PUBLIC HEARING ON
Bill 22-667, THE DISTRICT OF COLUMBIA
EDUCATION CHARITABLE DONATIONS ACT OF 2018

Before the
Committee on Finance & Revenue

The Honorable Jack Evans, Chairman

July 6, 2018
10:00 AM

Testimony of
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Government of the District of Columbia

Good Morning, Chairman Evans and members of the Committee on Finance and Revenue. I am Jeffrey S. DeWitt, Chief Financial Officer of the District of Columbia. I am pleased to testify on Bill 22-667, the "District of Columbia Education Charitable Donations Act of 2018".

Over the past several months, my office has analyzed the potential impact of the proposed bill on the District's finances, particularly its impact on Income Tax Secured Bonds ("ITSBs"), bond covenants, and credit ratings. My presentation this morning will outline the details of our analysis.

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B22-667
District of Columbia Education Charitable Donations Act of 2018

Offsetting the federal limitation on the state and local tax (SALT) deduction

Jeffrey S. DeWitt
Chief Financial Officer
July 6, 2018

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Presentation Overview

- Summary of Federal Changes to the State and Local Tax (SALT) Deduction
- Proposed Bill 22-667: District of Columbia Education Charitable Donations Act of 2018
- Operational and Financial Impacts of Proposed Bill
- Potential Risks
- Summary of Analysis

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Summary of Federal Changes to the State and Local Tax (SALT) Deduction

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What is the State and Local Tax (SALT) Deduction?

- The SALT deduction is part of federal itemized deductions and includes state and local income (or sales) taxes and real property tax. **(For most income tax payments and property tax payments made to DC were their SALT Deduction)**
- Before Tax Cuts and Jobs Act (TCJA) federal law allowed a 100% SALT deduction for those itemizing on their federal tax return
- The TCJA limits SALT deductions to $10,000
- Approximately 60,000 DC taxpayers (16.8%) have SALT deductions above the new limit
- The limiting of the SALT deduction was offset under the TCJA by nearly doubling the standard deduction, raising income levels subject to the Alternative Minimum Tax (AMT), and lowering tax rates
- Approximately 3% (11,318) of DC taxpayers will pay higher federal taxes due to the elimination of the SALT deduction not offset by other changes

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What is the impact of TCJA on the SALT deduction?

Full Implementation of TJCA

		ITEMIZERS	
Federal AGI	# taxpayers	Itemizers (before TCJA)	Itemizers (After TCJA)
Less than $50,000	162,449	28,591	11,382
$50,000-200,000	143,471	79,848	48,042
$200,000-500,000	25,434	23,194	16,934
Greater than $500,000	6,763	6,323	5,641
Total	**338,117**	**137,956**	**81,999**
		Share of Returns that Itemize	
		41%	24%

Source: ORA

- Under TCJA, the number of DC itemizers in 2018 will be reduced from 138,000 to 82,000, largely because of a doubling of the standard deduction
- The SALT limitation reduces the itemized deductions for about 60,000 DC taxpayers
  - 45,600 will owe less federal tax due to lower rates and other provisions
  - 16,900 will owe more in federal taxes
  - 11,000 (of the 16,900) will experience an increase due to the SALT limit

