 billion. Overall, the District has a balanced revenue system that incorporates most of the taxes that would be employed by both state and local governments.

Figure 12

D.C. Operating Revenues Less Expenditures
1990–1997



1991 revenues do not include recovery bonds of $336.6.
1993 revenues do not include accelerated taxes of $172.9.
1991 includes $100 million additional federal payment.

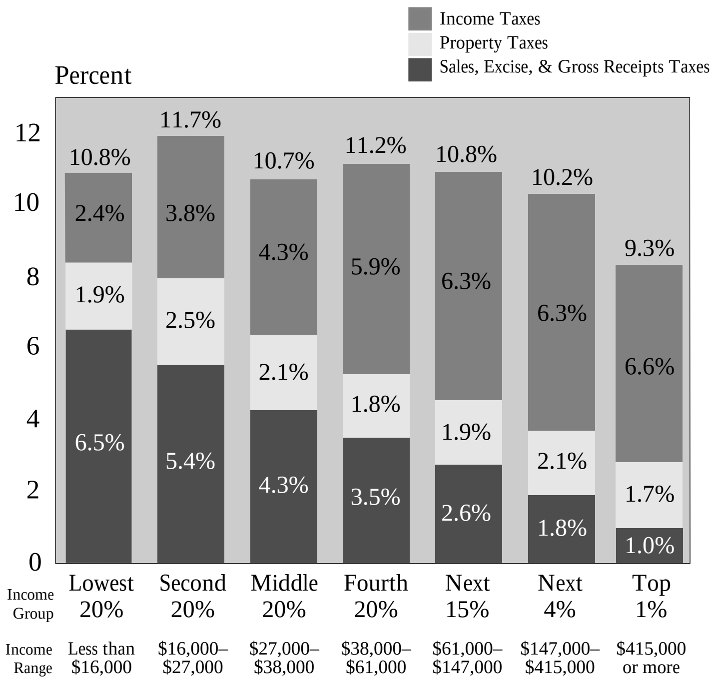
Source: D.C. Comprehensive Annual Financial Reports.

The most productive tax is the personal income tax, which had revenues of $753.5 million in 1997, followed by the real-property tax with $617.7 million in revenues, and the general sales tax with $514.5 million. The smallest revenue producer is the excise tax on alcoholic beverages with revenues of $5.5 million. The District's tax revenues are reasonably divided between income, sales, and property.

A review of the incidence of District taxes found them to be distributed relatively evenly across income classes. As a share of family income, they ranged from 10.8 percent on the lowest

Figure 13

D.C. Taxes as a Share of Family Income



Note: Effects of federal deductibility not included.
Source: Institute on Taxation and Economic Policy.

20 percent of incomes to 11.2 percent on the fourth 20 percent of incomes (Figure 13). (The review did not include the effects of federal deductibility of some District taxes.) Although the highest 1 percent of incomes pay only 9.3 percent of family income in District taxes, the tax system overall is more progressive than most state and local tax systems.

The District's nontax revenues constituted 9.7 percent of local general-fund revenues in 1997, a small increase from 1996.

In 1994, the Census Bureau, reporting on a different basis, concluded that when all nontax revenues were combined — including those received by the University of the District of Columbia (UDC), D.C. General Hospital, the sewer and water authority, and other special revenue funds — nontax revenues were 14 percent of total revenue.

Using either figure, the District's nontax revenues compare poorly with the combined state and local government nontax revenues in Maryland (19 percent), Virginia (27 percent) and the United States as a whole (24 percent). The lower reliance can be attributed to three factors: (1) The District does not receive revenues from existing charges for toll roads, airports, water ports, and natural resources, or from revenues from the sale of natural gas or utility; (2) District fees for higher education, hospitals, and solid waste management are relatively low; and (3) The District has a relatively high concentration of low-income families compared with state and local governments in the aggregate.

Comparing the District with neighboring jurisdictions

Throughout its work, the Commission compared the District's tax structure and tax rates with those of other cities nationally and with surrounding jurisdictions. These comparisons provide a necessary starting point, but are not always fair, given the District's unique structure.

While the evidence that taxes are retarding the District's economy may be lacking, the Commission believes that the city's long-term economic health requires that its tax system be competitive with those in neighboring jurisdictions. A comparison of rates clearly shows that some are not in line. The most prominent are the commercial and hotel property tax rates. At \$2.15 and \$1.85 per \$100 of assessed value, respectively, these rates are close to double the uniform property tax rates of

Arlington County ($.96), Prince George's County ($1.05), and Montgomery County ($1.07). The District's corporate income tax rate provides another example. Only three states have rates higher than the District's 9.975 percent, which also is well above the 7 percent Maryland and 6 percent Virginia rates.

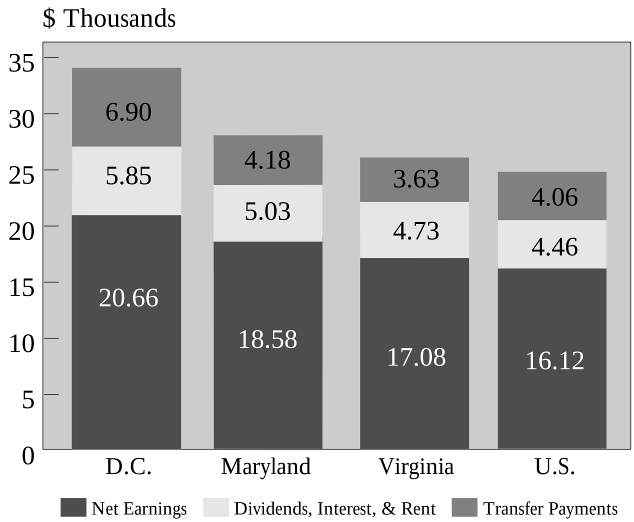
Comparisons of sales and personal income tax rates to those in neighboring jurisdictions are more complex because the jurisdictions structure these taxes differently and include different items in the bases. For example, the District's basic sales tax rate is 5.75 percent, but it has four additional higher rates — reaching 13 percent — that apply to parking, restaurant meals, hotels, and liquor. If these separate tax rates were combined to form a single general rate, that rate would be 7.6 percent. In comparison, Maryland's general rate is 5 percent, and Virginia's is 4.5 percent. These states do not have the separate higher rates for some purchases. Virginia's broader tax base, which includes food purchased for home consumption, somewhat offsets its lower rate.

The highest personal income tax rate in the District is 9.5 percent on taxable incomes in excess of $20,000. The highest rate in Maryland is 8 percent, and the highest in Virginia is 5.75 percent. In Maryland, however, the 8 percent applies to taxable income starting at $3,000, while the District's 9.5 percent rate does not apply until taxable income exceeds $20,000. Thus in Maryland, taxpayers pay $104 more on their first $20,000 of income than they do in the District.

In terms of burden, the District's income tax revenue is equivalent to 3.8 percent of total personal income compared to Maryland's 4.1 percent and Virginia's 2.7 percent. Taxes on District residents generally are comparable to Maryland for middle income residents, but are substantially higher than Virginia for all income levels.

Figure 14

Per Capita Personal Income
D.C., Md., Va., and U.S. Compared
1996



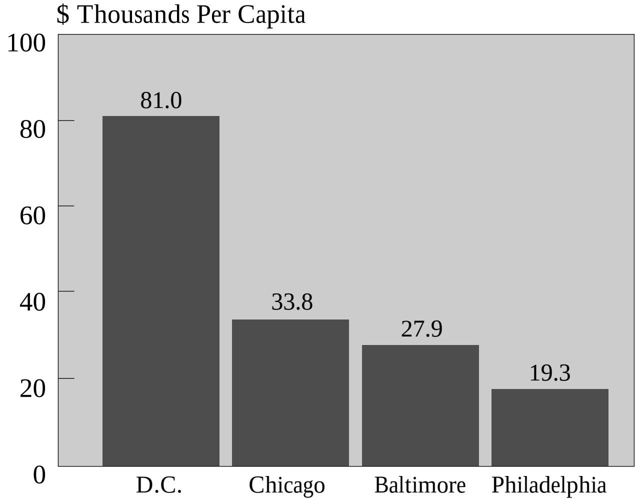
Source: *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis.

Effects of the Unique Federal Relationship

The District has a unique relationship with the federal government that influences the District's tax structure in ways not found in other state and local tax systems. The District is at the same time a major city, similar to other cities, and a constitutionally mandated capital under the jurisdiction of the U.S. Congress. This unique position provides both benefits and disadvantages. Among the benefits are the prosperity that comes from masses of tourists that flock to the city's attractions. The District also is a magnet for firms and organizations that do business with

Figure 15

Real Property Tax Bases of Major U.S. Cities Compared
1996*



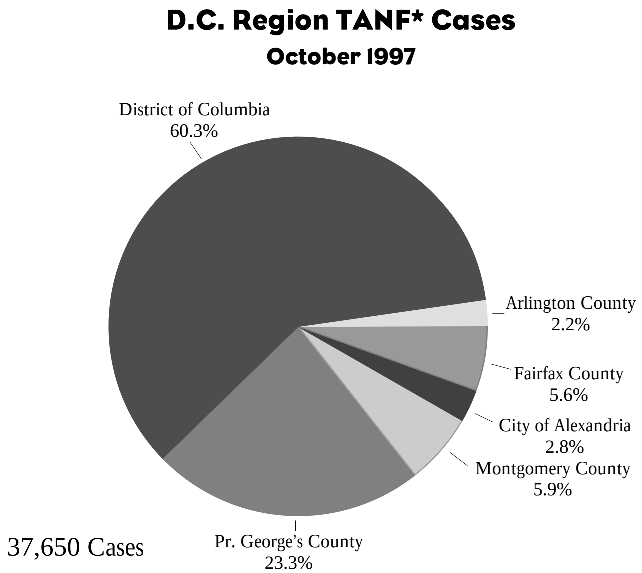
**1996 data with the exception of Philadelphia (1995) and Chicago (1993). Data reflect 100 percent of market value.*

Source: City Comprehensive Annual Financial Reports.

the federal government. Finally, the federal government provides benefits to the residents of the District through services and amenities that otherwise would be provided by the local or state government, including a national zoo and arboretum, and federally maintained museums, parks, recreation facilities, and streets.

As a consequence of the federal presence, the District is a prosperous jurisdiction with per capita income greater than that of Virginia, Maryland, and the United States as a whole (Figure 14). The District also has a real property tax base that far exceeds that of other major cities, despite the declines of recent years (Figure 15).

Figure 16



**Temporary Assistance for Needy Families*

Source: Compiled by the Greater Washington Research Center.

Offsetting this prosperity, the District has service demands and problems characteristic of other central cities. For example, the District supports more than 60 percent of Temporary Assistance for Needy Families (TANF) cases in the immediate metropolitan area (Figure 16). Unlike other cities, however, the District has no state to provide financial assistance in meeting these demands.

Unique restrictions distort the tax system

The District faces federal restrictions on its income tax base that apply to no other city or state. About two-thirds of District jobs are held by nonresidents, but the District cannot tax the income they earn within its borders. In addition, federal and foreign governments are a significant presence in the District, but their properties and purchases of goods, services, and equipment cannot be taxed. As a result of these unusual restrictions, the District's tax system is distorted in two ways. First, inability to tax broad revenue bases that would otherwise be available has resulted in high tax rates on the narrow bases that can be taxed. Second, in an effort to overcome the restrictions and access the forbidden tax bases, the District has instituted taxes that are in some ways flawed.

A good tax system pays for government services by taxing broad bases at low rates. This approach ensures that all who use the services help finance them, and it allows for sufficiently low rates that do not result in economic disincentives. The District's tax system, in contrast, must rely on narrow bases that require high rates on private-sector commercial activities and District residents. As the Commission examined District taxes, it found repeated instances of tax policy directly related to federal restrictions.

For example, the commercial property tax rate in the District — generally double the comparable rates in the suburbs — puts the District at a severe disadvantage. If federally and foreign-owned properties that are similar to commercial properties were taxable, the commercial property tax rate could be approximately halved to a rate almost identical to the suburban rates. Utility taxes also are distorted. The federal government does not pay sales tax, but it does pay a gross receipts tax contained in utility charges. The District, therefore, imposes a high 10 percent gross receipts tax on utility purchases.

The inability of the District to tax nonresident income — and thereby take advantage of its large earnings base — has been noted and protested for many years. Indeed, the District alone is subject to this federal restriction. In its efforts to overcome the inability to tax income, the District has both corporate and personal income tax rates that are substantially higher than adjoining jurisdictions. It also enacted a unique tax on unincorporated businesses in order to tax professional firms and other businesses that were not subject to the corporate profits tax. Unfortunately, the D.C. Court of Appeals ruled much of the unincorporated tax illegal, and the District now imposes the tax on only some firms.

These damaging tax features combined with other aggravating taxes that result from federal restrictions have given the District a bad tax reputation. As a consequence of the distortions caused by the federal role, the Commission is unable to recommend all the desirable changes that would remove tax inequities and provide positive incentives for businesses and residents to locate in the District. The Commission is concerned about this limitation on its recommendations. Therefore, in a separate section, it makes recommendations to the federal government that include changing its restrictions on District taxing powers.

Without the recommended federal actions, some of the worst features of the District tax system cannot be corrected. The Commission believes, however, that the District can make major changes that will improve the existing tax system, even without federal assistance.

The case for simplicity in the tax system

The District's current tax system has features that are difficult to understand and are cumbersome, bordering on ludicrous, for both taxpayers and tax administrators. The Commission set a goal of abolishing these features.

Under the Commission's proposal, three of the administratively worst taxes — the personal property tax, unincorporated business tax, and Class 5 property tax on vacant properties — are eliminated. Four confusing property tax relief measures are consolidated into one simple relief mechanism. The personal income tax is streamlined to a simple one-page form for all residents, and low-income residents no longer will have to file tax returns. Residential properties will no longer have to be divided into rental or owner-occupied classes.

Discarding taxing language

The language from some of the tax forms that would be eliminated demonstrates why these simplifications are overdue. For example, those who do business in the District must decipher the following language to determine which business tax they must pay:

> Generally, every corporation (including small businesses, professional and S corporations) … is required to file a franchise [corporate income] tax return, Form D-20 … Except for partnerships required to file an unincorporated business franchise tax return, DC Form D-30, all partnerships that engaged in any trade or business within the District of Columbia … shall file a D.C. partnership return … Every partnership which, during the taxable year, engaged in an "unincorporated business" … must file an unincorporated business franchise tax return, D.C. Form D-30, rather than a partnership return (Form D-65). The words "unincorporated business" do not include any trade or business which by law, custom, or ethics, cannot be incorporated or any trade or business in which more than 80 percent of the gross income is derived from personal services actually rendered by the individual or members of the partnership or other entity in the conducting or carrying on of any trade or business and in which capital is not a material income-producing factor.

Determining which tax to pay is just the beginning for businesses. The District imposes an extensive set of record-keeping requirements that businesses must maintain solely to determine the tax base subject to the personal property tax. The tax applies to items the business taxpayer owns, leases, or rents. The records must track property in four different classes: (1) books, cassettes, and other reference materials; (2) furniture, fixtures, machinery, and equipment; (3) unregistered equipment, which includes equipment mounted on vehicles but not the vehicles themselves; and (4) supplies.

In addition, all property must be classified into six categories, each of which has a different depreciation rate. Coffee makers, which can be depreciated at 20 percent per year, must be distinguished from kitchen equipment, which is to be depreciated at 10 percent a year. Likewise, linens in reserve, which cannot be depreciated, must be distinguished from those in service, which are to be depreciated at 50 percent a year. Finally, no item may be depreciated more than 75 percent of its original purchase price.

Residents also are subject to virtually incomprehensible language and long, confusing forms (Appendix E). The current *D.C. Tax Facts*, published by the District government, describes the residential property tax relief measures as follows:

> The assessed value for each Class I owner-occupied single family residence (including condominiums) is reduced by a $30,000 homeowner’s exemption. The assessed value of residential real property owned by a cooperative housing association is reduced by 60% (but the exemption may not exceed $30,000 multiplied by the number of units occupied by shareholders). The District also has a property tax relief “circuit breaker” program for qualified homeowners and renters, which provides a tax credit for those with low

and moderate income, the elderly, blind and disabled. Also, for qualified retired senior homeowners, the District allows a one-half reduction in the amount of real property taxes that would otherwise be payable.

These relief measures are further complicated by a provision that the homeowner's exemption is available only to those who apply for it and have paid the District's personal income tax. When the District recently sought to enforce this measure, many taxpayers failed to understand the requirements and were distressed by notices declaring their lack of compliance.

Regardless of the District's economy and finances, the Commission believes that removing these complications and streamlining the tax system is necessary.

2. Recommendations for Changing Course

Simplicity and fairness for businesses

The Commission recommends abolishing four existing business taxes — corporate income tax, unincorporated business tax, tangible personal property tax, and business and professional licensing tax — and replacing them with a broad-based general business activities tax at a rate of 1.50 percent. This tax will raise the same amount of revenue as the taxes it replaces (Figure 17).

The business activities tax is the cornerstone of a fundamental change in the way the District taxes business organizations. Current business taxes have high tax rates, are inequitable, contain confusing and complex administrative provisions, and do not provide stable revenue for the government. The business activities tax, in contrast, is fair, inclusive, and easy to administer. It will be imposed on a base that includes three elements: compensation, interest, and dividends. These elements represent the business enterprise's outlays for the use of capital and labor in the District, i.e., the value added.

Because the business activities tax includes compensation in its base, some may suggest that it violates the *Home Rule Act* (the federal law that serves as a city charter for the District). The *Home Rule Act* prohibits taxing any portion of personal income, "either directly or at the source thereof, of any individual not a resident of the District." The Commission, however, believes that a legal challenge to the tax is unlikely to succeed.

Figure 17

Business Activities Tax Rates Required to Replace Existing Taxes

Tax	1997 Revenue (millions)	Business Activities Tax Rate Required	Cumulative Business Activities Tax Rate
Corporate Income	$144.6	0.86%	
Unincorporated Income	38.9	0.23	1.09%
Personal Property	60.4	0.36	1.45
Professional License Fee	8.0	0.05	1.50
Total Revenue	$251.9		

Source: D.C. Office of Tax and Revenue and staff calculations based on data from the U.S. Department of Commerce, Bureau of Economic Analysis.

(See Appendix F for more information about the legal issues that may pertain to the business activities tax.)

Recommendation: Abolish the four existing business taxes

The District's four existing business taxes — corporate income, unincorporated business, tangible personal property, and professional license fee — do not tax businesses uniformly. The taxes have comparatively high rates, provide unstable revenues, and do not provide for revenue growth that reflects growth in the economy. In addition, they are administratively complex for both taxpayers and administrators.

The District currently imposes a 9.975 percent rate on corporate and unincorporated profits, the fourth highest among states that impose this tax. The 3.40 percent rate on personal property values, coupled with the District's conservative depreciation allowances, is higher than all of Maryland's and most of Virginia's neighboring jurisdictions. The tax is also shown to have a negative effect on District job growth. In contrast, the recommended business activities tax on all businesses will have a low rate, 1.50 percent of a firm's value added.

Revenues from the profit-based corporate income taxes are unstable because they fluctuate with the economy and drop dramatically during economic downturns. In the recession of the early 1990s, the corporate income tax revenue declined about 50 percent, from $125 million in 1989 to $63 million in 1992. It then rebounded to $114 million in 1994. The recommended business activities base would have increased each year over the same period, except for a 3 percent decline in 1991 and a 1.5 percent decline in 1994 (Figure 18).

