January 31, 2002
Council of the District of Columbia
PUBLIC HEARING ON:
BILL 14-432 “LONG TERM CARE TAX CREDIT ACT OF 2002”
BILL 14-462 “COMPENSATING USE TAX CLARIFICATION ACT OF 2002”
BILL 14-503 “PORTFOLIO INVESTMENT FUND COMPETITIVENESS ACT OF 2002”

Joint Testimony of Herbert J. Huff, Deputy Chief Financial Officer Office of Tax and Revenue, and Julia Friedman, Deputy Chief Financial Officer Office of Research and Analysis before the Committee on Finance and Revenue

Good morning, Chairman Evans and distinguished members of the Committee. I am Herb Huff, Deputy Chief Financial Officer for the Office of Tax and Revenue (OTR). Julia Friedman, Deputy Chief Financial Officer for the Office of Research and Analysis (ORA), is unable to join us, but members of her staff are available to answer questions as needed. We are pleased to present testimony on the three bills being considered here today. This joint testimony is being provided to consolidate the tax policy and tax administration positions of the Office of the Chief Financial Officer (OCFO).

Long-Term Care Tax Credit Act
Bill 14-432 would allow District residents who purchase qualified long-term care insurance policies to receive a credit against their income taxes in an amount equal to 15 percent of the premium costs paid during the taxable year.

The bill includes stipulations that: (1) no taxpayer can receive the credit if another taxpayer already has claimed that same expenditure for the same long-term care insurance policy; (2) the credit may not exceed $300 or the taxpayer’s income tax liability, whichever is less; (3) unused credits cannot be carried forward to the next tax year’s liability, and (4) taxpayers may not claim the credit if they have already deducted or excluded the amount of the premium to arrive at their net taxable income.

Based on data compiled by the Department of Insurance and Securities Regulation, premiums currently collected in the District of Columbia for long-term care insurance policies total $3.3 million annually. We estimate that the total credits applied against District income tax revenue would not exceed $500,000 in the year of implementation, based on the current volume of long-term care policies in the District.

However, beginning in fall 2002, the federal government will offer federal employees the opportunity to purchase long-term care insurance under the Federal Employees Health Benefits Program. This will increase the number of long-term care policies that will become eligible for the proposed credit and, accordingly, increase our estimate of the reduction in local general fund revenue.

Based on the expected increase in long-term care policies, the OCFO has determined that local general fund revenue would be reduced by approximately $1 million in the fiscal year following the year of implementation and by $3.5 million from FY 2002 through FY 2005.

The OCFO understands the intent of this proposed legislation, which is to offer relief to District residents facing the exorbitant cost of procuring long-term health care coverage for their loved ones and themselves. However, we do have concerns about provisions in the bill that would affect the administration and enforcement of such a tax credit program.

First, the long-term care insurance tax credit would not be based on any reportable federal tax information. This would be a freestanding credit, which means claims must be carefully scrutinized and substantiated before they are issued. Thus, it is our recommendation that the bill be amended to include a certification process that would require the Department of Insurance and Securities Regulation to verify to OTR a claimant’s insurance and premiums paid. This could be accomplished through a tax credit application and certificate process or policyholder affidavit.

There also is a need for additional or better defined restrictions in the bill regarding the maximum number of tax credits a policyholder may claim, the process by which a credit expires or is renewed, and what refund accommodation, if any, is intended for individuals with no income tax liability in a given tax year.

Finally, should this proposed legislation go forward, OTR recommends an effective date no sooner than Jan. 1, 2003. This would permit us to make necessary changes and additions to forms, returns processing, automated systems and enforcement procedures, as well as update customer service, public outreach and training programs.

We would be happy to work with the Council in modifying this proposal to assure its successful implementation and administration.

Compensating Use Tax Clarification Act
Bill 14-462 would provide an exemption from sales tax for tangible personal property temporarily stored in the District, no longer than 60 days, which will be transported and used solely outside the District.