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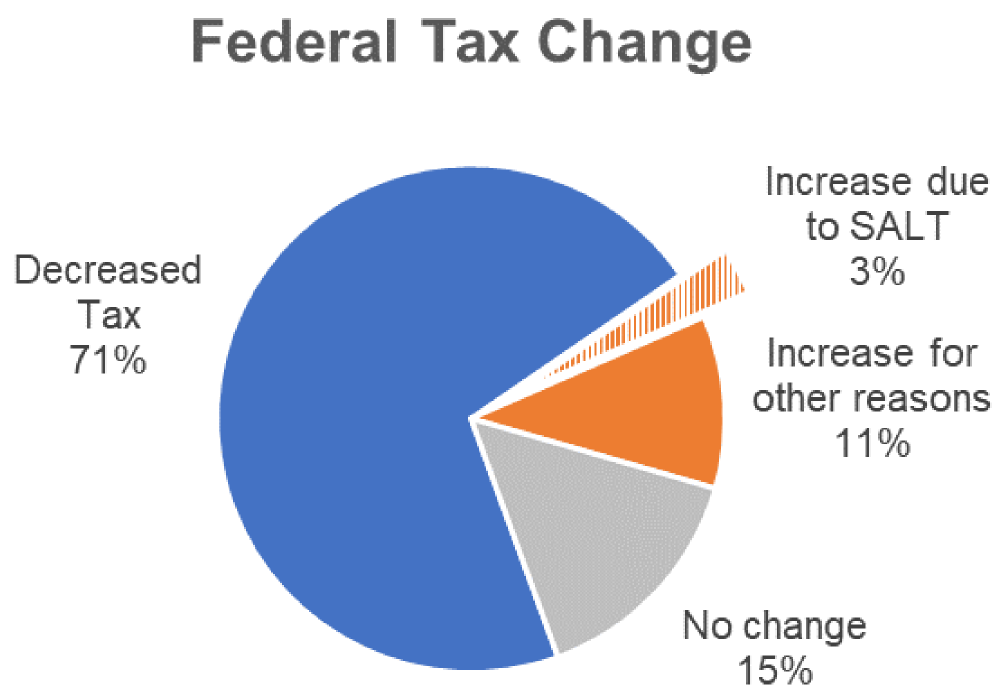
TJCA Impact on State and Local Tax (SALT) Deduction?

- 3% (11,310) of taxpayers with federal tax increase because the SALT limitation not offset by other tax changes.



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Summary of Proposed Bill B22-667: Charitable Contribution

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B22-667: Charitable Contribution Credit

- Council B22-667 provides a nonrefundable credit against DC income tax liability for 90% of contributions to the Public Education Investment Fund
- A taxpayer could contribute to the fund and deduct it from federal Adjusted Gross Income (AGI) like any charitable contribution, reducing federal taxable income and offsetting the SALT deduction limitation
- The taxpayer would then receive a credit of 90% of the contribution to reduce the taxpayer's tax liability to the District
- District budgetary resources increase by the 10% of the contribution to the fund that is not credited back to the taxpayer

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Important Distinction

- The B22-667 allows an additional federal tax deduction and a District tax credit
  - Deductions reduce income subject to taxes
  - Credits reduce taxes owed

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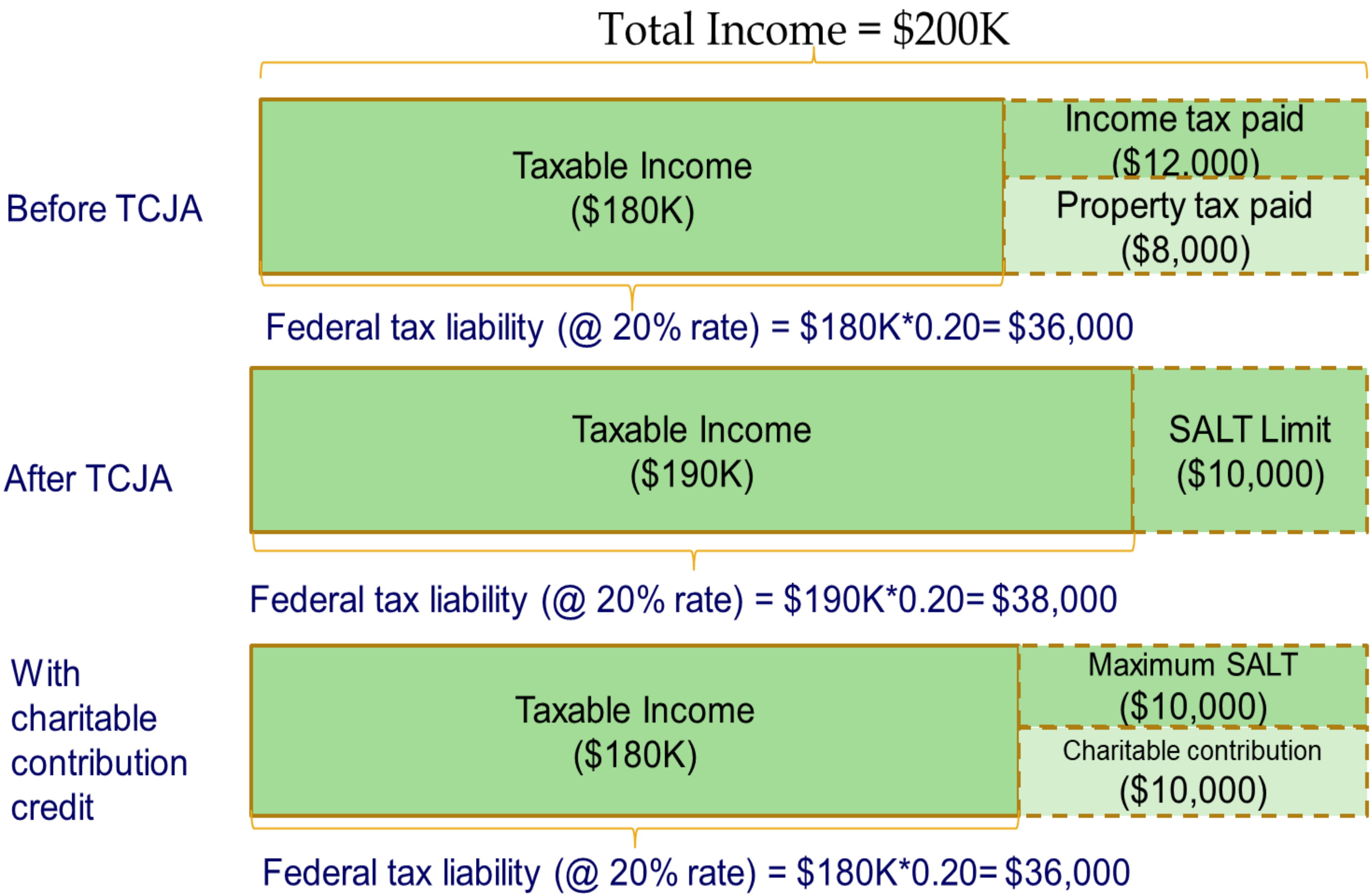
How it would work?