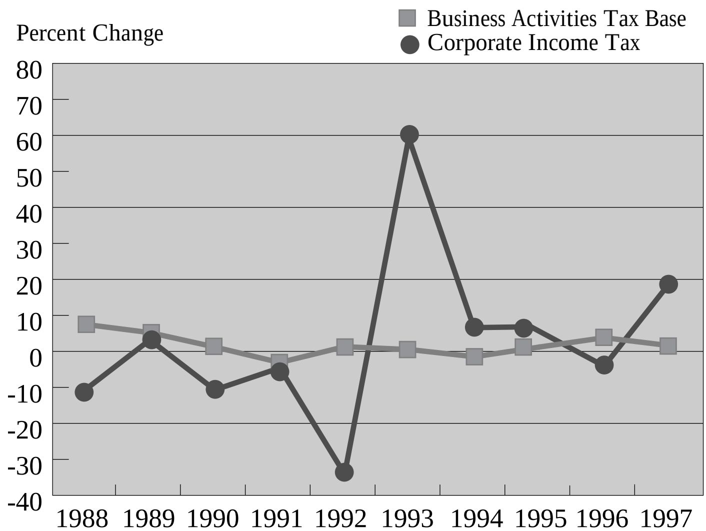
Finally, the existing business taxes cannot provide for adequate revenue growth, largely because the fastest-growing component of the District economy, the service sector, can easily and legally avoid paying these taxes. More than half of all those who work in the service sector work for professional service-based firms. In addition, from 1984 to 1994, all growth in the District's economy occurred in the private sector, and within the private-sector economy, all growth was in the service sector (Figure 19). Many service-sector establishments do not pay taxes on the income of incorporated or unincorporated businesses. They will, however, be required to pay the new tax, and its broad base will provide for a tax that keeps pace with the economy.

Abolishing the profit-based corporate income tax

The corporate income tax on net income is based on the "ability to pay" philosophy. It taxes profits, the portion of a firm's rev-

Figure 18

Revenue Stability
Business Activities Tax Base*
Compared to Corporate Income Tax Base



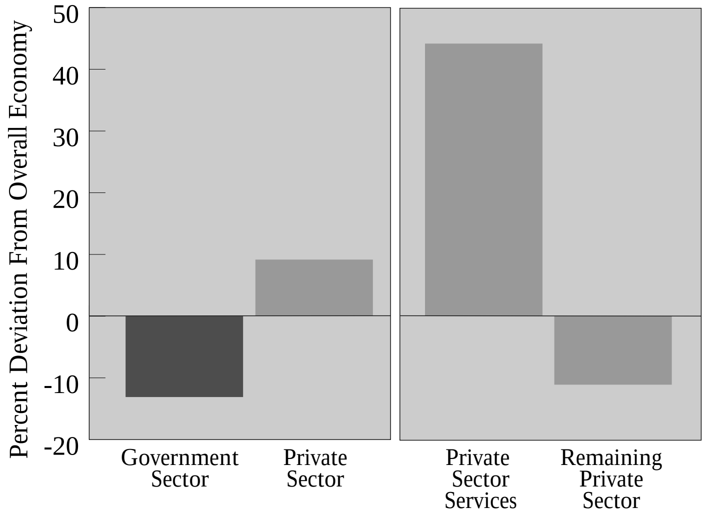
**Base assumed to change at same rate as private state product.*
Source: D.C. Office of Tax and Revenue and U.S. Department of Commerce, Bureau of Economic Analysis.

enues that remain after providing payments to labor, suppliers, and creditors. While basing taxation on ability to pay can be an important component of tax fairness, in practice this principle cannot be equitably applied to District businesses.

A large proportion of profitable District businesses are structured in ways that allow them to manipulate their profits to avoid the tax. This is particularly characteristic of moderate-size corporations in a range of service industries in which profits can be converted easily to salaries or other personal service pay-

Figure 19

Change in Business Sectors
Relative to Total D.C. Economy
1984–1994



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

ments. This conversion poses greater problems for the District than for other jurisdictions throughout the country. In most states, higher personal income tax payments on the salaries or personal service income would offset the lower business taxes, but federal restrictions prevent the District from taxing much of this income. As a result, the corporate income tax falls inequitably on a narrow segment of District businesses.

Because the ability-to-pay principle cannot equitably be applied to District businesses, the proposed business activities tax will be based on the benefit principle, which holds that burdens should be distributed according to the benefits that taxpayers receive from public goods and services provided by the government.

The benefits a business derives from public services depend on factors such as the nature and scale of production — not the amount of profit that is earned. While both profitable and unprofitable businesses in the same industry are likely to derive similar benefits from public services, only the profitable businesses are taxable under a profits-based income tax. As a result, corporate and unincorporated taxes paid by various types of firms are inequitable when compared to the business activities of, and services consumed by, these firms (Figure 20).

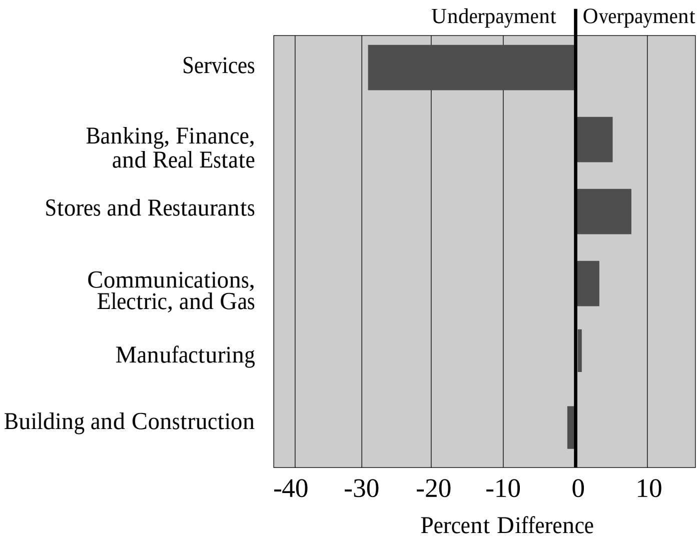
Abolishing the unincorporated business tax

The District's unincorporated business tax does not tax many unincorporated businesses, and its structure is unfair. In contrast with the District, few states impose a separate tax on unincorporated businesses. Instead, under the tax system in most states and the federal government, the income passes through to owners and then is taxed through personal income taxes at the individual level.

The case is quite different in the District. The District is unable to tax many unincorporated business owners through their personal income tax because of the ban on taxing nonresident income. Instead, it levies a tax on unincorporated businesses with gross receipts over $12,000; then, to avoid double taxation, the District allows residents to exclude such income (specifically the portion that originates in the District) from income at the personal level. The District also provides a 30 percent salary allowance for owners and a $5,000 exemption in determining unincorporated net business income. Aside from these provisions, determination of taxable income and apportionment of taxable income to the District follow the same tax rules that govern the corporate income tax.

Figure 20

Business Income Tax Payments Relative to Share of Economic Activity 1996



Source: Staff calculations based on data from D.C. Office of Tax and Revenue and U.S. Department of Commerce, Bureau of Economic Analysis.

The decision to create this complicated, separate tax for unincorporated business was prompted by a desire to maintain neutrality in the taxation of different forms of business organizations. But efforts to maintain uniform taxes have not been successful, primarily because individual income and corporate income taxes are not integrated. As a result, the tax burden for a firm depends more on how it is organized — as a corporation with shareholders or an unincorporated business with an owner — than on how much value it adds to the District or how many District resources it consumes.

In addition, the prohibition against taxing nonresidents' income led the courts to rule in *Bishop v. District of Columbia* that the *Home Rule Act* prohibits the District from taxing income of unincorporated businesses owned by nonresidents that provide professional services. In response to this ruling, the District has foregone collecting the tax from any unincorporated business providing professional services, regardless of where the business's owners reside. To do this, the District has had to devise exceedingly complex rules for separating firms that are taxable from those that are not.

The inability to tax unincorporated businesses that provide professional services is particularly damaging because the service sector is a large part of the District's economy (Figure 21).

Eliminating the tangible personal property tax

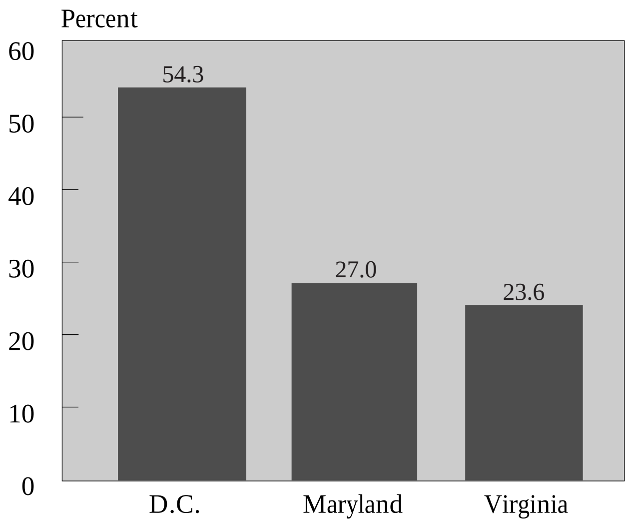
The District's tax on personal property does not uniformly apply to all personal property, has a complex and obsolete approach to estimating depreciation, and is difficult to administer. In addition, it does not appear to relate to either ability to pay or benefits received from government services.

Some problems with the tangible personal property tax — the unrealistic five-year depreciation of personal computers, for example — can be corrected, but require constant adjustment as conditions change. Other problems, however, are more complex. Consider the narrow tax base. It does not meet the test of uniform taxation because it is so limited, yet the Commission found reasonable justification for many of the existing exemptions, including exemptions for inventories, motor vehicles, and household furnishings.

In addition, the tangible personal property tax places a heavy burden on tax administrators, who must discover business personal property, audit returns, and maintain realistic depreciation

Figure 21

Service Sector as a Share of the D.C. Ec
Percent of Gross State Private Product, 1994



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

schedules. Businesses, in turn, must keep detailed records on the purchase costs and age of all taxable property.

Eliminating the Professional License Fee

The professional license fee is a charge of $250 for individuals who hold occupational licenses, such as attorneys, physicians, and accountants who are licensed to practice in the District. The tax was first imposed in 1992 and adopted as an alternative to a proposed 2 percent gross receipts tax on professionals. The fee was designed to tax professionals who are not subject to the unincorporated business tax. Total revenue from this tax is less than $10 million annually. The Commission recommends repealing this tax because under the proposed business activities tax, professional firms will be taxed in the same manner as other businesses and the tax no longer will be needed.

Recommendation: Enact a broad-based business activities tax at a rate of 1.50 percent

The Commission recommends a business activities tax that will tax all enterprises alike. It is equitable, has a low rate and broad base, provides revenue predictability and stability, and is likely to produce growing revenues without statutory rate changes. It also is simple for both administrators and taxpayers.

The business activities tax achieves these attributes by assessing business activity value, which is common to all businesses operating in the District. Its 1.50 percent rate is significantly lower than the current 9.975 percent corporate income tax and the 3.40 percent personal property tax. The business activities tax can have a far lower tax rate than the taxes it replaces and still raise the same amount of revenue because of a broader base (Figure 22).

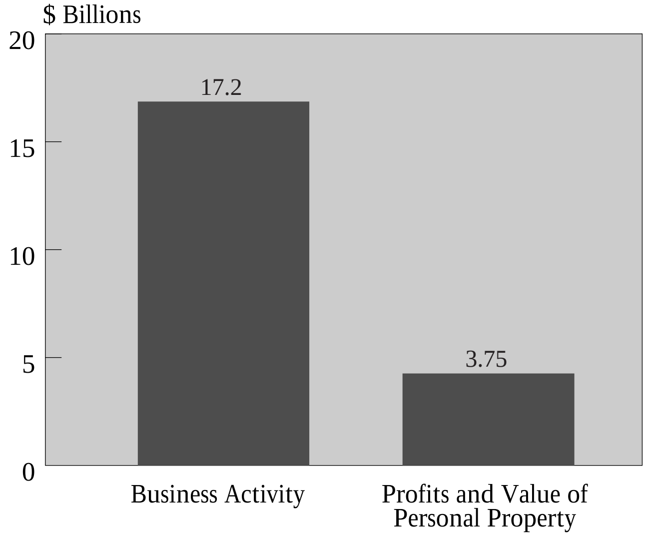
Why tax businesses

A principal reason for taxing businesses is to ensure that nonresidents support government services by bearing a share of the tax burden in the jurisdiction. A business firm is an organizational vehicle through which individuals derive benefits of economic activity in their roles as consumers, suppliers, workers, or shareholders. Given this principle, the question arises as to whether there is justification for taxing business. The answer is “yes” for a jurisdiction such as the District that operates in an open economy in which goods and services flow freely across borders.

Nonresident individuals owning all or part of a resident busi-

Figure 22

Business Activities Tax Base and Existing Business Tax Base Compared
1996



Source: Staff calculations based on data from D.C. Office of Tax and Revenue and U.S. Department of Commerce, Bureau of Economic Analysis.

ness enterprise cannot effectively be taxed directly on their income, wealth, or wealth transfers which are derived from the business activity. Similarly, resident individuals can engage in spending outside the District and therefore avoid direct payments under conventional sales taxes. Thus, employing the business enterprise as a tax-collecting intermediary is the only procedure available for assessing individuals, wherever they may reside, for the benefit of public services which accrue to them indirectly through the business entity.

There are several ways to tax businesses. The District's current system, like those of 46 states, is based on net income. The state of Washington taxes gross receipts from sales of goods and services instead of corporate income. Texas taxes capital stock, and Michigan and New Hampshire tax value added.

The Commission concluded that the best alternative for the District is a business activities tax, which taxes the value added from economic activity that takes place within the District's borders. All businesses directly or indirectly depend on a range of tax-financed goods and services, such as a judicial system, police and fire protection, roads, and schools. Business taxes serve as a form of payment for public services. Even businesses operating at a loss consume government services.

In looking for a broad uniform business tax, the Commission considered and rejected a tax on gross sales. Taxes on gross sales do not directly relate to business activities in the District because much of the value of what is sold is added outside the District. A gross receipts tax also permits pyramiding of taxes, or taxing purchases for resale two or more times. For example, a wholesaler pays the tax on its sales to retailers; retailers, in turn, pay the tax on the same goods and services when they are resold at the retail level.

In addition, a gross receipts tax is not equitable unless it has multiple rates. Without multiple rates, high-volume, low-margin vendors are penalized relative to high-profit vendors. For example, a food wholesaler may operate on a profit margin of less than 5 percent, while retail jewelers may have profit margins of 50 percent or higher, but have fewer sales. If both vendors were subject to the same gross receipts tax rate, the wholesaler would have a significantly higher tax. Thus, a gross receipts tax cannot be equitable unless low-profit vendors can have a lower tax rate than high-profit vendors. These multiple rates, however, would result in complex administration and difficulties in defining sales subject to the different rates. For these reasons, the Commission believes that a tax directed at the value added in the District by businesses is a better tax.

Summing up the benefits of the business activities tax

Enacting a tax on business activities to replace the corporate income taxes and the personal property tax will have the following advantages:

1. *Fairness.* A tax on value added, compared to taxes on net income, personal property, or gross receipts, is much more likely to be related to the benefits that a business derives from public services. For example, large firms that place significant demands on the services of a jurisdiction can pay little in corporate income taxes. Similarly, a gross receipts tax can provide a poor measure of economic activity because a firm with significant sales but few employees or little property faces a relatively high gross receipts tax burden even though it uses few services.

2. *Revenue Stability.* Revenue generated by a business activities tax will be less volatile than that generated by the corporate income tax, largely because the base will include most of the corporate income tax base as well as labor compensation. Labor compensation, which is far larger than the corporate income tax base, tends to vary little from year to year. The combination of a low rate and a tax base dominated by a stable component will provide stable tax revenue.

3. *Administrative Ease.* A business activities tax is easy to collect and has low compliance costs because of its broad base

and relatively low rates. The simplicity is dramatic when compared with the complicated structure of the existing net income and personal property taxes. The change to a business activities tax will lower both the District's administrative costs and taxpayers' compliance costs. First, the calculations required to determine tax liability are straightforward. Second, most of the information needed to ensure compliance is provided by the federal return, which should lower audit costs. Finally, unlike the corporate income tax base, the business activities tax base is relatively insensitive to changes in federal corporate income tax rules.

4. *Economic Neutrality.* A business activities tax is relatively neutral with respect to decisions made by businesses. Absent other taxes, a firm that operates only in the District will find little tax advantage in altering its mix of inputs. The firm's choices of different forms of capital inputs will mirror those found in a world with no taxes. While the firm will find that the cost of labor would rise, the increase in labor costs will be quite small because the rate is small. Finally, a firm will find that its financing choice of debt or equity will not be affected.

Design of the business activities tax

Michigan and New Hampshire currently impose taxes on business activity. While both states reach a similar end point of taxing the value added by firms, there are significant differences in the approaches used to do so. Michigan starts with a firm's federal taxable income, adds labor compensation, depreciation, net interest paid, and subtracts capital expenditures. New Hampshire uses a simpler approach by merely adding three factors: compensation, interest, and dividends. Because of its simplicity, the Commission used the New Hampshire model to develop its recommendation. The specific elements are as follows:

- Every business enterprise in the District will pay a tax at the estimated rate of 1.50 percent upon its business activity tax base.

- A business enterprise is any profit or nonprofit enterprise or organization, whether corporation, partnership, limited liability company, proprietorship, association, trust, or other form of organization carrying on any business activity within the District, except enterprises expressly exempt from income taxation under sections 501(c)(2) and 501(c)(3) of the U.S. Internal Revenue Code and insurance companies subject to the District Insurance Premiums Tax. (See Appendix G for definitions of enterprises included in section 501(c) and whether they are subject to the business activities tax.)

- Business enterprises with gross receipts below some minimum amount, before apportionment, should be tax-exempt to encourage start-up and small businesses and to reduce administrative requirements. The Commission believes that $50,000 might be an appropriate minimum, but recognizes that some phase-in of the tax will be necessary to avoid a notch problem in which one extra dollar of base creates a substantial tax liability.

- The Commission also recommends exempting insurance firms that pay the insurance premiums tax. The taxation of insurance companies is unique in that the courts as well as Congress have allowed states to retaliate if their insurance companies face differential taxation in other states. The prospect of retaliation has led to significant uniformity across state insurance tax codes. For this reason, the Commission does not recommend making insurance firms subject to the tax.

- Other than these limited exemptions, the definition of a business enterprise should apply to all organizations and proprietorships, regardless of whether federal rules may provide for "pass-through" treatment, such as that provided for S corporations, partnerships, or limited liability companies. The only exemption proposed is for tax-exempt organizations under section 501(c)(2) and 501(c)(3), and they must file to reflect any "unrelated business income." Accordingly, fraternal organizations, business groups, credit unions, and other organizations covered by other provisions of section 501 will be subject to the tax to the extent that they have taxable value. While extending the tax this far will be controversial, the Commission believes that if it is to be a broad based tax at low rates, it must be very inclusive to be effective.

- "Business activities" should be defined very broadly so as to encompass all economic activities taking place in the District. The New Hampshire definition includes: "a transfer of legal or equitable title to or rental of property, whether real, personal or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, whether in intrastate, interstate, or foreign commerce, with the objective of gain, benefit, income, revenue or advantage, whether direct or indirect, to the business enterprise or to others." Michigan uses a virtually identical definition.

Calculating the base

The business activities tax base is the sum of: (1) all compensation paid in wages, salaries, bonuses, commissions, or other payments paid on behalf of or for the benefit of the employees, officers, or directors of the business enterprise; (2) interest paid for the use of money or property, excluding interest on borrowings to fund financial assets; and (3) dividends or other distributions paid to the owners of the enterprise.

Wages and benefits in the tax base include all payments to persons that are made pursuant to an employer-employee relationship. The definitions of employer and employee are the same as those used for federal tax withholding purposes. Amounts reported as self-employment income for federal tax purposes are considered compensation paid to the proprietor or partner and should be included in the base.

The interest element of the tax base is designed to measure the value of borrowed or debt capital employed by the enterprise. This definition is intended to exclude interest paid to depositors in the case of banks or other financial institutions and interest on borrowings to fund financial assets. Interest paid or credited by insurers to fulfill policy and contractual responsibilities to policyholders also should be exempted from the tax base.