The bill would correct an oversight in the law that has required entities to pay sales tax but not use tax for property stored in the District only temporarily while en route to its end-use destination. The measure adds a sales tax exemption to the DC Code, in conformance with an existing use tax exemption.

However, we note that the bill provides a 60-day storage allowance for the sales tax exemption. DC Act 13-271, approved Feb. 18, 2000, provides a 90-day exemption from use tax for temporarily stored personal property. For better enforcement, OTR recommends Bill 14-462 be amended so the two periods agree.

Additionally, it is our understanding this exemption is intended to apply to construction cranes and other equipment that is ordered in advance of use date and stored in the District and ultimately transported "outside the District for use solely outside the District." However, the provisions of section 47-2005 and new legislation that would become section 47-2005(30) could be construed to apply to any "tangible personal property temporarily stored." From a compliance standpoint, it is difficult for us to apply a broad exemption statute in a narrow fashion. Consequently, we respectfully suggest that, while the Council is revising the statute at this time, the revision be drafted more narrowly to apply specifically to construction equipment and cranes.

We also recommend that the wording of the use tax exemption provision [in section 47-2206(4)] be similarly narrowed and that the period of the exemption, whether 60- or 90-days, be consistent in both statutes.

Portfolio Investment Competitiveness Act
Bill 14-503 would require that income received as interest, dividends, capital gains and capital losses be excluded from gross income, and not taxed under the provisions of the unincorporated business tax when earned by an entity such as a partnership, limited partnership, limited liability corporation or other unincorporated entity.

We have a number of concerns with this proposal. While we are still looking at the details of the bill, our preliminary estimate is that the possible reduction in local general fund revenue would be in the range of $2-3 million in the first year of implementation and in the range of $7-8 million from FY 2002 through FY 2005.

For District residents who are partners in such passthrough entities, this bill would not likely provide a benefit. The District tax form D-40 already provides for a subtraction for earnings taxed under the unincorporated business tax provisions. As a consequence of this subtraction, portfolio investment income that is subject to the unincorporated business tax is not subject to tax under an individual tax return filed by a District resident.

It appears this bill provides an economic benefit solely to Maryland and Virginia residents who invest in the passthrough investment vehicles specified in the bill.

It is true that neither Virginia nor Maryland tax partnerships and other passthrough entities like LLPs and LLCs. However, both Virginia and Maryland law are able to tax the distributive share of Virginia or Maryland partnership income allocable to nonresidents.

To illustrate, Virginia requires nonresidents who have earned "Virginia taxable income" to file a return with the state and to pay tax to Virginia on this income. "Taxable income" includes a nonresident partner's allocable share of a Virginia partnership's income. In addition, under Virginia law, portfolio income is specifically ***included*** in "taxable income." So the District resident partner would pay tax to Virginia on his or her distributive share of the partnership income.

The Home Rule Act imposed a congressional prohibition that prevents the District from enacting rules similar to Virginia, Maryland and many other jurisdictions. Under the Home Rule Act, the District does not have the authority to impose any tax on the whole or any portion of the ***personal income of nonresidents***. But for the unincorporated business tax imposed at the entity (partnership) level, the District does not have the ability to tax income earned by partnerships and other entities that are the subject of this bill. Thus, OTR is concerned that this bill opens a loophole for investors or others currently subject to tax under the unincorporated business tax provisions of District law.

Such revenue concerns call for a more targeted approach. If the Committee and the Council wish to exclude certain hedge funds from the application of the unincorporated business tax, the Council could opt to amend DC Code section 47-1808.01 that currently carves out four specific exclusions from the term "unincorporated business." The amendment would add a fifth exception to this section. The broader exception for partnerships and other passthroughs as currently drafted in Bill 14-503 could effectively undermine the unincorporated business tax.

This concludes my testimony, Chairman Evans. We will be happy to answer any questions you might have.