- A taxpayer with $20,000 in SALT deduction would only get to deduct $10,000.
  - At 20% effective federal tax rate, the taxpayer's tax would be $2,000 more because of the SALT limit
- Taxpayer contributes $10,000 to Public Education Investment Fund.
  - Total itemized deductions restored and taxpayer pays $2,000 less federal tax
- Taxpayer claims $9,000 credit on DC tax return (90% of $10,000).
- Taxpayer ultimately pays $2,000 less federal tax and $1,000 more to DC (through the contribution) saving a total of $1,000.
- DC income tax revenue goes down by $9,000 but fund contributions are up by $10,000, a net DC revenue increase of $1,000.

How it would work? Federal tax Liability



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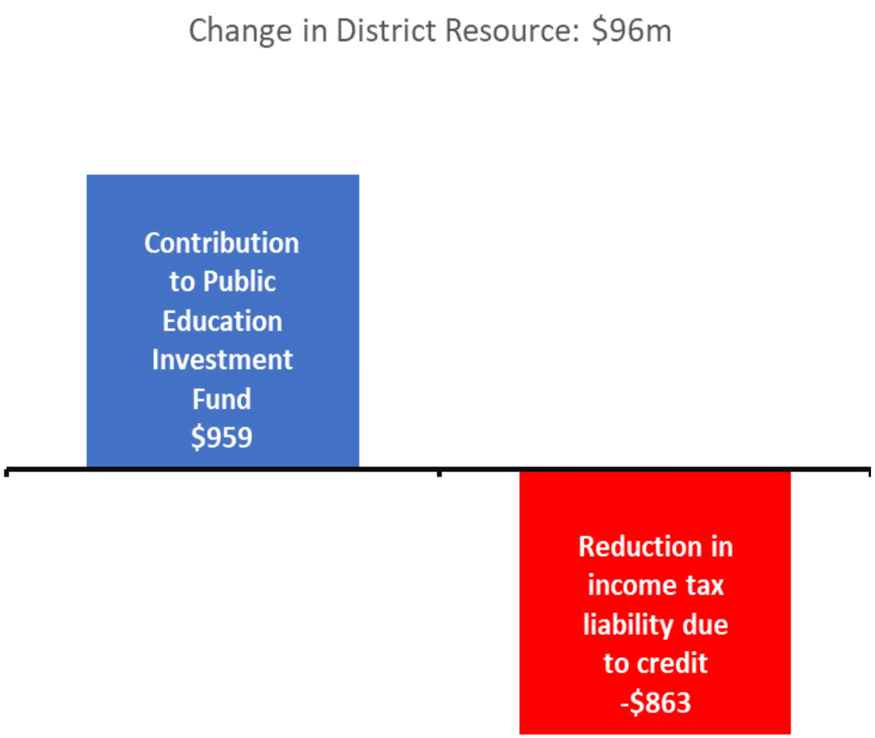
Estimated impact of the charitable contribution credit