Dividends from an affiliated subsidiary that previously have been included in the payer corporation's taxable base should be deducted to avoid double taxation. A subsidiary is "affiliated" when the taxpayer owns at least 80 percent of its total voting power and 80 percent of the value of its stock.

Tax nexus

Any proposed tax must address whether, and to what extent, the District can tax enterprises that operate outside the District but perform business activities within the District. Constitutionally, the District can tax an entity only if it has a legal nexus, or presence, in the District, and it can only tax activities occurring within the District.

The Commission's broad definitions of business enterprise and business activity should create a taxable nexus for just about any activity carried on in the District. Although Public Law 86-272 (15 U.S.C. Sec. 381) prohibits taxing personal income of individuals whose only presence in a state is soliciting, a Michigan court in *Gillette v. Department of Treasury* ruled that a business activities tax is not an income tax and not subject to Public Law 86-272. Therefore, the District's nexus for purposes of taxing business activities should be broad and inclusive.

Apportionment

A business with activities that are taxable both within and outside the District should apportion its business activities tax base so as to allocate to the District a fair and equitable proportion of such base. The tax is not a separable series of several smaller taxes on compensation, interest, and dividends, but an indivisible tax on business activity. Therefore, taxpayers must determine their apportioned District tax base.

Apportionment is calculated by multiplying the total business activity tax base of the enterprise in all states — compensation, interest, and dividends — by the portion of its business activities attributable to the District. Taxpayers use the average of three ratios to calculate apportionment, just as the corporate income tax is apportioned under the existing system. The ratios are: (1) District payroll to total payroll; (2) District property to total property; and (3) District sales to total sales.

Figure 23

Revenue Effect of a Single Commercial Property Tax Rate
(using tax year 1996 assessments)

	Current Rate	Proposed Rate	Change in Revenues (millions)
Class Three (Hotels)	1.85%	1.92%*	+$1.1
Class Four (Commercial)	2.15		-43.6
Class Five (Vacant)	5.00		-5.5
Total			**-$48.0 million**

**Rate is twice the residential rate; assumes continued residential tax rate of 0.96 percent.*
Source: Staff calculations based on data from *D.C. Tax Facts*, D.C. Office of Tax and Revenue.

Recommendation: Introduce a single commercial property tax rate

The District currently has five real property tax classes, two for residential, two for commercial, and one for vacant property. The highest rate, the one on vacant property, is 5 percent, compared to a 0.96 percent residential rate. Both Maryland and Virginia, in contrast, have a single uniform tax rate of about 1 percent on all properties.

The Commission recommends eliminating the multiple classes and having a two-tier system with one commercial rate and one residential rate. Moreover, the rate on commercial property should be no more than double the residential rate. The recommended commercial rate, which assumes that the residential rate is maintained at 0.96 percent, is 1.92 percent (Figure 23). (For more information on residential real property tax rate recommendations, see page 69.)

A growing discrepancy

In 1978, the District had one uniform tax rate on all types of property, a system that still is used by all the adjoining suburbs. A separate tax rate on commercial property was introduced in 1979 with a rate that was a modest 119 percent of the residential rate. In 1986, a separate lower commercial rate for hotels was enacted, and in 1991, a higher rate was established on vacant properties. In addition, the general commercial rate has been changed four times since 1980. The current general commercial rate is 224 percent of the owner-occupied residential rate (Figure 24). This 224 percent difference is among the highest in the country — the fifth highest of the 32 states that permit separate rates on commercial property.

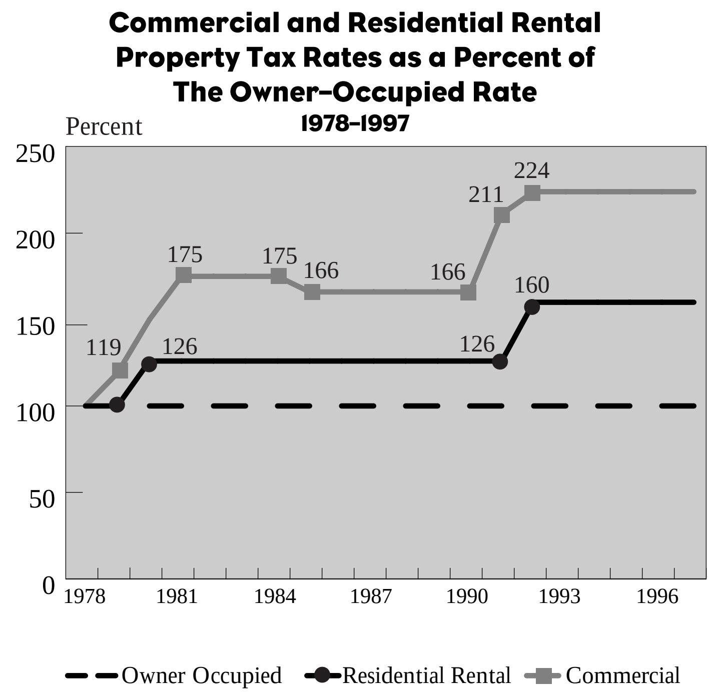
Effects of inflated property taxes

Today's 2.15 percent general commercial rate is almost double the next highest rate on commercial property in the Washington area. This differential endangers commercial space development and leasing, and statistical evidence also shows that the classified property tax reduces net District employment. The Commission concludes that the high rate and uncertainty caused by the growing increase in the gap with the residential rate have had a damaging effect on the value of commercial real estate.

The lower rate for hotel properties was justified at a time when commercial development was generally robust, but hotel development was lagging. In recent years, however, hotels have been doing well compared to other commercial properties, and the Commission does not believe a separate rate is justified for economic reasons. Any problems with inequities in the way that hotels are valued should be addressed as an assessment issue.

The separate, higher rate on vacant properties was expected to act as an incentive to their development or rehabilitation. It also was expected to address concerns that vacant properties

Figure 24



would become neighborhood centers for illegal activities. There is no evidence that the higher rate has been successful in changing the situation. In addition, it has created severe problems of fair administration and compliance. The Commission believes that the goal of turning vacant properties from community liabilities to assets has merit, but that the property tax structure is an inappropriate instrument for achieving this end.

Achieving equity for real property taxes

The Commission considered returning to a single uniform property tax rate for both commercial and residential properties, but rejected this option for two reasons. First, reducing the commercial rate to the current residential rate would create a major revenue loss. The only other path to a single rate — increasing the residential rate — is unfair to residents. Second, the high commercial rate reflects the District's need to overcome its inability to tax income at its source. One of the few ways that the District has to assess nonresidents — those who use District services but pay no District income taxes — is to tax the properties where they work. If the District is allowed full access to its tax base, a single, uniform property tax rate should be enacted.

The Commission recommends a commercial rate that is no more than twice the base residential rate, or a rate of 1.92 percent, assuming the residential rate is maintained at 0.96 percent. The estimated net cost of lowering the general commercial and vacant property rates, while slightly increasing the hotel rate, is about $48 million. The Commission has not identified a source to offset this lost revenue, but recommends that this change be made as soon as the fiscal situation permits. (For more information, see Tax Reductions, page 85.)

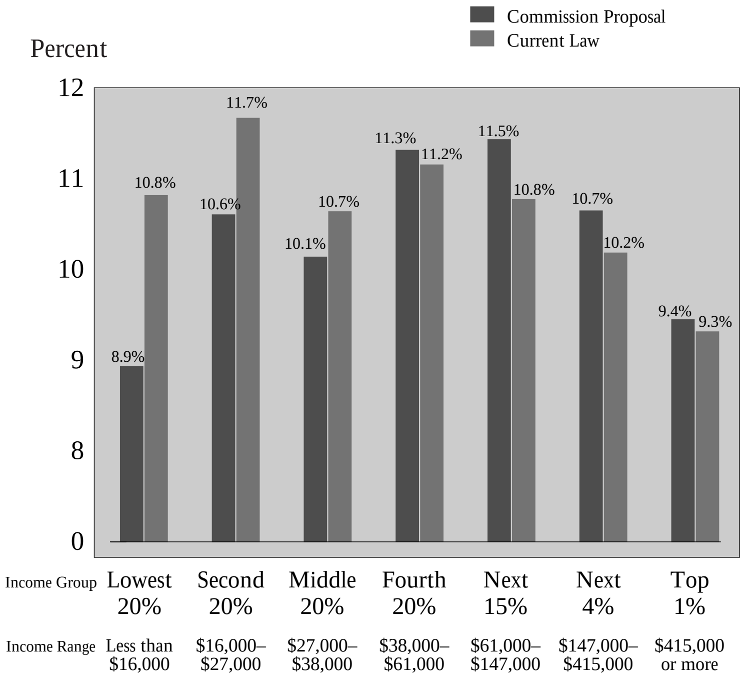
Simplicity and fairness for individuals

The Commission's recommended changes for individual taxpayers include simplifying District income tax filing, introducing a single 0.96 percent residential real property tax rate, and replacing current real property tax relief measures with a generous circuit breaker. Other Commission recommendations, such as the new business activities tax, also will affect individual taxpayers.

These Commission recommendations, when fully enacted, will affect individuals' total tax burden. For the poorest 20 percent of taxpayers, taxes as a share of income will decrease by 1.9

Figure 25

Total D.C. Taxes as a Percent of Family Income
Current Law and Commission Proposal Compared



Source: Institute on Taxation and Economic Policy.

percentage points. Those in the top 20 percent of taxpayers, however, will see an increase of 0.5 to 0.7 percentage points in their taxes as a share of income (Figure 25).

Recommendation: Reduce complexity by conforming the District income tax to federal net taxable income

District residents use the same adjusted gross income to calculate their federal and District income taxes. The net taxable income, however, is different because the District has lower personal exemptions and standard deductions and allows different itemized deductions. The Commission recommends that District residents calculate their District income tax liability using the net taxable income amount from their federal tax returns.

This change will simplify the process of calculating District tax liability and remove income filing requirements for poor families. The higher personal exemption and standard deduction used in calculating the federal taxable income will increase the income level at which tax is first owed — and eliminate the requirement that up to 40,000 District residents file tax returns. As a result, no District taxpayer with income below the poverty level would have to file a tax return, and the District's current low income tax credit would no longer be required to protect low income households from the income tax. Tax administration will be made simpler by having fewer returns to process and having fewer District tax calculations on the return.

Changes in exemptions, deductions, and filing status

Under the Commission's recommendation, both personal exemptions and standard deductions will increase in allowable amount, and each year, they automatically will be adjusted for inflation. Indexing the personal exemption and standard deduction for inflation ensures that taxes do not increase when the buying power of a family's income remains stagnant.

The District's current personal exemption is $1,370, and the standard deduction is $2,000. The federal personal exemption for 1997 is $2,650, and the standard deduction is $4,150 for a single filer, $6,050 for a head of household, $6,900 for married filing jointly, and half that level ($3,450) for married filing separately. The federal personal exemption and standard deduction are adjusted administratively each year to account for inflation, but the District's exemption and standard deduction only change when the Council passes new legislation. If inflation adjustments had been made since the last Council action, in 1997 the personal exemption would have been $1,602 and the standard deduction would have been $2,795.

Under the Commission's recommendation, interest on obligations of the federal government and income received while not a District resident will still need to be subtracted out of federal taxable income, and the federal deduction for District taxes paid will need to be added back.

Some income currently not taxed under District law will become taxable, including portions of Social Security income, disability income, and pension and annuity income. However, some District residents who are 65 years of age or older may benefit from the higher federal standard deduction for senior citizens. Some federal reductions in income currently taxed by District law no longer will be subject to the District tax, including deductions for contributions to Individual Retirement Accounts.

Finally, the recommended change generally will require taxpayers to file District returns using the same filing status used in the federal return. The federal tax code allows for four categories: single, head of household, married filing jointly, and married filing separately. The District allows for an additional status, married filing combined separate, which would be eliminated. Most District taxpayers who currently file married-filing-combined-separate in the District would change their filing status to married-filing-jointly.

The District's married-filing-combined-separate status allows married couples to avoid paying the highest marginal tax rate on all of one spouse's income. Those who use this status benefit because both spouses can have earnings taxed at less than the top marginal rate.

Figure 26

Proposed D.C. Personal Income Tax Rates
Using Federal Taxable Income as the Base, 1998

	Married Filing Jointly	Single	Head of Household	Marginal Tax Rate on Taxable Income
Income Brackets	Up to $20,000	Up to $10,000	Up to $15,000	8%
	$20,000–$50,000	$10,000–$25,000	$15,000–$37,000	9%
	$50,000+	$25,000+	$37,500+	9.5%

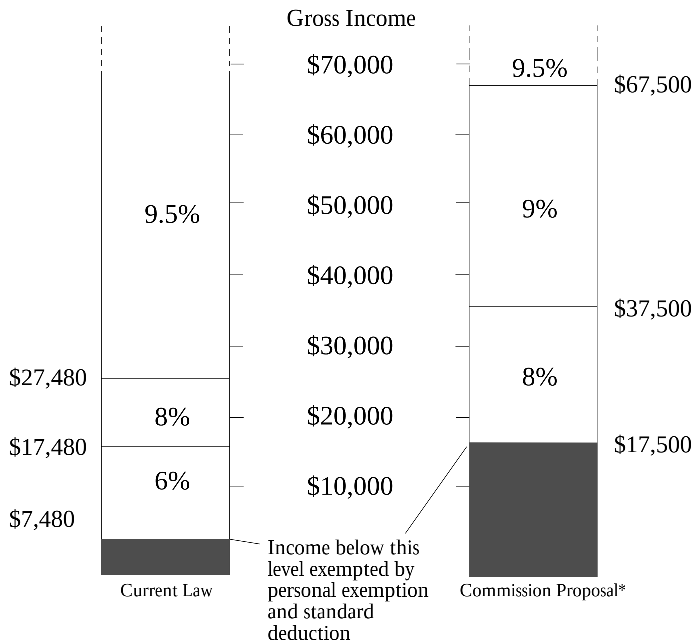
The Commission addresses this concern by proposing tax rates that provide income brackets that are twice as wide for those who file married-filing-jointly than for those who file singly. Thus, a single person will face a marginal rate of 8 percent on the first $10,000 of income; a married couple will face the same 8 percent rate on the first $20,000 of income. A single person will pay the top marginal rate on taxable income over $25,000; married couples will face the same rate on taxable income over $50,000. This proposal also benefits married households with only one wage earner.

Effect on rates and liability

District personal income tax rates will be changed to make the new tax base produce revenue that equals revenue from the current rates. The new tax rates should preserve the current top marginal rate of 9.5 percent and should be designed to parallel existing tax burdens among income classes. One proposal that will accomplish these goals — rates and income levels at which these rates would

Figure 27

Existing and Proposed Income Tax Rates Compared
Family of Four



**Reflects federal standard deduction and personal exemptions for 1997.*

apply — is shown in Figure 26. While the proposed rates may appear to be higher than some of the comparable existing rates, the income levels at which the rates first apply are higher, so the higher brackets affect income at higher levels (Figure 27).

Using these rates, it is estimated that the poorest 60 percent of taxpayers as a group would experience a small tax reduction. The next highest 20 percent would have no increase, and the

Figure 28

Impact of Proposed Rates on Tax Burden

1998 Income Group	Gross Income Range	Personal Income Tax as a Share of Gross Income: Current D.C. Law	Personal Income Tax as a Share of Gross Income: DCTRC Proposal	Change as a Percent of Gross Income
Lowest 20%	Up to $16,000	2.4%	1.4%	-1.0%
Second 20%	$16,000–$27,000	3.8	3.2	-0.6
Middle 20%	$27,000–$38,000	4.2	4.0	-0.3
Fourth 20%	$38,000–$61,000	5.9	5.9	0.0
Next 15%	$61,000–$147,000	6.3	6.5	+0.2
Next 4%	$147,000–$415,000	6.2	6.4	+0.2
Top 1%	$415,000+	6.4	6.6	+0.2

Source: Institute on Taxation and Economic Policy.

highest 20 percent would have a slight increase (Figure 28). Of course, some individual taxpayers whose returns have unusual financial characteristics could experience changes in liability outside the average effects.

The change in calculating net taxable income — from the current District tax code to conformity with the federal tax code — will account for most shifts in tax liability within income classes. As noted earlier, some forms of income currently are not taxable in the District, but would be under a policy of conformity. These income sources include Social Security income subject to federal tax, pension and annuity income up to the $3,000 cap now excluded, and distributions from unincorporated businesses. Under current law, distributions from some unincorporated businesses are taxed as profits at the business level, and this gross income is not included in the gross personal income of District residents. However, the Commission proposes to abolish the unincorporated business tax, so all personal income will now be taxed at the individual level, regardless of source.

Making residential property taxes more equitable

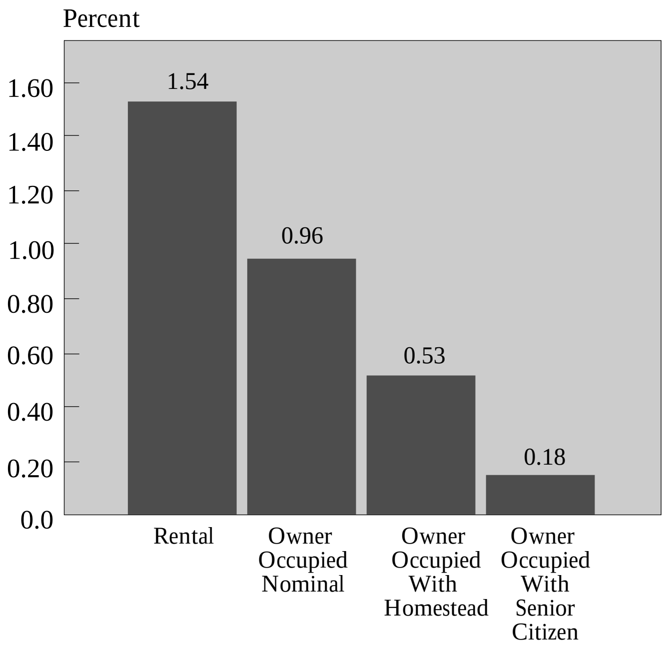
The Commission recommends taxing all residential property at a uniform effective rate and providing property-tax relief through a single program that is based on ability to pay as measured by current income. To achieve this goal, the Commission recommends: (1) consolidating the 0.96 percent owner-occupied rate and the 1.54 percent rate on rental properties into one 0.96 percent tax rate; (2) repealing the $288 homestead exemption for owner-occupied properties and the 50 percent tax reduction programs for senior citizens with incomes less than $100,000; and (3) consolidating the two programs that provide relief based on property-tax liability related to income into a single more generous program.

These changes are recommended to provide equity among residents of the District and to remove the administrative confusion and complexity that accompany the existing residential tax system.

The existing tax relief programs result in substantial differences in effective residential tax rates. Under the current system, properties occupied by owners who pay District income taxes are taxed at rates less than the 0.96 percent rate; some are taxed as low as 0.18 percent. These rates contrast with a 1.54 percent rate for rental residential properties (Figure 29).

Figure 29

Effective Residential Property Tax Rates



Note: Homestead and Senior Citizen rates are for homes in the first decile of home value.
Source: Staff calculations based on data from D.C. Office of Tax and Revenue.

Current rates do not provide appropriate relief based on ability to pay for either homeowners or renters. The rates cause administrative problems and taxpayer confusion. For example, all homeowners must certify their status as both homeowners and District income tax payers to receive the exemption. Failure to file the required form results in disallowance of the exemption.

Recommendation: Introduce a single 0.96 percent residential property tax rate

The Commission recognizes that establishing a single residential property tax rate will be difficult. A single rate will require either increasing the lower rate paid by homeowners or incurring the revenue loss of a decrease in the rate on rental properties. Because repealing the $288 homestead exemption and the senior citizen reduction will increase the effective property tax rate on homeowners from an average 0.73 percent to the stated rate of 0.96 percent, the Commission does not recommend increasing the 0.96 percent rate. Instead, the Commission recommends reducing the 1.54 percent rate to 0.96 percent.

This decrease will result in an estimated $41 million loss in revenues for which the Commission is unable to identify a revenue-neutral source within the District's current resources. Therefore, it recommends establishing a single residential rate as a long-term goal to be achieved as rapidly as the city's improving fiscal situation permits or the federal government begins to meet its financial obligation to the District, consistent with the Commission's recommendations (discussed in the next section of the report).

Recommendation: Replace current property relief measures with a generous low-income tax credit (circuit breaker)

The District currently provides lower property taxes to homeowners for a variety of reasons, including age, physical condition, and owner occupancy of residences. The Commission believes, however, that all residents of the District receive the benefits of government services and are entitled to equal treatment, regardless of whether they rent or own, or are old or young. Therefore, the Commission recommends repealing the

Figure 30

Use of Existing Circuit Breakers

Adjusted Gross Income	Number of Taxpayers	Number with Circuit Breaker	Percent with Circuit Breaker
0–$1,500	15,459	3,604	23%
$1,500–$5,000	15,961	1,084	7%
$5,000–$10,000	26,544	3,100	12%
$10,000–$15,000	29,211	3,792	13%
$15,000–$20,000	28,458	2,870	10%
Total under $20,000	**115,633**	**14,450**	**12.5%**

Source: D.C. Office of Tax and Revenue.

$288 homestead exemption, which is based solely on home ownership, and the senior citizen reduction, which is based on age. Reduction of property taxes should go only to those who need the most help paying their taxes.

It should be noted that the Commission supports home ownership, but concludes that other incentives — the ability to deduct property taxes and home mortgage interest from personal income taxes, and the first-time federal homebuyer credit of $5,000 — are more appropriate than property tax incentives to encourage homeownership.

The two existing circuit breakers, which the Commission recommends consolidating into one, are specifically designed to provide relief through the personal income tax to both renters and homeowners based on the relationship between income and the amount of property tax liability. They provide relief in hardship cases without providing relief to high income homeowners. The elderly, blind, and disabled circuit breaker is more generous than the all-ages circuit breaker. Both relief programs provide relief to homeowners with a maximum of $20,000 in income. The maximum relief is $750. The formulas used in both circuit breaker programs are quite complex in that they use both a threshold and a sliding scale, and they must be claimed on the income tax form.

The complexity of these circuit breakers no doubt contributes to the low number of taxpayers who use them. In 1996, 115,633 District taxpayers, or 43 percent of the total, had incomes below the $20,000 ceiling for use of the circuit breaker. Among these relatively low-income taxpayers, only 14,450, or 12.5 percent of all low-income taxpayers claimed this exemption (Figure 30).

The Commission therefore recommends a single relief measure in the form of a generous, revised circuit breaker. This revised circuit breaker should be simple and have only one criterion for eligibility: ability to pay. The circuit breaker should have the following characteristics:

1. A sliding scale that is based on the owner's household income bracket and specifies the percentage of property tax that will be relieved for each bracket.

2. Maximum relief of $1,000 for any individual taxpayer.

3. Relief that is provided to both owner-occupied properties and to renters, using the assumption that 15 percent of the rent paid is for property taxes.

Figure 31

Proposed Sliding-Scale Circuit Breaker

Household Gross Income	Relief Percentage	Maximum Relief
Under $5,001	85%	$1,000
5,001–10,000	80	1,000
10,001–15,000	75	1,000
15,001–20,000	70	1,000
20,001–25,000	65	1,000
25,001–30,000	60	1,000
30,001–35,000	55	1,000
35,001–40,000	50	1,000
40,001–45,000	45	1,000
45,001–50,000	40	1,000
50,001–55,000	35	1,000
55,001–60,000	30	1,000
60,001–65,000	25	1,000
65,001–70,000	20	1,000
70,001–75,000	15	1,000
75,001–80,000	10	1,000
80,001–85,000	5	1,000
over 85,000	0	n.a.

4. For owner-occupied properties, credit that is returned through an offset to property tax liability, as is done in Maryland.

5. For renters, credit that is claimed on the personal income tax and is refundable if the income tax liability is smaller than the credit.

The Commission's proposed property tax relief through the new circuit breaker should be accomplished on a revenue-neutral basis so the total amount of relief is the same, but the basis for allocating it is more equitable. The homestead exemption, consisting of a $30,000 reduction in assessed value for owner occupied properties that creates a $288 savings for each homeowner, has a revenue cost of about $27 million. The tax reduction of 50 percent of the tax liability for taxpayers over 65 who own and occupy their property and have less than $100,000 of household income has a revenue cost of about $13.6 million. The two circuit breakers together cost about $9 million. Thus, repealing all four of these programs will make approximately $49.6 million available for a new means-tested tax relief program.

A sample circuit breaker with these characteristics could provide relief starting at 85 percent of tax liability for household gross income under $5,000, with decreases in relief of 5 percentage points for each additional $5,000 of income (Figure 31). The Commission believes such a program will be revenue neutral but was unable to obtain from the city the information needed to test this premise. Some adjustments may be necessary when additional information is available.

Because of the differences among taxpayers in the relationship between incomes and house values, it is difficult to determine how each taxpayer would fare under the new program relative to the prior relief programs, but two results are apparent. First, many homeowners will receive a greater benefit from the Commission's proposed relief measure, but homeowners with incomes over $85,000 will no longer receive the $288 in tax relief now given to them by the homestead exemption (Figure 32). The Commission does not believe this creates a hardship.

Second, taxpayers whose 50 percent senior citizen reduction in liability was more than $1,000 will get reduced relief because of the $1,000 limit on relief under the new program, and some with higher incomes and high-value properties will experience substantial percentage increases in their tax liabilities (Figure 33).

Figure 32

Property Tax Relief: Proposed Circuit Breaker Compared to Homestead Exemption

Household Income	House Value	Amount of Tax Relief		As a Percent of Tax	
		Homestead Exemption	Proposed Circuit Breaker	Homestead Exemption	Proposed Circuit Breaker
$25,000	$60,000	$288	$374	50.0%	64.9%
30,000	60,000	288	346	50.0	60.1
30,000	300,000	288	1,000	10.0	34.7
50,000	120,000	288	461	25.0	40.0
60,000	120,000	288	346	25.0	30.0
60,000	300,000	288	864	10.0	30.0
70,000	180,000	288	346	16.7	20.0
90,000	180,000	288	0	16.7	0.0
100,000	300,000	288	0	10.0	0.0

For example, a senior citizen with a $70,000 income and a $180,000 home would see tax relief reduced from $1,008 to $346. Therefore, the Commission recommends that the senior citizen reduction be phased out over several years.

Recommendations for the federal government

A HISTORY OF FEDERAL ASSISTANCE

The District's relationship with the federal government is unique. Over the years, the two governments have had various financial

Figure 33

Property Tax Relief: Proposed Circuit Breaker Compared to Homestead Exemption and Senior Citizen Relief

Household Income	House Value	Amount of Tax Relief		As a Percent of Tax	
		Homestead and Senior	Proposed Circuit Breaker	Homestead and Senior	Proposed Circuit Breaker
$25,000	$60,000	$432	$374	75.0%	64.9%
30,000	60,000	432	346	75.0	60.1
30,000	300,000	1,584	1,000	55.0	34.7
50,000	120,000	720	461	62.5	40.0
60,000	120,000	720	346	62.5	30.0
60,000	300,000	1,584	864	55.0	30.0
70,000	180,000	1,008	346	58.3	20.0
90,000	180,000	1,008	0	58.3	0.0
100,000	300,000	288	0	10.0	0.0

arrangements, including the 41-year period from 1879 to 1920, when the federal government paid for half of all District expenditures. The history and equity of these arrangements have been the subject of numerous studies. Most of them, including recent ones by the Commission on Budget and Financial Priorities (Rivlin Commission), D.C. Appleseed Center, Carol O'Cleireacain (Brookings Institution), and McKinsey and Company, conclude that the District has been given inadequate compensation to offset its special costs and restricted revenue-raising capacity.

The federal government prohibits the District from taxing nonresident incomes, federally owned properties and other

Figure 34

Federal Payments on Behalf of the District
1997–1998 ($ millions)

	Approved Budget 1998
Management Reform	$8.0
Contribution, Deficit Reduction	30.0
Contribution, Financial Plan	160.0
Corrections Trustee	169.0
Criminal Justice System	108.0
Parole, Adult Probation, and Offender Superv.	26.9
Public Defender	9.0
Pretrial Services	6.3
U.S. Parole Commission	0.8
Police and Fire Retirement	163.3
Teachers Retirement	84.4
Medicaid	136.2
Total Payments for Local Funds Operating Budget	$901.9
1997 Federal Payment	$665.7
Increase in 1998	**$236.2**

Source: Staff compilation from *D.C. Appropriations Act, 1998.*

properties specified in federal law, federal purchases of goods and services, and profits of some District corporations. Historically, these federal tax limitations have been offset to a degree by a direct federal payment to the District. This payment in fiscal year 1997 was $665.7 million, or about 20 percent of all locally raised revenues.

During 1997, the traditional arrangement of federal support in the form of a federal payment was dramatically altered by the federal government's assuming direct responsibility for some District costs by a federal "contribution," and by the creation of federal tax incentives available only in the District. As a result of these actions, there no longer will be a federal payment.

The net result of these changes is that in fiscal 1998, the District will receive a little more than $900 million in direct assistance, which is roughly $236 million more in direct assistance than it received in fiscal 1997 (Figure 34); $190 million of this additional assistance, however, is in the form of a one-time contribution that may or may not be renewed in future years.

Uncertainty notwithstanding, the changes provide important long-term benefits because they relieve the District of its financial responsibility for adult corrections (jails and prisons) and the unfunded local retirement systems, and reduce the local responsibility for Medicaid by 40 percent. Over the period from 1991 through 1996, costs of the retirement systems alone grew from $224 million to $336 million, a 50 percent increase.

The federal tax incentives provided in 1997 are expected to provide $1.2 billion in benefits over the next 10 years (see Appendix C), although the amount will depend on how extensively the incentives are used. While the benefits will go to private firms and individuals and only indirectly to the District government, they may provide a significant advantage to the District in its efforts to encourage businesses and people to locate in the city.

Despite the federal 1997 initiatives, additional actions are required to ensure that the District will have stable revenues to support its needs. The District must have access to reliable revenues, not just discretionary appropriations for annual budgets, such as the current "contribution."

The federal government can provide revenue certainty to the District through a variety of actions. These include the three principal provisions that have long been sought by the District: (1) permitting the District to impose a tax on nonresident earnings; (2) making a payment in lieu of taxes for federally owned buildings; or (3) adopting a formula federal payment or contribution. Concerned parties have discussed all three options over the years, and the District has made a strong case for each of them.

Recommendation: Allow the District to tax income at its source

The Commission's highest priority for help from the federal government is lifting the ban on the District's ability to tax all income at its source. No state government is prohibited from taxing revenue earned within its borders.

If this ban were lifted, the District could assess everyone who uses its services. Some of the distorted tax arrangements now used to make up for the ban on nonresident taxes could be eliminated. For example, the top marginal personal income tax rate, which is the highest in the area, could be reduced.

Of course, the District will have to exercise discretion in how it taxes nonresident earnings to avoid making the District noncompetitive with the suburbs. However, this is a judgment that is appropriately made by District officials in the same way that all taxes imposed must be evaluated.

Recommendation: Make a payment in lieu of taxes for federally owned property

The Commission recommends that the federal government make an annual payment in lieu of property taxes to the District. Other properties that the federal government has exempted, such as the World Bank, the International Monetary Fund, and other international organizations, should make in lieu payments, or the federal government should make in lieu payments on their behalf.

There are adequate legal and policy precedents for such payments because the federal government already makes payments in lieu of taxes in other parts of the country and pays sewer and water charges to the District. In addition, the federal government already pays imputed property taxes on space it leases in the District, and it has agreed to make payments to the new business improvement districts when federal buildings are located in these areas. It is difficult for the Commission to understand why the federal government will pay its share for street sweepers hired by the improvement district but will pay nothing for those hired by the District government.

If the federal government were to acknowledge its property tax responsibilities, the District could substantially reduce its commercial property tax levy and make it competitive with nearby jurisdictions (Figure 35).

Payments in lieu of taxes should be made as payments from the General Services Administration building services revolving fund and should not be the subject of a separate annual appropriation to the District. This approach will make accounting for the tax payments in the federal budget the same as accounting for lease payments. Property owned by the federal government that qualifies for tax exemption under District property tax laws, e.g., the Mall, Rock Creek Park, the museum portion of the Smithsonian Institution, should not be subject to federal payments.

Recommendation: Adopt a formula federal payment

If the federal government neither lifts the ban on taxing nonresident income nor makes a payment in lieu of property taxes, it should make a formula payment to the District. The Commission is not recommending a specific formula because

Figure 35

Effect of Federal Property Tax Payment on Commercial Property Tax Rate

	Assessed Value	Tax Rate	Revenue
Taxable commercial property	$19.0 billion	2.15%	$407.8 million
Tax-exempt federal government property	$18.7 billion	0	0
Combined Value	**$37.7 billion**	**1.08%**	**$407.8 million**

Commercial Rates Comparison

Montgomery County	1.07%
Prince George's County	1.06
Arlington County	.96
Fairfax County	.84
City of Alexandria	1.07
D.C. without federal in lieu payment	2.15
D.C. with federal in lieu payment	1.08

Note: Montgomery County and Prince George's County rates are blended to reflect variation for special districts.

Source: Staff calculations based on *D.C. Tax Facts*, D.C. Office of Tax and Revenue, Fiscal Years 1995 and 1996.

many others already have completed extensive work on the justification and design of a formula federal payment. A wealth of suggested solutions is available.

For example, in a 1980 report, *Federal Payment Formula*, the House of Representatives Committee on the District of Columbia noted that "the legitimacy of a federal obligation to compensate the District for the extraordinary impact of the federal presence has been accepted by the majority of both Houses." This 904-page report discusses the problem of finding the proper means for meeting the federal obligation. It found that "over 150 [formula]

Federal Payment bills have been introduced in the past 40 years alone.” Not one of them passed.

The problem has not been finding an appropriate federal payment formula. The problem has been getting such a formula approved.

Recommendation: Ensure that the District is compensated for GSEs' federal exemption from District business taxes

Government Sponsored Enterprises (GSEs) provide secondary markets for mortgage loans. GSEs operate under federal charters that exempt them from state business taxes. This exemption results in a loss of revenue in the states where GSEs do business. The Commission concluded that if Congress believes the exemption for GSEs has merit, the federal government should make payments to the states to compensate for this exemption.

3. Recommendations on Tax Reductions

Tax reductions

The law creating the Commission directed it to consider "the possibility that general rates might be reduced." The source of funding for such reductions was not identified.

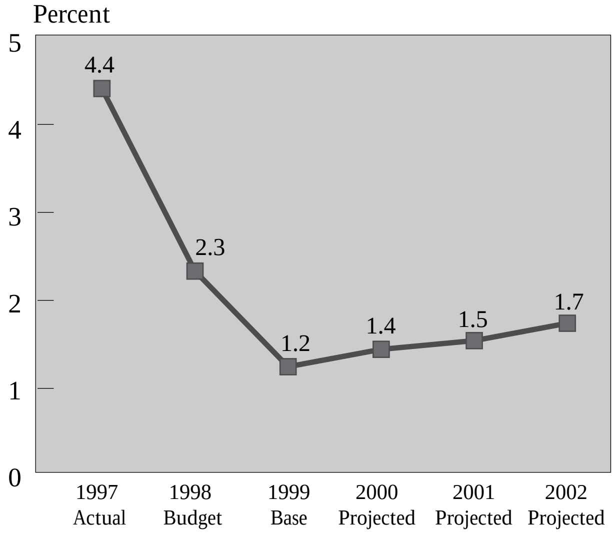
Rate reductions may stimulate a growth in tax bases over time, but the Commission believes rate reductions will not be able to offset immediate revenue losses within a reasonable time. To recommend rate reductions, therefore, the Commission must find a source of funds to offset the lost revenues. There are three possibilities: (1) excess revenues may be available in the budget to pay for reductions; (2) the Commission can recommend new revenue sources or increased rates in some taxes to pay for reductions in other taxes; (3) the federal government can provide additional funds. The Commission is recommending only those reductions that can be accomplished within the District's current revenue-raising powers. Possible reductions that could be financed by changes in federal policy are discussed in a separate section (see page 76).

The Commission is not in a position to estimate the availability of revenue in the District's budgets to pay for rate reductions, but funding from this source does not appear to be an assured permanent answer.

Based on the official revenue projection of the D.C. Office of Tax and Revenue, local revenues will increase less than 2 percent annually through 2002 (Figure 36). This projection may be conservative because it projects continued stagnant property taxes

Figure 36

D.C. Projected Total Local Revenues
Percent Change 1997–2002



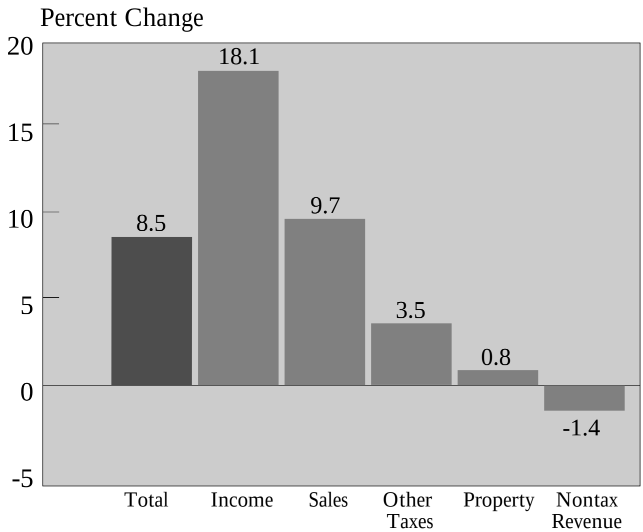
Source: D.C. Office of Tax and Revenue.

and a decline in nontax revenues (Figure 37) despite some evidence of improvement in property values. Nevertheless, the District's economy and the historic performance of the tax system indicate that revenue growth rates over the next few years are not likely to exceed the inflation rate. It also is unclear whether this rate of growth even will be sufficient to provide necessary services.

The District has not determined the amount of spending that will be required in fiscal year 1999 or in future years. The preliminary baseline budget spending estimate — which does not include pay raises, management improvements, or other new spending — is about $200 million less than 1999 estimated revenues

Figure 37

D.C. Projected Local Revenues, by Type
1997 Actual–2002



Source: D.C. Office of Tax and Revenue.

(Figure 38). This amount is available for deficit reduction, spending increases, or tax reductions. The mayor, District Council, and Financial Authority are deciding how to allocate the surplus.

The Commission recommends that any available revenues be used to reduce and eliminate the accumulated deficit without the use of long-term debt; to maintain and improve District services to retain residents and businesses; to reduce tax rates. These long-term goals are important because:

- No long-term economic recovery will be assured until the District is financially healthy. Eliminating the accumulated

Figure 38

D.C. Revenue/Expenditure Comparison
1996–1999 ($ millions)

Revenues:	1996 Actual	1997 Actual	1998 Budget	1999 Baseline
Property	$701.6	$687.6	$670.0	$674.5
Sales	530.4	540.8	558.0	566.0
Income	843.6	937.0	1,005.7	1,031.9
Other Taxes	326.9	324.6	341.0	330.4
Nontax Revenues	253.6	282.7	262.9	269.6
Total	**2,656.1**	**2,772.7**	**2,837.6**	**2,872.4**
Federal Payment	660.0	665.7	198.0	
Total	**$3,316.1**	**$3,438.4**	**$3,035.6**	**$2,872.4**
Expenditures:				
Government Direction	$106.3	$100.9	$90.3	$120.4
Economic Development	50.5	54.1	40.4	36.0
Safety and Justice	940.4	988.3	510.3	497.7
Education	674.4	630.1	530.2	540.3
Human Services	961.2	930.4	789.4	770.8
Public Works	218.3	230.8	228.0	236.8
Financing and Other	410.6	425.6	460.9	474.6
Total	**$3,361.7**	**$3,360.2**	**$2,649.5**	**$2,676.6**
Revenues Less Expenditures	-45.6	$78.2	$386.1	$195.8
Sale/Lease Back		$55.9		
Medicaid Adjustment		$51.8		
Difference After One-Time Adjustments		$185.9		

Source: Comprehensive Annual Financial Reports and FY 1999 Baseline Budget and Financial Plan.

deficit will change the District's image both locally and nationally.

- Another important element of financial health is the commitment of the government to financing high-quality basic services used by residents and businesses. The cost of providing good services is difficult to predict because quality services require both improved management and adequate financial resources.

- Of concern to the Commission is an equitable and productive revenue system that is viewed by businesses as reasonable for paying the costs of government. Therefore, the District should consider reducing taxes to eliminate inequities discussed in earlier sections and to make the tax system more competitive with adjoining jurisdictions.

Because the Commission cannot be sure that funding will be available in the budget to reduce taxes, the Commission's tax reduction recommendations are limited to reducing the rental property tax rate from 1.54 percent to 0.96 percent, and combining classes 3, 4, and 5 into a single commercial rate no higher than 1.92 percent or double the residential rate. The two property tax reductions should be made as soon as revenues are available for tax reductions.

4. Taxes to Modify or Maintain

Sales of goods and services

The Commission is concerned that the District's sales tax base is small relative to personal income and has significantly declined during the 1990s. Several causes for the restricted base were identified, including a wide variety of exemptions that represent over 60 percent of sales, the presence of the federal government and international organizations that neither pay nor collect sales taxes, the ability of residents to shop in Maryland and Virginia, and perhaps lapses in administration.

The Commission considered but rejected several possible changes to sales tax policy, including broadening the tax base by taxing additional services and food, decreasing the tax rate, creating one uniform rate, and taxing organizations that now are exempt.

Sales tax changes considered, but rejected

Tax more services. The Commission considered increasing the types of services subject to the sales tax because services are the fastest-growing component of the national and District economies. In addition, if the sales tax base is to expand at a rate equal to the overall economy, it needs to include more of the services sector.

The District already taxes services more broadly than surrounding jurisdictions, but there are some services not taxed in the District that are taxed by other jurisdictions, such as barber and beauty services, coin-operated laundries, and interior and decorating services (see Appendix H for information about services not taxed by the District). The Commission concluded, however, that the revenue generated by taxing these services would be minor and not worth the administrative problems that would be created. Moreover, many of the inputs in the production process of these services already are subject to taxation.

The larger component of untaxed services is professional services, such as legal, medical, and consulting. Other states have had little success in taxing these services. The Commission concluded that these services would be particularly difficult to tax in the District because of the close proximity of Maryland and Virginia, which do not tax professional services.

Tax all food. Extending the sales tax to food for home consumption also would broaden the tax base. Food for home consumption is taxed in Virginia but not in Maryland or the District. Taxing all food purchases would make the sales tax easier to administer and would provide more revenue stability in economic downturns. However, the Commission concluded that these benefits would not offset the increased burden that a tax on food would place on low-income households. It also noted the changes would yield only $18.5 million additional revenue.

Alternatively, the Commission considered taxing food and offsetting the additional burden with an income tax credit for low-income persons. However, a credit would be cumbersome to administer and would not be available at the time purchases were made. In addition, the credit would consume a substantial portion of the estimated $18.5 million that would be gained from including food for home consumption in the sales tax base.

The Commission considered whether snack foods should be taxed at the 5.75 percent rate used for food for immediate consumption. It concluded that drawing the line between what is food for home consumption and what is food for immediate consumption will always be a problem as long as some food is exempt. Because there would be a loss of revenues from exempting snack foods and the exemption does not appear to provide administrative savings, the Commission recommends no change in the policy of taxing snack foods.

Decrease tax rate. The Commission considered decreasing the sales tax rate to make it comparable to the rates of neighboring jurisdictions as a way of stimulating more taxable sales in the District. The small geographic area of the District makes it easy for residents and businesses to make purchases in nearby states with lower rates. Even though the use tax should provide revenues to the District for these purchases (the use tax applies to products purchased outside the District for use in the District), it is difficult to enforce the use tax except for some business purchases.

Even though sales tax rates usually influence buying patterns, the Commission's research found that the high sales tax rate has not been the principal cause of the District's declining share of retail activity. Instead, the decline is attributable to the District's loss of population.

Therefore, the Commission concludes that any decrease in rates could be expected to have only long-term effects because shopping habits and locations have been formed over many years and would change slowly. The Commission also notes that more than 50 percent of the sales tax revenues are paid by tourists and businesses. A rate reduction would result in an immediate loss of revenues from those sources over the short term, and the Commission is not able to recommend a source to replace them.

Reduce complexity. The Commission also rejected reducing the complexity of the sales tax by replacing the five existing sales tax rates with one uniform rate. To maintain existing revenues, combining the taxes would result in a 7.6 percent sales tax. The Commission found the benefits of a uniform rate were not sufficient to justify the potential shift in sales tax burden from visitors and commuters to residents. This shift would result because the rates of taxes most likely to be paid by visitors and commuters — parking, restaurants, meals, hotel rooms, and alcoholic beverages — would be lowered. The Commission recommends retaining the selective sales tax rates on cigarettes, gasoline, and alcoholic beverages for the same reasons.

Tax organizations that are now exempt. The Commission also rejected changing the legal incidence of the sales tax so it is imposed on the seller rather than on the purchaser. This shift would have expanded the base of the tax to include sales to the federal government, international organizations, and nonprofits. And there is some precedent in that the District uses this procedure so these organizations pay the utility gross receipts tax. In addition, New Mexico has successfully taxed sales to the federal government by imposing its tax on the seller.

The Commission believes, however, that if the District used such an approach to tax sales to the federal government and surrounding jurisdictions did not, District businesses would lose sales to their competitors in Maryland and Virginia. Therefore, the Commission concludes that changing the sales tax from the buyer to the seller should only be done on a regional basis.

Recommendation: Repeal tax on sales of manufacturing equipment

The Commission recommends repealing the sales tax on purchases of manufacturing equipment. This change will be consistent with the current policy of not taxing purchases of materials incorporated in a product that later will be taxed when sold at retail. By not taxing inputs to manufactured products, the District avoids double taxation or pyramiding. It also adds consistency because the District now imposes the sales tax on sales of manufacturing equipment, but not on rentals of manufacturing equipment. The loss of revenue is estimated to be negligible because there is little manufacturing in the District.

Recommendation: Enforce collection of sales tax on goods sold by federal entities and nonprofits to nonexempt purchasers

Sales made by nonprofits, the federal government, or federal entities (such as the Smithsonian Institution) to otherwise taxable purchasers are subject to the District sales tax, and the District should vigorously enforce its right to tax these sales. For example, if a tourist pays a sales tax when purchasing a gift in a hotel gift shop, he or she should pay the tax when purchasing the same gift at the Air and Space Museum; the tax is on the tourist, not the museum. The tax status of the seller should not exempt it from the duty to collect the sales tax on taxable purchasers.

Current District law, which would not change under the Commission's proposal, exempts most purchases by nonprofit organizations from the sales tax. To be exempt, institutions must be located within the District and carry on activities to a substantial extent within the District. Such activities also must result in substantial benefits to citizens of the District.

The Commission rejected a proposal to impose a stricter standard for exempting nonprofit organizations from the sales tax on their purchases. The administrative process required to enact a stricter standard would be too complex relative to the potential increase in revenues that could be achieved.

Electronic commerce

Electronic commerce poses a new challenge to taxing purchases in the District. When an individual enters a store in the District and purchases a good or service subject to the sales tax, District law requires the seller to collect the applicable sales tax. Electronic commerce, however, involves a different kind of interaction; sales via the Internet may never involve face-to-face contact between buyer and seller. The Commission believes that the place a customer makes a purchase — whether a computer or a store — should not change the tax treatment of the transaction.

If the tax due on Internet sales and other forms of electronic commerce is not collected, the impact will be twofold: (1) electronic sellers will enjoy a price advantage (equal to the 5.75 percent sales tax rate) over District merchants; and (2) the District will lose sales tax revenue.

Recommendation: Follow four principles in addressing sales by electronic commerce

Legislation pending in Congress would limit the ability of the District (and all states) to collect sales tax from electronic sellers. This legislation would impose an unfunded mandate on the District, limiting its ability to collect the tax on sales to consumers in the District. The Commission recommends that the District oppose any legislation that would limit collecting sales tax on electronic sales. The Commission also recommends that the District join coalitions of other state and local governments that oppose this potential unfunded mandate.

The Commission recommends that the District follow four principles in addressing the challenge of electronic commerce:

- Electronic presence should be treated similarly to physical presence. Selling and delivering goods and services to persons in the District constitutes economic presence, and the sale should be subject to the applicable sales tax.

- The means of the sale (electronic or face-to-face) should not determine the sale's tax status.

- The tax should be applied on the basis of the destination of a sale.

- Sales should be taxed at the point of final use.

Recommendation: Continue to tax charges for Internet access

The Commission recommends no change in the District's current taxing of charges for Internet access by Internet service providers. Internet access service is similar to many other entertainment and retail services that are currently subject to the sales tax.

Nonprofit organizations

Recommendation: Continue to exempt nonprofits from property taxes

The Commission does not recommend changing at this time the District's policies that exempt nonprofit organizations from paying property taxes. Although the Commission finds that many of these organizations should be required to contribute to the cost of government, it is unable to recommend an administratively and legally acceptable system for differentiating those organizations that should pay from those that should not.

Figure 39

Nongovernmental Tax-Exempt Property

Category	Revenue Foregone ($ millions)
Religious	$27.1
Educational	37.4
Charitable	6.9
Hospitals	15.2
Libraries	.3
Cemeteries	2.5
Other	39.2
Total	**$128.6**

Note: Revenue foregone is based on the 2.15 percent commercial property tax rate using 1996 assessment levels. "Other" includes property exempt by act of Congress and property exempt or partially exempt through District home ownership promotion programs.

Source: D.C. Office of Tax and Revenue, *Study of Property, Income and Sales Tax Exemptions in the District of Columbia,* 1995.

The District government exempts from the property tax a wide variety of privately owned properties that meet nonprofit and other eligibility requirements and that potentially might pay substantial amounts of taxes (Figure 39). In general, the exemptions provided in the District law are similar to those provided by other states and cities. They include churches, schools, higher education and research institutions, hospitals, cemeteries, museums, and other similar facilities, provided the properties are not operated for profit. In addition, federal law exempts some specific properties, such as the American Chemical Society. Some of the properties exempted by federal law also would be exempt under District law. The number of tax-exempt properties in the District is increasing.

Arguments for making nonprofits pay taxes

The Commission believes nonprofits should pay taxes for several reasons:

- Tax-exempt properties benefit from the same police, fire, and other services as those received by taxable properties.

- Exempting properties owned by nonprofit organizations creates inequities in tax treatment between organizations that own their facilities and those that rent space. Nonprofit organizations that rent space pay implicit (or often directly stated) property taxes as part of their rent payment. By owning a property, the tax is avoided and a hidden government subsidy is thereby provided.

- Those *most* able to pay generally own buildings and benefit from the exemption, while those *least* able to pay generally rent property and are taxed. If the subsidy were a budgeted outlay of the District, the organizations receiving the subsidy undoubtedly would be much different than the organizations now receiving tax exemptions.

- The current system also violates tax neutrality because some organizations providing competing services are taxed, while others are not. For example, hospitals and nursing homes may be operated either as profit or nonprofit enterprises, and they compete for the same patients. To some extent, this difference in taxes may be justified if the tax-exempt facilities are providing services to the poor not provided by the taxable facilities. In many cases, however, the benefits provided by tax exemption may not directly equate to services provided, and the taxable facility may provide similar services.

Barriers to taxing nonprofits

The Commission nevertheless recognizes that it would be difficult to recommend taxing all nonprofits uniformly. Some organizations, such as cemeteries, have few or no resources to pay taxes. Others, such as churches, are almost universally not taxed on their actual places of worship. Many nonprofit organizations provide valuable services to District residents that might otherwise have to be provided by the District government; these include nursing homes and day care centers. Others provide national benefits, such as basic research, but provide few benefits locally. The Commission explored, but rejected, the possibility of a tax or payment in lieu of taxes to target those organizations that provide few services to District residents. This approach was rejected because the administrative and legal tests required to distinguish between the national and local benefits are likely to be arbitrary and uncertain, and violate the Commission's goal of tax simplicity.

Other state and local governments have had trouble with policies that require some nonprofit organizations to pay taxes or make in lieu payments. They report difficulty in determining what level of services justifies the exemption and the extent to which those services must directly benefit residents. The design of such legislation for the District would present similar difficulties. Also, the legality of such legislation may be questioned because in a Maine case, the U.S. Supreme Court ruled against state tax exemptions that take into account the proportion of benefits that flow to a state's residents.

Administering a policy that fairly distinguishes exempt from nonexempt organizations would be complex because it would require separately evaluating each applicant. In addition, Pennsylvania's experience shows that nonprofits that are denied exemptions tend to appeal, leading to many lawsuits.

While the Commission is unable to recommend imposing taxes on or requiring other payments by nonprofits, it believes nonprofit organizations should contribute to the cost of the benefits they receive from the District. Therefore, the Commission does not rule out possible payments in the future. In anticipation of this possibility, the Commission urges the District to improve the accuracy of its assessments of nonprofit properties.

Utility services

Recommendation: Tax all functionally equivalent services uniformly

The Commission recommends that the District uniformly tax utility services that are functionally equivalent. This policy requires changing the law that links the gross receipts tax to services classified as “public utility services.” Instead, the law should enumerate the services subject to the gross receipts tax and leave the list open to administrative expansion to accommodate new technologies for delivering those services. The Commission also recommends that outside firms — those without a physical presence in the District — that are permitted to sell utility services to District customers be required to pay the District tax, as a condition of market entry.

These changes are required by the changing marketplace. The gross receipts tax on utility services historically involved a single local firm providing all the services taxed: one company provided telephone service, one company provided electricity, one company provided natural gas service. But these markets are being opened to competition. Entry into long-distance telecommunications already is open, and more than 100 firms provide these services in the District — and are taxed for them. As deregulation continues, there may be as many firms providing local telecommunications, natural gas, or electricity services.

Utility tax changes considered, but rejected

The Commission considered but rejected several possible changes to utility taxes, including reducing the gross receipts tax, repealing the sales tax on nonresidential services, and taxing prepaid long-distance phone cards.

Reduce gross receipts tax. The Commission considered and rejected, at this time, reducing the 10 percent gross receipts tax rate. The District's tax is higher than Maryland's and Virginia's. But it *does* apply to sales to the federal government and tax-exempt organizations. As a result, to offset the attenuated District tax base, the Commission recommends maintaining the current rate, which represents a way of taxing otherwise exempt institutions.

Repeal sales tax on certain nonresidential services. The Commission also rejected, at this time, repealing the 5.75 percent general sales tax that is now added to the gross receipts tax levied on nonresidential services. This combined rate is the highest on any purchase of goods or services in the District. Although the Commission is concerned about this additional tax on top of the gross receipts tax, it has not identified another offsetting revenue to replace the $24 million that would be lost if the 5.75 percent general sales tax were repealed. The Commission recommends, however, that the goal should be to eliminate the tax on commercial consumers if the fiscal situation improves.

The Commission makes no recommendation on imposing user fees to finance "911" services or imposing right-of-way fees on utilities that make use of the public right of way.

Tax prepaid long-distance phone cards. The Commission considered and rejected, at this time, changing the taxation of phone cards. Prepaid phone cards are an example of a new technology's challenging traditional approaches to taxing. Prepaid phone cards now are most commonly purchased in retail outlets and are subject to a sales tax of 10 percent when purchased in the District. But the District does not tax cards purchased in other jurisdictions, even when they are used to make calls in the District. The Commission recognizes that collecting taxes at the retail outlet is the administratively simplest approach. Although phone cards now tend to be convenience purchases, they have the potential to be used on a large scale to avoid the District's long distance telecommunications tax of 10 percent. If this occurs in the future, the Commission recommends that the current policy be reconsidered.

Property assessment

Fair and equitable property taxes must be based on assessments that reflect true value of all properties assessed on a uniform basis. In addition, taxpayers must have credible and clear evidence that such assessment policies are being followed. Much of the dissatisfaction with property taxes stems from taxpayers' belief that properties are not being assessed uniformly. The Commission recognizes that this loss of confidence in the fairness of assessments has been particularly prevalent in the District in recent years.

Recommendation: Return to annual assessments

The Commission notes that the District is undertaking major reforms of its assessment procedures and concurs in general with the changes. However, one of those changes institutes triennial assessments of property. The Commission believes that fair and productive property taxes require annual assessments of value and recommends that the District should return to annual assessments at an early date, perhaps at the end of the second round of triennial assessments.

Triennial assessments mean that, effective with tax year 1999, the city is divided into three geographic areas, with assessments in each area to be conducted on a staggered basis over three years. The new values are to be phased in by equal increments in each of the three years following the valuations. This triennial system is patterned after the one in use in Maryland. The reason cited for the change is the inability of the assessment staff to do “an effective property inspection and data collection process.”

At first, the triennial system probably will improve individual property assessments because the assessors will have smaller annual workloads of properties to value. However, because assessed values will be determined and fully implemented over three years, the new system will produce assessed values that are different overall and less uniform than those produced by a good annual assessment system.

In addition, under the triennial system, individual property owners will never see the true market value of their property used as an assessment base for calculating their tax liability. For the year in which the assessment is made, the owner can judge the accuracy of the valuation relative to other properties valued in that year of the three-year cycle. However, the property owner cannot judge the fairness of the value compared to values established on properties in the other two years of the cycle. Thus, two properties with the same market value in any year can have different bases of assessment and will be taxed different amounts in that year. While the relative taxes paid over time may be about the same for the two properties, the triennial system will not provide transparent, fair treatment.

In contrast to the annual assessment goal of full-value assessments for all properties each year, all properties in the triennial system will be taxed on values that are less than true value. This means that when true values of property are increasing, the District's property tax base will always yield less revenue than would have been received from the stated rates, if they were applied to true values. In periods of low inflation, the lower assessments will not seriously erode District revenues. In high inflation periods, however, the District will find it difficult to obtain sufficient revenues from the property tax without raising tax rates.

With full-value annual assessments, a rate increase or decrease will be applied uniformly to all property owners in the classification. By contrast, rate increases or decreases with triennial assessments will cause unequal changes in individual tax liabilities. Properties with the same market value will be assessed and taxed at different levels, creating problems of equity.

As the District relies more on a computer-assisted, mass appraisal system, it will be feasible to return to annual changes in assessed values, where warranted. Annual physical inspection of every property should not be necessary to reflect values accurately.

Recommendation: Improve assessments of cooperative housing

Uniform assessments require that assessors be able to use the most appropriate means to determine the fair current values of properties; legal restrictions or directives that inhibit assessors should be removed. Therefore, the Commission recommends repealing the special statutory provisions for assessing cooperative residences and instead, requiring the assessment office to enact rules for the methods of assessing them. The

Commission recognizes that the ownership structure of cooperatives is unique, but it is only one of several factors that must be considered by assessors when establishing values. If a cooperative taxpayer believes an assessment is not accurate, the same right of appeal should be followed as that used by other owners.

Recommendation: Change performance measures

The Commission recommends that, regardless of how well future assessments are made, the public will need solid proof that assessments are uniform. Therefore, the Commission recommends the following changes in performance measures used to evaluate assessments:

- In computing sales assessment ratios, all qualifying sales should be used to calculate ratios and coefficients of dispersion. The method currently used includes only the middle 50 percent of the properties arrayed by assessment level. To assure comparability, both the current method (not using all sales) and the recommended method (using all sales) should be reported.

- The District should calculate and publish assessment ratios that show the relationship between assessment and price. This will permit residents to observe whether there are biases in assessments related to properties of different values.

- Properties of different types and in different areas tend to change in value at different rates because of underlying differences in their attributes. Therefore, assessments should not be increased from year to year by a uniform multiplier.

Split-rate property tax

Recommendation: Do not impose a split-rate property tax at this time

The *Tax Commission Establishment Act of 1996* requires the Commission "to conduct an analysis of a split-rate approach to real property taxation together with a recommendation as to how it could be structured with minimal effect on taxes paid by the average taxpayer." The Commission conducted the required analysis, and after reviewing the results, does not recommend a split-rate property tax (one with higher rates on land than on improvements) at this time.

Evidence presented to the Commission found that while higher taxes on land would be neutral relative to development, there is no evidence that they would be beneficial in promoting increased development. For example, Professor Robert Schwab, co-author of a current and landmark study of Pittsburgh's graded tax, concluded that "a land tax did not cause a building boom in Pittsburgh, but it did allow the city government to avoid policies that might have undercut that boom."

To impose a split-rate structure on the existing five-rate classified structure would require either establishing five differential rates on land or eliminating the classification system. Five separate land rates would violate the concept that land should be valued uniformly and not on the basis of its current usage. Eliminating classifications would result in unacceptable, substantial shifts in tax burdens from commercial to residential. Even with a reduction in classifications to two, as recommended in this report, the classification problem would remain.

After reviewing five different possibilities for implementing split rates, the Commission was concerned that there would be large, inadvertent shifts in taxes for individual property owners. While the alternatives examined showed that it would be possible to maintain reasonably equal burdens by classes of taxpayers and by geographic areas, it is impossible to establish a split-rate structure without shifting burdens on individual properties in unanticipated ways.

The Commission also was concerned that a shift to split rates would cause administrative problems for assessors in determining fair land values independent of current use, and would result in substantial legal challenges to the resulting assessments. Some emerging technologies, such as computer-assisted mass appraisals using multiple regression analysis to test accuracy, may be feasible in the future, but they currently are not within the District's capabilities.

Earmarking

Recommendation: Reduce or eliminate earmarking

The Commission recommends reducing or eliminating earmarking revenue sources for particular purposes, whenever legally possible. Earmarking does provide some advantages: It permits a tax to be linked to a specific service, such as using gasoline and motor vehicle taxes to finance highway construction and maintenance, and it also may ensure a minimum level of funding for essential services or for services that are difficult to finance with general revenues.

Nevertheless, the Commission recommends discouraging earmarking because it limits the flexibility of fiscal choices and reduces oversight of spending. Moreover, there is evidence that earmarking reduces long-term support for earmarked services. Also, earmarking creates an administrative burden, diverting staff from what should be their first priority, efficient tax administration.

About 23 percent of the District's revenues are dedicated to earmarked purposes. Earmarks have been used mainly to facilitate the sale of bonds and to meet federal mandates. Ten specific taxes and several other major revenues are earmarked in the District to be used for six different categories of expenditures. Several of the revenues are earmarked for more than one purpose.

For example, about three-quarters of all property tax revenues are earmarked for payment of general obligation debt service in 1998. The MCI Arena construction required earmarking the arena tax on business gross receipts for improvement bonds. The proposed new convention center bonds require earmarking portions of five different taxes. The federal government requires the District to earmark fuel taxes for highways and parts of seven different taxes to provide “stable and reliable” revenue support for the Washington Metropolitan Area Transportation Authority (WMATA). The only nonbond, nonfederal earmarking is the hotel occupancy tax ($1.50 per day) for promoting the District as a travel and tourism destination.

Other states also use earmarks; they account for a range of revenues, from 87 percent in Alabama to 4 percent in Kentucky. The District’s percentage is about average. All states earmark taxes on motor fuel. Other frequently earmarked taxes include general sales (33 states), motor vehicle registration (32 states) and tobacco (27 states).

Recordation and transfer taxes

Recommendation: Tax transactions involving cooperative housing

The Commission considered two issues in the transfer and recordation tax. In one area, the exemption of nonprofits from the tax, the Commission recommends no change. In the second, the Commission recommends taxing cooperatives in the same way as other housing transfers.

The District imposes a 1.1 percent tax to record deeds and transfers of real property. In the case of cooperative housing, there is no deed because the purchaser is not purchasing a distinct plot of ground or unit in a building. Instead, the purchaser buys shares in a corporation that owns the housing and a proprietary lease agreement for the unit. The Commission recommends that lease assignments involving cooperatives be treated in the same manner as property transactions that involve deeds. Owners of proprietary leases in cooperatives would be required to register their assignments with the Recorder of Deeds at the time of sale and pay the transfer and recordation taxes. Data from these transactions also will make it possible to implement another of the Commission's recommendations — to assess cooperatives based on fair market value. Data on transaction prices can be used by the District's real property assessors for this purpose.

Superseded recommendations

The Commission was prepared to recommend changes in several other areas. However, in each of these areas, the issue has been made moot by one of the broader recommendations for change.

Personal income tax

The Commission was concerned that the structure of the current Low Income Credit creates a "notch," a point at which only $1 more in income leads to a large increase in taxes. The credit protects low-income individuals and families from D.C. income tax obligations. It applies to taxpayers who have zero federal income tax liability but a positive level of District income tax liability.

As the Low Income Credit works today, having $1 in federal liability causes loss of the entire credit and subjects the taxpayer to the full District tax liability. For a family of four, married filing jointly, that first $1 in federal liability means loss of eligibility for the Low Income Credit and an increase in District tax liability from zero to $602. However, conforming the District's income tax to the federal levels of the personal exemption and standard deduction, as the Commission has recommended, would eliminate the notch in the current law.

Personal property tax

The Commission was concerned that the depreciation schedules for the personal property tax are unrealistic. For example, personal computers are required to be depreciated at a rate of 10 percent per year, and the value is never allowed to fall below 25 percent of the purchase price. Computers made five years ago with 386 processors are being sent to the trash heap as worthless. The District's approach to depreciation clearly departs from economic reality. However, the Commission's recommendation that the personal property tax be replaced with a business activities tax obviates the need to reform depreciation.

Business income tax

District entities cannot use net operating loss deductions from a non-District affiliate firm to reduce their tax liability. The District's treatment of losses should conform to the federal law. The Commission's recommendation that the business activities tax substitute for the business profits tax diminishes the significance of this issue. The proposed business activities tax should permit net operating loss carryovers to be used as credits against the new tax for a three-year transition period.

Appendix A: D.C. Tax Revision Commission Reports

Texts are available at the Commission's Web site at **www.dctrc.org**

Non-Tax Revenues in the District of Columbia: Current Practices and Future Prospects
Examines the District's reliance on user fees compared to the neighboring jurisdictions. Also explores whether and to what extent the District should increase its reliance on nontax revenue sources (Michael E. Bell, MEB Associates, and James O'Keeffe, Georgetown Public Policy Institute, April 1998).

Real Property Tax Relief in the District of Columbia
Discusses property tax relief measures and how they are used in the District (John H. Bowman, Virginia Commonwealth University, February 1998).

Triennial Assessment of Real Property in the District of Columbia
Discusses the effects of the change to triennial assessments in the District of Columbia (John H. Bowman, Virginia Commonwealth University, February 1998).

Tax Policy Review for the Electric and Natural Gas Utility Industries in Washington, D.C.
Reviews the tax policy challenges that have arisen due to the ongoing transition of the electric and gas utility industries. Offers options for dealing with these challenges (Rodney D. Green and Daniel Muhammad, Department of Economics, Howard University, January 1998).

Taxation of Telecommunications in the District of Columbia
Addresses the challenges that arise from changes in technology

and market structure in the industries that provide goods and services taxed by the gross receipts and toll telecommunications tax (David Meyer, Tax and Economic Policy Administration, D.C. Office of Tax and Revenue, January 1998).

A Distributional Analysis of the District of Columbia Tax System
Analyzes the distributional effects of the District's existing tax system (Michael Ettlinger, Institute on Taxation and Economic Policy, January 1998).

The District of Columbia's Individual Income Tax: Structure, Characteristics, and Policy Alternatives
Reviews the personal income tax and a related issues (Robert P. Strauss, Professor of Economics and Public Policy, Carnegie-Mellon University, January 1998).

Earmarking Tax Revenues in the District of Columbia: A Description and Evaluation
Describes the earmarking practices for District taxes and their budgetary and revenue implications (Mark I. Gripentrog, D.C. Office of Tax and Revenue, December 1997).

Real Property Tax Appeals Process of the District of Columbia
Provides a preliminary report on District's real property tax appeals process (John H. Bowman, Virginia Commonwealth University, with the assistance of Michael E. Bell and Thomas E. Heinemann, December 1997).

Tangible Personal Property Taxation in the District of Columbia
Studies the personal property tax system in the District (John H. Bowman, Virginia Commonwealth University, December 1997).

The Changing Population of the District of Columbia, 1990-1996
Reports the District's household and population changes between 1990 and 1996 (George Grier, The Grier Partnership, November 1997).

Aspects of the Real Property Tax System of the District of Columbia
Reports on the classification of property tax rates and the fairness of assessments (John H. Bowman, Virginia Commonwealth University, with the assistance of Michael E. Bell and Thomas E. Heinemann, November 1997).

D.C.: A Capitalist City?
Provides a preliminary analysis of the new federal tax incentives for the District of Columbia (Martin A. Sullivan, Tax Analysts, Arlington, Virginia, October 1997).

Taxes and Economic Development in the District of Columbia
Discusses the effects of taxes and tax incentives on the District economy. Includes findings and recommendations based on consideration of the current performance of the District economy, the effectiveness of tax incentives, and the effect of taxes on employment and population in the District (Therese McGuire and Stephen Mark, Institute of Government and Public Affairs, University of Illinois and Leslie Papke, Department of Economics, Michigan State University, October 1997).

Business Franchise and Insurance Taxes in the DC Tax System
Examines the business franchise tax and possible alternatives for taxing businesses (Joseph J. Cordes and Harry S. Watson, Department of Economics, George Washington University, October 1997).

An Analysis of the Graded Property Tax
Analyzes the split-rate approach to real property taxation (Professor Robert M. Schwab and Amy Rehder Harris, Department of Economics, University of Maryland, October 1997).

Sales Taxes in the District of Columbia
Describes the current conditions and policy options for sales taxes in the District of Columbia (William F. Fox, Professor of Economics, The University of Tennessee, September 1997).

District Tax Comparisons
Compares the District's taxes to those in neighboring jurisdictions, other major cities, and other states (Staff report, April 1997).

Appendix B: Criteria and Conceptual Framework

Adopted by the D.C. Tax Revision Commision on February 10, 1997.

The Tax Revision Commission is committed to developing and recommending a comprehensive and integrated revenue system for the District of Columbia. To be successful, the Commission must make clear why its recommendations are being made and why they should be enacted. This requires establishing goals for the new proposed revenue system and using sound criteria to measure the achievement of those goals.

The current revenue system consists of a patchwork of diverse revenue sources, many with complex tax base definitions and multiple rate structures. In addition, the revenue system is strewn with exemptions, incentives, and tax relief measures that reduce revenues and add to complexity. In many instances, important measures to provide relief or incentives are not targeted properly and may even be counterproductive.

Many of the features that now clutter the revenue system were enacted because of strong constituencies — constituencies that may now vigorously oppose change. The task of the Commission is to evaluate the claims of competing interests objectively against the criteria for a good revenue system and then make the trade-offs.

The Commission finds that a good revenue system should have the following characteristics:

1. The system must be fair in apportioning tax burdens and must be consistent in its application. Fairness means recognizing that there are differences in ability to pay and in the benefits residents receive and that taxes must recognize

those differences both in terms of individuals and in terms of the overall system. An important aspect of fairness will be treating taxpayers in similar circumstances consistently and not favoring some individuals or groups over others without an explicit reason for doing so.

2. The system must be easy for taxpayers to understand, must not impose unnecessary administrative burdens on the taxpayers or tax collectors, and must provide confidence that all those subject to the tax are paying it.

3. The tax rates and tax structure must be acceptable to District businesses and individual taxpayers as a reasonable cost for locating in the District. While acceptance may take into account whether rates are competitive, other factors such as fairness, consistency, costs of compliance, and predictability may be more important.

4. The revenue system should have as its primary purpose raising revenues from the city's overall wealth base to support basic services required of the District. It should not be used for nonrevenue purposes without an explicit statement of the purpose and justification for using the revenue system.

5. The District government's ability to administer and enforce all parts of the recommended revenue system must be a key consideration. The government's capability should be based on an assumed competent staff with sufficient equipment and resources to administer the system.

6. The District's revenue system must be viewed in conjunction with the federal revenue system for evaluating the

degree to which it satisfies the criteria for a good revenue system, but it remains the responsibility of local elected officials to design a local revenue system that citizens can understand and control.

The overall goal of the Commission is to provide the citizens of the District of Columbia a complete and systematic analysis of revenues that will complement the restructuring that is currently in the planning stage for expenditures. Without an intensive, comprehensive review of own source revenues, a coordinated solution to the District's financial problems will not be achieved.

Appendix C: Summary of the New Federal Tax Incentives for the District of Columbia

On August 5, 1997, President Clinton signed into law the *Taxpayer Relief Act of 1997*. The Act provides a net tax cut estimated to be $275 billion over 10 years — the first significant tax cut since 1981. One component of this tax reduction package was a set of tax incentives uniquely available to District residents and businesses operating in certain impoverished areas of the District. According to official estimates, the Act provides the District federal tax relief totalling approximately $1.2 billion over the 10-year period from 1998–2007.* There are five parts to the District's tax relief package:

1. *Wage credit.* A tax credit of up to $3,000 per employee will be available for wages paid to any District resident by businesses operating in areas of the District with poverty rates of 20 percent or more. Wages paid during calendar years 1998 through 2002 are eligible.

2. *Tax-exempt financing.* The District will have the authority to issue enterprise zone facility bonds for businesses operating in areas of the District with poverty rates of 20 percent or more. These tax-exempt financing bonds can be issued during the period after December 31, 1997 and before January 1, 2003.

* This estimate does not include tax benefits of allowing an immediate write-off of environmental remediation expenses (the so-called "brownfields" initiative) or temporary extension of the work opportunity tax credit. These benefits are available in many areas of the United States in addition to the District; no separate estimates for this provision's impact on the District are available.

3. *Faster write-offs.* Small businesses operating in areas of the District with poverty rates of 20 percent or more will have an additional $20,000 of first-year deductions for expenditures on capital equipment. The additional first-year deductions will be available for qualified taxpayers with taxable years beginning after December 31, 1997 and ending before January 1, 2003.

4. *Zero-percent capital gains rate.* A zero-percent capital gains rate will be available to investors who have owned, for at least five years, business property used in areas of the District with poverty rates of 10 percent or more, or who have owned a business operating primarily in areas of the District with poverty rates of 10 percent or more. To qualify for the zero rate, an investment must be paid for in cash after December 31, 1997 and before January 1, 2003.

5. *Homebuyer credit.* Since August 5, 1997, a tax credit of up to $5,000 has been available for couples with incomes below $130,000 (and singles with incomes below $90,000) making their first purchase of a home anywhere in the District. (An eligible taxpayer may currently own a home as long as it is not in the District.) This credit expires on December 31, 2000.

In addition, two tax benefits will become available to District businesses as a result of the District's new status as an empowerment zone:

1. "*Brownfields.*" Businesses operating in areas of the District with poverty rates of 20 percent or more will be able to deduct environmental cleanup expenses in the year these

expenses are incurred. Under current law, these expenses often could not be deducted at all. (Urban sites contaminated with hazardous substances are commonly referred to as “brownfields.”) These special deductions are available for expenditures incurred in the years 1997 through 2000.

2. *Work opportunity tax credit.* District employers can earn a tax credit of up to 40 percent on wages paid to high-risk youths (ages 18 through 24) and qualified summer youth employees (ages 16 and 17) as long as these employees reside in areas of the District with poverty rates of 20 percent or more. In general, the credit is available for the first $6,000 of wages paid to each employee. This credit is available only in the District during the first six months of 1998.

Appendix D: Revenue from D.C. Taxes and Other Sources, Fiscal Year 1996 and 1997

Taxes	1996 ($ thousands)	1997 ($ thousands)
Real Property, Class 1, Homes	$113,769	
Real Property, Class 2, Apartments	97,118	
Real Property, Class 3, Hotels	27,244	$617,694
Real Property, Class 4, Commercial	378,365	
Real Property, Class 5, Vacant	7,886	
Personal Property	65,201	60,392
Public Space Rental	12,052	9,513
General Sales @5.75%	248,210	245,274
General Sales @10% (Restaurants)	129,020	135,260
General Sales @13% (Hotel Rooms)	82,030	96,652
General Sales @12% (Parking)	24,150	25,093
General Sales @8% (Alcoholic Beverages)	11,730	12,188
Alcohol	5,100	5,460
Cigarette	18,676	18,946
Motor Vehicle Fuel	31,842	31,020
Motor Vehicle Excise	31,668	30,271
Hotel Occupancy	7,420	7,612
Individual Income	689,408	753,475
Corporate Franchise	132,305	148,151
Unincorporated Business Franchise	31,863	39,919
Insurance	33,121	42,625
Public Utility	144,842	141,901
Toll Telephone	45,464	52,994
Health Care Provider Fee	11,530	0
Estate	32,175	27,314

continued

Taxes (cont.)	1996 ($ thousands)	1997 ($ thousands)
Deed Recordation	33,099	30,821
Deed Transfer	26,711	27,162
Arena Tax	9,432	9,587
Total Taxes	**$2,481,431**	**$2,569,324**
Percent of Total Local Revenues	**90.9%**	**90.4%**

Nontax Revenues		
Business Licenses and Permits	$26,663	$28,268
Nonbusiness Licenses and Permits	19,737	17,221
Other Revenues	28,100	52,320
Fines and Forfeitures	40,792	51,664
Charges for Service	46,134	37,801
Lottery and Games	75,250	69,200
Interest	14,311	18,599
Total Nontax Revenues	**$253,987**	**$275,073**
Percent of Total Local Revenues	**9.3%**	**9.7%**
TOTAL LOCAL REVENUES	**$2,728,447**	**$2,842,457**

Source: D.C. Office of Tax and Revenue.

Proposed Form (one page)

D-40 **1997**
Individual Income Tax Return

★ ★ ★ DISTRICT OF COLUMBIA GOVERNMENT
OFFICE OF TAX AND REVENUE

OFFICIAL USE ONLY

Date received	A	B	A	B
	C	D	C	D

TAXABLE YEAR beginning: ending:

If this is a final return for a decedent, enter the date of death here: (See page 2 for instructions.)

PLACE LABEL HERE

YOUR FIRST NAME AND INITIAL	LAST NAME		YOUR SOC. SEC. NO.	OCCUPATION
SPOUSE'S FIRST NAME AND INITIAL (If joint return)	LAST NAME		SPOUSE'S SOC. SEC. NO.	OCCUPATION
HOME ADDRESS (NUMBER AND STREET)		APT. NO.	CITY STATE	ZIP CODE

Filing status

☐ Single

☐ Head of Household

☐ Married filing jointly

☐ Married filing separately. Spouse's name:____________________ Spouse's Social Security Number____________________

ADJUSTED GROSS INCOME	1. Federal net taxable income (From line 38 of Form 1040 of your federal retun)		
	2. Addition: Amount reported on schedule A of Form 1040, line 5, for state and local income taxes		
	3. Deduction: Subtract the amount of state and federal bond interest and state tax refunds reported on line 10, Form 1040		
	4. District net taxable income (Line 1 plus line 2 minus line 3)		
TAXABLE INCOME	5. Tax from either tax table or tax rate schedule		
	6. Out-of-state tax credit (Attach copy of out-of-state return) Note: Do not use the witholding tax shown on Form W-2 as the credit		
	7. Tax credits (Calculate the child and dependent care credit and the DC Metropolitan Police Department housing income tax credit on Schedule J and report on this line)		
	8. NET TAX (Line 5 minus line 6 minus line 7)		
TAX CREDITS AND PAYMENTS	9. D.C. Income tax withheld (Attach original copy of Form(s) W-2)		
	10. 1997 estimated tax payments		
	11. Payments submitted with extension of time to file (Attach copy of Form FR-127)		
	12. Total payments and credits (Add lines 9, 10, and 11)		
AMOUNT YOU OWE OR REFUND	13. AMOUNT YOU OWE (If line 8 is more than or equal to line 12, subtract and enter here) PAY THIS AMOUNT WITH RETURN		
	14. OVERPAYMENT (If line 8 is less than line 12, subtract and enter here (For refund, you must complete this line and line 16.)		
	15. Amount of line 14 to be applied to your 1998 estimated tax.		
	16. Amount of REFUND (Line 14 minus line 15)		
	17. CONTRIBUTION TO THE PUBLIC TRUST FOR DRUG PREVENTION AND CHILDREN AT-RISK. Indicate amount you want to contribute		
	18. Enter amount of refund or payment after your contribution (see instructions)		

SIGN HERE

Under penalties of law, including criminal penalties for false statements and tax preparer penalties under D.C. Code §22-2514 and §47-161, *et seq.*, I declare that I have examined this return and to the best of my knowledge and belief, it is true, correct, and complete. If prepared by a person other than the taxpayer, this declaration is based on all information available to the preparer.

Taxpayer's Daytime Telephone ( )_____-_____

► Your Signature — Spouse's Signature (If Filing Joint or Combined) — Date

► Signature of Preparer if other than Taxpayer — Date — Address — Fed. I.D. No. or S.S. No.

Make check or money order payable to *D.C. Treasurer*. Enter your social security number, D-40, and tax year on your payment. Mail this return and payment to the Office of Tax and Revenue, Ben Franklin Station, P.O. Box 7861, Washington, D.C. 20044-7861, on or before April 15, 1998.

RETURN MUST BE PROPERLY SIGNED, OTHERWISE, IT WILL BE SENT BACK TO TAXPAYER(S) wd-602

Note: Possible revised tax form after implementation of Commission recommendations (not an official document).

Current Form (two pages)

D-40 **1997**
Individual Income Tax Return

★ ★ ★ DISTRICT OF COLUMBIA GOVERNMENT
OFFICE OF TAX AND REVENUE

OFFICIAL USE ONLY

Date received	A	B	A	B
	C	D	C	D

TAXABLE YEAR beginning: ending:

If this is a final return for a decedent, enter the date of death here: (See page 2 for instructions.)

PLACE LABEL HERE

YOUR FIRST NAME AND INITIAL	LAST NAME		YOUR SOC. SEC. NO.	OCCUPATION
SPOUSE'S FIRST NAME AND INITIAL (If joint return)	LAST NAME		SPOUSE'S SOC. SEC. NO.	OCCUPATION
HOME ADDRESS (NUMBER AND STREET)		APT. NO.	CITY STATE	ZIP CODE

PART-YEAR RESIDENTS: Period of residency in D.C.: From__________ to__________. Months you were a D.C. resident
NOTE: (See page 2 for instructions on how to file a part-year return.) Part-year residents must prorate Line 6 and Line 9.

FILING STATUS (Check one)	EXEMPTIONS: YOURSELF	65 OR OLDER	BLIND	DEPENDENTS	TOTAL EXEMPTIONS COL. A	COL. B
A ☐ Single	A 1	+ ☐	+ ☐	+ ☐ =		
B ☐ Head of household With qualifying person. If qualifying person is a child but not your dependent, enter the child's name here:	B 2	+ ☐	+ ☐	+ ☐ =		
C ☐ Married filing jointly. See instructions for surviving spouse.	C 2	H ☐ W ☐	H ☐ W ☐	+ ☐ =		
D ☐ Married filing separately Spouse's name: Spouse's Social Security No.:	D 1	+ ☐	+ ☐	+ ☐ =		
E ☐ Married filing combined separate Col. A	E 1	+ ☐	+ ☐	+ ☐ =		
Col. B	1	+ ☐	+ ☐	+ ☐ =		
F ☐ Dependent taxpayer	F 0					0

DEPENDENT'S NAME	RELATIONSHIP	SOC. SEC. NO.	DEPENDENT'S NAME	RELATIONSHIP	SOC. SEC. NO.

For combined separate filing, use Col. A for husband and Col. B for wife. Otherwise, use Col. B only

• ATTACH WITHHOLDING STATEMENT(S) HERE • ATTACH CHECK OR MONEY ORDER HERE •

			COLUMN A	COLUMN B
ADJUSTED GROSS INCOME	1. **Federal adjusted gross income** (From Line 45, Part I, page 2)	1		
	2. **Additions** (From Line 46, Part II, page 2)	2		
	3. Total (Add Lines 1 and 2)	3		
	4. **Subtractions** (From Line 56, Part II, page 2)	4		
	5. **D.C. adjusted gross income** (Line 3 minus Line 4)	5		
TAXABLE INCOME	DEDUCTIONS: (Use Line 6 or Line 7) 6. Enter $2,000 for filing status (A), (B), (C) or (F); enter $1,000 for (D); or $1,000 in each column for (E)	6		
	7. Itemized deductions. Enter amount from Line 61, page 2 (Attach copy of Schedule A)	7		
	8. Net income (Line 5 minus Line 6 or Line 7)	8		
	9. Multiply **total exemptions** by $1,370 (Enter "0" if you checked filing status F)	9		
	10. **Taxable income** (Line 8 minus Line 9)	10		
TAX CREDITS AND PAYMENTS	11. Tax from either tax table or tax rate schedule	11		
	12. Out-of-State tax credit (Attach copy of Out-of-State return). Indicate state► NOTE: Do Not use the withholding tax shown on Form W-2 as the credit	12		
	13. Child and dependent care credit (32% of federal credit. Attach D.C. Form 2441 if part-year).	13		
	14. (a) D.C. low income credit (attach copy of your 1040)	14(a)		
	(b) D.C. Metropolitan Police Department housing income tax credit	14(b)		
	15. Total credits. Add Lines 12, 13 and 14(a) and 14(b)	15		
	16. **NET TAX.** Line 11 minus Line 15. If Line 15 is more than Line 11, enter "0"	16		
	17. **D.C. income tax withheld. (Attach original copy of Form(s) W-2)**	17		
	18. 1997 estimated tax payments	18		
	19. Payments submitted with extension of time to file (Attach copy of Form FR-127)	19		
	20. **Property tax credit.** (Schedule H must be attached)	20		
	21. Total payments and credits. Add Lines 17, 18, 19 and 20	21		
AMOUNT YOU OWE OR REFUND	22. AMOUNT YOU OWE. If Line 16 is **more** than or equal to Line 21, subtract and enter here. Filing Status A, B, C, D, or F **PAY THIS AMOUNT WITH RETURN**	22		
	23. **OVERPAYMENT.** If Line 21 is more than Line 16, subtract and enter here. (FOR REFUND, you **must** complete this line and Line 25.)	23		
	24. Amount of Line 23 to be applied to your 1998 estimated tax. If joint, check here ☐	24		
	25. Amount of REFUND (Line 23 minus Line 24). FOR REFUND complete this line.	25		
	26. Combined separate filing status E filers **only: NET AMOUNT YOU OWE**	26		
	27. Combined separate filing status E filers **only: NET REFUND**	27		
	28. **CONTRIBUTION TO THE PUBLIC TRUST FOR DRUG PREVENTION AND CHILDREN AT-RISK.** Indicate amount you want to contribute.	28		
	29. Enter amount of refund or payment due after your contribution (see instructions)	29		

RETURN MUST BE PROPERLY SIGNED, OTHERWISE, IT WILL BE SENT BACK TO TAXPAYER(S)

Note: Not an official document.

You must complete your federal income tax return before you prepare your District of Columbia individual income tax return. All taxpayers must complete Part I. Status "E" filers use Columns A and B, all others use Column B only. Complete Part II if you had modifications to your federal adjusted gross income. Complete Part III if you itemized deductions on your federal income tax return. Complete Part IV if you were required to complete the federal itemized deductions worksheet.

PART I—INCOME AND ADJUSTMENTS FROM FEDERAL RETURN If applicable, attach copies of federal Schedules C and E	COLUMN (A)	COLUMN (B)	COLUMN (C)
30. Wages, salaries, tips, etc.			
31. Taxable interest income			
32. Dividend income			
33. Refunds of state and local income taxes			
34. Alimony received			
35. Business income or (loss)			
36. Capital gain or (loss)			
37. Taxable amount of pensions, annuities and IRA distributions			
38. Rents, royalties, partnerships, estates, trusts, etc.			
39. Farm income or (loss)			
40. Unemployment compensation (insurance)			
41. Taxable portion of social security and tier 1 railroad retirement			
42. Other income (Specify)			
43. Total (Add Lines 30 through 42)			
44. Adjustments to income from federal return			
45. Federal adjusted gross income, (Line 43 minus Line 44. Enter here and on Line 1, page 1)			

PART II—MODIFICATIONS TO FEDERAL ADJUSTED GROSS INCOME

ADDITIONS TO INCOME	COLUMN (A)	COLUMN (B)	COLUMN (C)
46. **Total additions.** Enter here and on Line 2, page 1 (See pg. 3 of instructions)			
SUBTRACTIONS FROM INCOME			
47. Interest on U.S. obligations			
48. Refunds of state and local taxes included on federal return (From Line 33 above)			
49. Income received during period of nonresidence			
50. Social security and tier 1 railroad retirement income from Line 41 above			
51. Disability income exclusion			
52. Income reported and taxed on D.C. franchise or fiduciary return			
53. Interest and dividend income of child reported on federal Form 8814			
54. Pension or annuity exclusion			
55. Other subtractions (Specify)			
56. **Total subtractions** (Add Lines 47 through 55. Enter here and on Line 4, page 1)			

PART III—ITEMIZED DEDUCTIONS FROM FEDERAL FORM 1040, SCHEDULE A AND D.C. ADJUSTMENTS

(You must attach a copy of federal Schedule A to your D.C. return)

	COLUMN (A)	COLUMN (B)	COLUMN (C)
57. Total federal itemized deductions on federal Schedule A			
58. Enter all income taxes shown on federal Schedule A, or line 67, Part IV below			
59. Deductions during period of nonresidence			
60. Add Lines 58 and 59			
61. **Total D.C. deductions** (Line 57 minus Line 60. Enter here and on Line 7, page 1)			

PART IV—INDIVIDUAL INCOME TAX SCHEDULE TO ADDBACK THE PERCENTAGE OF STATE INCOME TAX REDUCTION.

Part IV is to be completed only if your itemized deductions must be reduced on your federal tax return

	COLUMN (A)	COLUMN (B)	COLUMN (C)
62. Enter the amount of reduction of your federal itemized deductions from federal itemized deductions worksheet			
63. Total federal itemized deductions from federal itemized deductions worksheet			
64. Divide Line 62 by Line 63 and enter (percentage)	%	%	
65. Amount of state income tax deduction from federal Schedule A			
66. Multiply Line 65 by the percentage shown on Line 64. This is your D.C. state tax addback			
67. Subtract Line 66 from Line 65 and enter the result here and on Line 58, Part III above			

SIGN HERE

Under penalties of law, including criminal penalties for false statements and tax preparer penalties under D.C. Code §22-2514 and §47-161, *et seq.*, I declare that I have examined this return and to the best of my knowledge and belief, it is true, correct, and complete. If prepared by a person other than the taxpayer, this declaration is based on all information available to the preparer.

Taxpayer's Daytime Telephone ( ) -

▶ Your Signature — Spouse's Signature (If Filing Joint or Combined) — Date

▶ Signature of Preparer if other than Taxpayer — Date — Address — Fed. I.D. No. or S.S. No.

Make check or money order payable to *D.C. Treasurer.* Enter your social security number, D-40, and tax year on your payment. Mail this return and payment to the Office of Tax and Revenue, Ben Franklin Station, P.O. Box 7861, Washington, D.C. 20044-7861, on or before April 15, 1998.

RETURN MUST BE PROPERLY SIGNED, OTHERWISE, IT WILL BE SENT BACK TO TAXPAYER(S)

wd-602

Appendix F: Potential Legal Challenges to the Business Activities Tax

The *Home Rule Act* (the federal law that serves as a city charter for the District) prohibits taxing any portion of personal income, "either directly or at the source thereof, of any individual not a resident of the District." Because the business activities tax includes compensation in its base, some may suggest that it violates this act. The Commission, however, believes that a legal challenge to the tax is unlikely to succeed.

In developing their recommendation, members of the Commission were mindful of the 1979 D.C. Court of Appeals decision in *Bishop v. District of Columbia*. The Court determined that "The nature and effect of a tax, not its label, determines if it is an income tax or not." Based on this conclusion, the Court prohibited the District from imposing its unincorporated business tax on the income of most professionals.

A ruling on the proposed business activities tax, however, likely would be different. The proposed tax, in nature and effect, is not a tax on income and therefore should not be subject to the Bishop interpretation. In addition, the 1991 U.S. Supreme Court decision in *Trinova Corp. v. Michigan Dept. of Treasury* set a relevant precedent. This case involved the Michigan single business tax, which has a tax base — compensation, depreciation, and profits — that is virtually identical to the one proposed by the Commission. The Court concluded that Michigan's tax was not a tax on the component pieces of the base, but was "*an indivisible tax upon a different, bona fide measure of business activity, the value added*," (emphasis added). The Court went on to say:

> One of the acknowledged advantages of value added as a measure of taxation is its neutrality. A VAT [Value Added

> Tax] is neutral in the sense that it taxes all business activity alike: Under a pure VAT, all forms of business organization (corporation, partnership, proprietorship), all types of financing (debt, equity), and all methods of production (capital intensive, labor intensive) bear the same tax burden.

Based on this Supreme Court ruling, it seems clear that when interest and dividends are added to compensation, as they are in the proposed tax, the product is not a tax on compensation. It is on a bona fide measure of business activity, as legal under the Home Rule Charter as the taxes it would replace.

Appendix G: Federally Tax-Exempt Organizations Subject to the Business Activities Tax

IRS Code and Type of Organization	D.C. Tax Exemptions under Current Law	Exempt under the Proposed Business Activities Tax
501(c)(1) Corporations organized by Acts of Congress	Corporate income, sales, and personal property tax	Depends on Act of Congress
501(c)(2) Corporations organized to hold property and turn proceeds over to an exempt organization	Corporate income tax only	Yes
501(c)(3) Charitable, religious, scientific groups, educational organizations	Corporate income and personal property tax; sales tax if "benefits dispensed in D.C." test is met	Yes
501(c)(4) Civic leagues or promotion of social welfare groups	Corporate income tax; sales tax, in some instances	No
501(c)(5) Labor organizations	Corporate income tax only	No
501(c)(6) Business leagues, chambers of commerce, trade associations	Corporate income tax only	No
501(c)(7) Clubs	None	No

IRS Code and Type of Organization	D.C. Tax Exemptions under Current Law	Exempt under the Proposed Business Activities Tax
501(c)(8) Fraternal beneficiary societies	Corporate income tax only	No
501(c)(9) Voluntary employee beneficiary societies	Corporate income tax only	No
501(c)(13) Cemetery companies	Corporate income tax only	No
501(c)(19) A post or organization of past or present members of the Armed Forces	None	No
501(c)(25) Corporation or trust organized to acquire or hold real property, etc.	Corporate income tax only	No

Appendix H: Services Not Taxed in the District

Source	*Potential Sales Tax Revenues ($ thousands)	Number of States Taxing this Service
Attorneys	$133,154	5
Public relations, management consulting	41,775	7
Construction contractors	18,038	11
Physicians	13,849	4
Engineers	7,819	5
Accounting and bookkeeping	6,745	5
Carpentry, painting, plumbing	4,824	13
Dentists	3,211	4
Travel agent services	2,254	3
Advertising agency fees	2,171	11
Barber shops and beauty parlors	1,512	6
Admission to cultural events	1,187	31
Private investigation (detective) services	1,115	13
Secretarial and court reporting services	929	9
Interior design and decorating	815	9
Sewer and refuse, industrial	729	13
Personal instruction (dance, golf, tennis)	574	7
Medical test laboratories	373	4
Construction service (grading, excavating)	290	11
Membership fees in private clubs	189	22
Coin-operated laundry and dry cleaning services	126	8
Automotive washing and waxing	117	21
Automotive road service and towing services	99	15
Rental of films and tapes by theaters	71	45
Land surveying	32	7
Massage services	23	10
Carpet and upholstery cleaning	20	15

**Based on sales level in 1992.*

Source: Fox, William F. *Sales Taxes in the District of Columbia.* A report to the D.C. Tax Revision Commission, September 1997.

Appendix I: Dissents and Additional Views from Commissioners

Commissioner Richard Halberstein

First, I wish to commend the members of the Commission, especially the Chairman, and the entire staff, for the many hours of hard work over the past many months devoted to improving our current D.C. individual, business, real property, sales, and other tax laws. The Commission's final recommendations, if implemented, would make D.C. a more attractive place to live and operate a businesses, while imposing more reasonable and fair taxes upon those persons and entities who utilize D.C. services. As a 28-year D.C. resident who has conducted a tax law practice here for most of those years, I appreciate the Commission's efforts to achieve these goals.

I wish to state my frustration as an active member of this Commission, feeling as if one hand were tied behind my back while I was expected to perform a two-handed task. I'm referring to the Congressional restriction upon the District's ability to tax the D.C. business income of individuals who work here but reside elsewhere. This restriction affected almost every D.C. tax topic reviewed by the Commission, and presented roadblocks in our efforts to create more desirable options or alternatives for consideration by the Council. This restriction seems especially inappropriate to me during this current period when the District's revenue system, expenditure habits, and budget process have come under so much deserved criticism and control.

I will not likely be elected to public office, nor am I a paid representative or lobbyist seeking to protect the interests of particular individuals or business associations. Therefore, my frustration may seem naive or uninformed. However, I believe that the obstacles created by this Congressional restriction have seriously limited the Commission's ability to carry out its mandate from the City Council. I therefore recommend that the Commission's report be amended to present the following questions to Congress, the Council, and the public:

1. Why should an attorney whose office is near mine, with the same annual net income, pay no D.C. business income tax solely due to residence outside D.C.?

2. Why should that other attorney's salaried associate also totally escape D.C. income tax solely because of residence outside D.C., while my salaried associate, living a few blocks from the office, is subject to D.C. income tax withholding? All four (attorneys and associates) pay the same sales taxes on purchases in the neighborhood; we pay the same restaurant sales tax at lunch; and we pay the same gasoline tax when we stand next to each other at the local self-service station. We all utilize the same sidewalks and streets to get to and from these shops, restaurants, and gas stations, and I'm certain if there is ever a need, we would all call the same 911 number for police or other emergency assistance.

Having said this, and with one hand tied behind my back, I wish to make the following brief comments and suggestions to supplement the report of the Commission:

Taxing business fairly

I support the Commission's recommendations to eliminate or phase out the varied and complicated current taxes imposed on many but not all of the business entities currently operating in the District, to be replaced with a broad based, low rate, business activities tax. The experts who testified before us, and the studies presented to us, indicated clearly that the greater portion of the current business taxes are being paid by a relatively small number of the entities subject to these taxes. As I have stated above, I cannot understand why our system should be allowed to permit some members of a particular profession to escape all D.C. income taxes, while other members of the same profession are fully taxed. On the other hand, I do not condone the current imposition of professional license fees or other charges imposed upon only particular professions or businesses, which are not uniformly imposed on all District businesses, and which bear no relationship to the administrative costs of the licensing function. I believe the Commission's recommendations meet the goal of similarly, fairly, and reasonably taxing all similar D.C. businesses.

Although the Commission approved exclusions from this new tax for businesses with gross incomes or tax bases below stated levels (the Commission recommends a $50,000 gross receipts minimum), I am concerned that this proposal would in some cases impose an undesirable or unreasonable cost of doing business upon entities with large gross incomes, and large labor or payroll costs, but with little or no real net income for any particular year (i.e., income earned by the business entity or as passed through by it in any form to its owners). I am not advocating that D.C. should continue to impose a business net profits tax, and I do support the concept of the low-rate business activities tax imposed on all business entities that derive benefits from the D.C. government while located within the city. However, I recommend that the Commission's proposal be modified to provide for only a reasonable and affordable minimum tax (such as exists with the current franchise taxes) for any year during which gross income or the new activities tax base exceeds the minimum thresholds, but where little or no net income is earned by the business entity or is passed through from the business to its owners.

Finally, current law (consistent with Congressional pronouncements and court cases) permits a D.C. resident to deduct from his or her individual income tax base, all income subject to the current D.C. franchise tax. With one hand still tied behind my back, I recommend that the Commission's new business activities tax proposal be modified to permit D.C. residents to deduct some part of the new business tax base from the same resident's D.C. individual income tax base. If the Council adopts the Commission's proposal to adopt the federal definition of personal "taxable income," this will presumably be accomplished since I believe there would be a federal deduction from income for the new D.C. business activities tax. If the Commission's income tax proposals are not adopted, however, then I recommend the Council should take the necessary steps to ensure that D.C. residents do not pay taxes twice for the same business income.

Reducing complexity and increasing tax fairness for individual residents

I support the Commission's recommendations to adopt the federal definition of "taxable income" and thereby eliminate an estimated 40,000 lower income taxpayers from the obligations of filing or paying taxes. This alone will greatly simplify the income reporting burdens of these citizens and I believe also greatly reduce the burdens upon the city's tax administration. I realize adopting someone else's definition of one's taxable income can include some undesirable and unforeseen consequences. However, for several years, D.C. has already adopted the federal definition of "adjusted gross income" for personal income tax purposes, and D.C. has conformed to most federal changes in this definition over the years. I sincerely believe that the disadvantages of adopting the federal definition of "taxable income" would more than be offset by the benefits of a higher threshold for individual filing, greater simplicity, increased compliance, and decreased burden of administration. One might even accuse me of contradiction since I have consistently criticized Congress for telling D.C. *whom* it may tax, but I am now advocating Congress telling D.C. *what income* it may tax. Our staff and consultants have informed us that this proposal will result in very little if any tax increase or decrease for most taxpayers still subject to the tax.

I would go further than the Commission. I support the so-called "piggyback" approach, wherein the D.C. personal income tax would be calculated as a percentage of the IRS income tax (flat percentage for all or graduated rates as the Council would determine), and if possible, would be collected, audited, and enforced by the IRS for the District. The Commission was informed that this approach was not feasible because: (1) the percentage-of-federal-tax plan as originally proposed in the 1970s and again in later years was coupled with a plan to have the IRS collect the D.C. taxes, but such IRS collection plan was never satisfactorily negotiated by D.C. and the IRS; and (2) the percentage-of-federal-tax plan would result in increased taxes upon upper income D.C. residents, due to the greater federal tax progressivity at the upper income levels, resulting from many factors such as the federal phasing out of certain itemized deductions and family member exemptions, and the application of the alternative minimum tax to certain higher income taxpayers.

Adopting the federal tax as a base upon which a graduated D.C. tax would be imposed would be the simplest approach to imposition of a local income tax, and could virtually remove the D.C. government from the business of administration of the personal income tax. With all of its faults and administrative problems recently publicized in the press and before Congress, I believe the IRS is better suited to enforce the income tax laws, collect the taxes, and more likely to inspire D.C. taxpayers to comply completely with filing and reporting requirements. I believe the complete conformity would greatly increase and improve taxpayer compliance, and that the current D.C. individual income tax enforcement personnel could be more productively reassigned to work in areas more suited to local tax administration, such as real property and sales taxes. The so-called "marriage penalty," which the Commission has attempted to reduce or eliminate in its proposal, would also be reduced though not eliminated under this recommendation since federal tax law now contains such a penalty as well. However, if (as anticipated) Congress soon addresses elimination of this penalty, then a similar benefit would automatically flow to D.C. taxpayers. Also the percentage-of-federal-tax approach would recognize the "head of household" status for unmarried parents, in the same proportion as the IRS rules now recognize such status. I also am convinced that the D.C. tax rates (upon the federal tax) could be adjusted to ensure that no D.C. taxpayers, especially in the upper brackets, would be unduly burdened or penalized by this simplification effort.

Residential property tax relief

I support the recommendations of the Commission to make residential property tax relief based upon ability to pay, rather than any other factor such as age, blindness, or disability. I especially support the idea of removing the homeowners entitled to the current so-called "circuit breaker" relief from the D.C.'s present income tax system, and giving such relief through the property tax system itself, similar to the relief provided currently for all owner-occupants regardless of income or ability to pay. I reluctantly agree to continue providing such relief to qualifying tenants as a refundable credit through the D.C. income tax system, since there appear to be no more desirable alternatives. I am troubled by my own experience in working with the present "circuit breaker" program, in which I believe there are many residents who are unaware of the possibility of relief at tax return time, and who might not otherwise be required to prepare or file a D.C. tax return. If the Commission's recommendations are accepted, I urge the Council and the tax administration to make every possible effort to educate all D.C. tenants (as well as all homeowners) on a regular basis as to the existence of this relief program, and to make information and forms available to all who might potentially qualify for such relief.

I am concerned, however, with the Commission's adoption of "household income" as a measure of one's ability to pay. I do believe "household income" can be an appropriate measure if properly and truthfully reported. However, I think the past several years' experience with the current "circuit breaker" has proven this is not a practical approach. Asking one property owner or tenant in D.C. to report *for a non-income tax purpose* the names and incomes of all other persons in the household is not realistic. More importantly, there is no practical method for the administration to monitor, verify, and enforce such rules for this purpose.

To achieve the Commission's intent to provide relief to individual homeowners or tenants who do not have the financial ability to pay the full real estate taxes (directly or through the landlord), I recommend we measure each claimant's ability to pay by his or her own gross resources for the past year. By "gross resources," I mean all financial resources including gross taxable income, plus nontaxable resources such as tax free bond interest, nontaxable portions of social security and retirement income, child support, etc. This is a similar approach to the current "circuit breaker" test, except that I recommend measuring *only the claimant's* resources, not the resources of others who may live in the same household. After having worked with lower income D.C. residents for over 25 years, and having claimed numerous "circuit breaker" benefits each year for such residents, I don't believe changing the test of ability-to-pay to "claimant's resources" will result in a substantial revenue loss, because I believe the present system has invited and encouraged misrepresentation which cannot be avoided or monitored by the administration, and which has in effect permitted claimants to report only their own resources anyway. I believe using only the claimant's information, especially when that claimant has filed an income tax return, will greatly assist the tax administration in monitoring and enforcing these provisions, and will greatly encourage claimants to file truthful and accurate information.

I also have a recommendation concerning who would be the proper claimant for the new real property relief measure. Presently, only one person or "head of household" is entitled to claim either the homestead exemption or the income tax "circuit breaker" present tax credit. The Commission's proposal does not address the issue of multiple homeowners or co-tenants occupying the same rental property. In the case of multiple or joint homeowners, and similarly in the case of multiple co-tenants, I recommend that the Commission proposal be modified to provide that each individual (owner or tenant) may claim relief for his or her portion of the real property taxes paid (directly or through the landlord), provided that each claimant must meet the ability-to-pay test for relief from the respective portion of the tax.

Commissioner Jacquelyn V. Helm

While I find myself in dissent on what I believe to be a central failing of the Commission's report, I want to make clear at the outset that I have the deepest respect for the members of the

Commission, its Chairman, and staff. It has been an honor and an exciting learning experience to serve with my fellow Commissioners, persons whom I have found to be exceptionally dedicated, knowledgeable, and hard-working. Even in those areas where I reach a conclusion at variance with that of the Commission, I respect both the decision-makers and the decision reached.* Throughout our deliberations, it was always clear that Commissioners shared a common concern for the impact of various tax alternatives on the District, its residents, and businesses, and were united in their goal of creating a tax system that would fairly balance the interests of all three.

It is precisely because of the regard I have for my fellow Commissioners and all the effort that went into the Commission's final report, that I find it so distressing to file this dissent. Nonetheless, I feel compelled to go on record with my dissenting view in regard to a central tenet of the Commission's report. I believe that by submitting a report whose recommendations are, with one notable exception, driven by a goal of revenue neutrality the Commission fails in its responsibility to propose the best possible tax system for the District.

By this I do not mean to suggest that the Commission should have ignored the very real revenue needs of the District. Rather, because it is the local elected officials who must serve as the ultimate arbitrators between the often competing calls for tax reductions and increased services, the Commission's report

* As other Commissioners have noted, many of us did not agree with everything in the final report. I did not dissent on the basis of any disagreement with one or more specific recommendations, rather my dissent speaks to a determination that colors the tenor of the entire report. However, I will note for the record that I recused myself from the vote on the business activities tax on the basis of a conflict of interest.

needed to provide those officials with a description of the best tax system for the District. In devising the *best* tax system for the District, one would, of course, take into account those factors that are fixed beyond the control of local officials — i.e., the Congressional prohibition on a nonresident income tax, the inability of the District to support heavy industry, and the tax rates and burdens in surrounding jurisdictions.

Only after that *best* system was devised, would one calculate the amount of revenue it would generate. If that amount exceeded revenues from the current system, the Commission could point with pride to the bounty and leave the decision on how it would be spent to the local officials. If that amount produced less revenue than the current system, the Commission would have to continue work to identify the least harmful ways in which the *best* system could be adjusted to increase revenues to the current level and leave the decision on whether to adopt the *best* system or some adjustments thereto to the local officials. Not only would this approach have made it clear that the adjustments were moving the District further and further away from the *best* tax system, but it would have given elected officials a clear goal toward which to aspire.

As things stand, the tax system devised by the Commission is not based on a determination that the taxes and tax rates recommended are the best for the District. Rather, they are the best at generating the same amount of revenue as we generate under the current tax system. This is clearly illustrated by the Commission's recommendations; for example:

1. **A 1.5 percent rate on the business activities tax**

"The business activities tax can have a far lower tax rate than the taxes it replaces *and still raise the same amount of revenue* because of a broader base." (Emphasis added.) (page 50)

2. **New rates and brackets in the individual income tax**
"District personal income *tax rates will be changed* to make the new tax base *produce revenue that equals revenue from the current rates*." (Emphasis added.) (page 66)

3. **A new circuit breaker program to replace the existing circuit breakers, and the real property homestead exemption and 50 percent tax reduction for senior citizens**
"The Commission's proposed property tax relief through the new circuit breaker should be accomplished on *a revenue-neutral basis* so the total amount of relief is the same, but the basis for allocating it is more equitable." (Emphasis added.) (pages 74–75)

Do these actions result in the *best* tax rates? Would different rates place the District in a better competitive position to attract businesses and residents? If more revenue is provided as a result of some of the Commission's other recommendations (repeal of the prohibition on a nonresident income tax, a federal payment in lieu of taxes for tax-exempt property, adoption of a formula federal payment) or through other means, is there anything that should be done to revise the tax system?** Which taxes should be reduced further and in what priority order? For instance, is a reduction in the proposed business activities tax rate more important than a further reduction in the commercial real property tax rate? The Commission's report simply does not address these questions.

This lack of vision, this failure to see beyond the revenue needs of today and formulate a goal for the future is the direct,

** The only nonrevenue-neutral proposal the Commission makes is to create a single commercial class of real property and apply a tax rate no greater than twice the residential real property tax rate of $0.96 per $100 of assessed value.

and regrettable, result of a focus on revenue-neutrality. One of the biggest obstacles to reforming the District's tax system and adopting a rational, equitable, and competitive tax policy has always been that the pain — a revenue loss — would be immediate, while the gain — economic development and its attendant revenue growth — would come later in the "out years." The need to find the "up front" money to finance tax reform has, until recently, precluded a serious look at what shape that tax reform should take. The Council took the all-important first step out of this box by creating the Tax Revision Commission and mandating a comprehensive review of the District's tax system and recommendations for changes and policy directives.

Unfortunately, the Commission did not fully accept the challenge. Rather, it decided for the local officials that the city's revenue needs were too acute for there to be fundamental change. Thus, even if all of the Commission's recommendations are adopted, the District will maintain its dubious status as the nation's second or third highest-taxing jurisdiction. This can change over time, but not without a well reasoned plan. With the intellect, expertise, will, and commitment brought to bear, the Commission could have, and I believe should have, formulated such a plan. It now remains for others to do.

The Tax Revision Commission may have given the District a blueprint for a better tax system. It did not give the District a blueprint for the *best* tax system. And therefore I dissent.

Commissioner Walter Nagel

I thank [Tax Revision Commission Chair Robert Ebel] and my fellow commissioners and our staff for an outstanding effort with which I am proud to be associated. While I agree with the majority of the recommendations contained in our report, I must express my disagreement with the following four recommendations:

1. **Recommendation: Enact a business activities tax on value added at a rate of 1.5 percent** (page 50)
A business activities tax or VAT is traditionally a foreign tax. It is highly unusual in the United States. Only two states have adopted modified VATs. Attempting to measure the value added to a product or service as it moves along the retail distribution chain creates undue tax compliance burdens. A complex tax structure may discourage the location of businesses in the District.

2. **Recommendation: Follow four principles in addressing sales by electronic commerce** (page 96)
Electronic presence does not equate to physical presence. Remote sellers do not enjoy the same governmental benefits as local sellers, therefore, burdens to collect use tax should be different. Moreover, any attempt to expand nexus and thus use tax collection obligations to vendors transacting business over the Internet may violate the Commerce Clause of the United States Constitution and is at odds with the United States Supreme Court's decision in *Quill Corp. v. North Dakota*, 510 U.S. 859 (1993).

3. Recommendation: Continue to tax charges for Internet access (page 97)
Internet access provides a gateway for the District's residents to a wide array of education and information services. Generally, telecommunications services utilized to access Internet service providers are already heavily taxed. To tax Internet access would result in multiple layers of taxation.

4. **Recommendation: Allow the District to tax all income at its source** (page 80)
This recommendation calls for a tax on nonresidents. The District and surrounding states are closely interrelated. Businesses and employees have made economic decisions based in part on the taxation of income. A dramatic change, such as removing the present prohibition on taxation of nonresidents, could hinder the District's efforts to attract new businesses.

Commissioner Matthew S. Watson

Recommendation: Property tax relief through a single circuit breaker
The Commission, after considering the current complex series of individual property tax relief measures, has recommended a much simpler single circuit breaker relief measure which applies to both homeowners and renters to replace existing property tax relief programs (page 71). I fully agree with this part of the recommendation. The present measures to relieve burdens of the real property tax are a hodgepodge of programs based on the owner's age, health and ability to pay.

The Commission, however, recommends that the "relief through the new circuit breaker should be accomplished on a revenue-neutral basis so the total amount of relief is the same, but the basis for allocating it is more equitable" (pages 74–75). I believe that the examination of revenue neutral changes is a worthwhile analysis tool, however, I must dissent from the recommendation of a revenue neutral change. To recommend revenue neutrality assumes that the existing levels of benefits are appropriate. That is simply not the case, particularly with regard to the homestead exemption and the tax reduction for senior citizens.

The homestead exemption is based entirely on the fact of the owner living in the property. The District gives a tax reduction of

$288 to every residence in which the owner principally resides, regardless of the value of the property, or the wealth of the owner. The same reduction is given for a $30,000 property as a $3 million property. Similarly, the benefit is the same whether the owner is unemployed or has annual income in the millions of dollars. I do not believe that any tax relief program is justified based solely on homeownership with no means test whatsoever.

The current senior citizen relief provision, while means tested, has an income level so high that it is nearly irrelevant. The current relief is provided to all residences owned by senior citizens living in households with incomes under $100,000 per year. Substantially all senior citizens meet the income requirement. In addition, once qualified by income, the relief is unlimited. Under the existing program, annual relief exceeds $1,000 for homes valued at over $238,333 owned, and exceeds $2,000 annually for senior citizen owners of properties valued at over $446,000.

In contrast to the current exceedingly generous current property tax relief for homeowners, under current law, no renter, whether young or old, with income over $20,000 per year receives any relief whatsoever, regardless of the amount of rent paid and the amount of tax payment attributed to that rent. It would appear almost axiomatic that a homeowner with identical income to a renter is likely to have a greater ability to pay than the renter who owns no real property. This is even more likely to be the case for homeowning senior citizens, who, for the most part, are likely to have no mortgages, or very small mortgages. The disparate treatment of otherwise equally situated owners and renters is unconscionable. The proposal by the Commission to combine all of the real property relief measures into one circuit breaker applicable to both owners and renters is certainly an improvement on current law.

As noted above, however, I believe that the current relief programs have been too generous at higher income levels, causing the total amount of current relief, $49.6 million, to be excessive. Maintaining neutrality perpetuates this excessive tax expenditure. Although the Commission proposal is means tested, the constraint of neutrality results in a maximum income level of $85,000 to qualify for some benefit. While less than the current $100,000 limit in the senior citizen program, $85,000 is still unreasonably high. Setting the level at $85,000 results in some relief being granted to 85 percent of all of the households residing in the District. Both that percentage and the absolute dollar amount is, I believe, unjustifiable.

I recommend that, in place of the Commission-recommended relief formula of 85 percent of real property tax for households with incomes under $5,000, declining by five percentage points for each $5,000 of household income above that amount (Figure 31, page 74), the formula should provide for the same starting point, but a 10-percentage-point reduction for each $5,000 of household income above the lowest $5,000. This formula will result in eliminating relief entirely to households with incomes over $45,000, and some reduction in relief to households with incomes between $5,000 and $45,000. The exact effect will be dependent on income and house values. I estimate that this reduction would cut the tax expenditure from the existing relief programs and Commission recommended circuit breaker approximately in half, while still providing relief to approximately 63 percent of all households in the District.

Although I recognize that this will result in an increase in real property taxes paid by *homeowning* households, and particularly senior citizen *homeowners*, I do not believe that as generous a homestead or senior citizen relief program as exist now should have ever been adopted. The benefits of the single recommended circuit breaker, even with my modification, for homeowners with household income between $20,000 and $45,000 will be greater than renters of the same income levels currently receive, since renters above $20,000 do not receive any relief whatsoever. Indeed, to the extent that the higher Class 2 rates are passed on to tenants, renters currently pay more real estate taxes than similarly situated homeowners.

The proposed single circuit breaker will, for the first time, grant relief to renters with household incomes over $20,000 per year. If my proposal were adopted by the District, the tax expenditure saving could be used to offset approximately half of the reduction in revenue which would be caused by the Commission's recommended establishment of a single residential property tax rate at $0.96, for which the Commission has not identified any revenue source (page 71).

Although I recognize that my proposal will result in some increase in tax payments for all homeowners with household incomes over $20,000, and senior citizen homeowners with incomes up to $100,000, if any class of citizens, whether younger or older, is able to absorb a slight increase in real property taxes, it is households who have sufficient assets to own their own homes, and particularly home owning households with incomes over $45,000 who are in the top third of all residents of the District by household income.