Source: ORA; $ in Millions

- With full participation of eligible taxpayers, an estimated $959 million will be contributed to Public Education Investment Fund generating $863 million (90% of $959 million) in income tax credit

- Full participation initially unlikely:
  - Perceived audit risk
  - Taxpayers' inability to pay: contribution has to be made by 12/31 and credit can't be claimed until February
  - Lack of knowledge/information about credit

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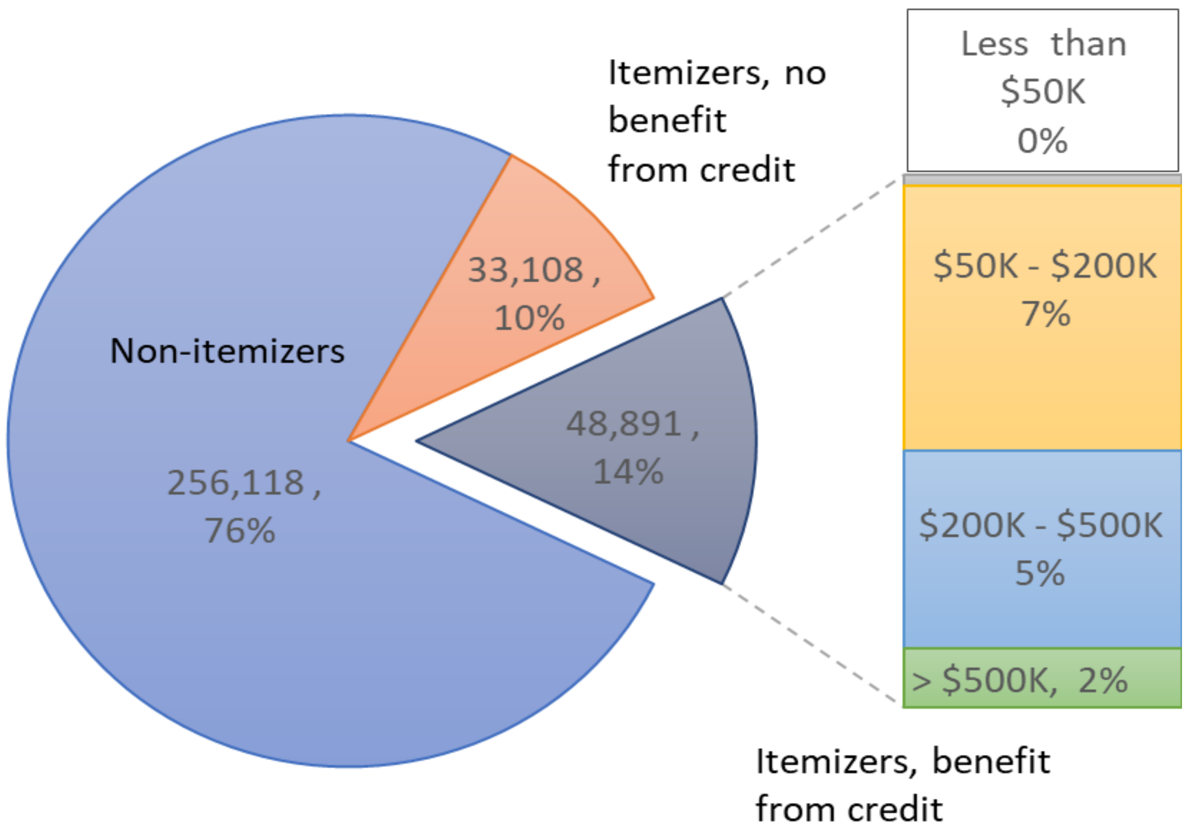
Who benefits from the Charitable Contribution Credit?



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Operational and Financial Impacts of Charitable Contribution Credit

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Operation and Financial Impacts of Charitable Contribution Credit

- Charitable Contribution Credits divert revenue from income tax payments, predominantly made in April, to charitable contributions, most likely paid in the previous December
  - Reduces revenues pledged to Income Tax Secured Municipal Bonds impacting bond covenants
  - Impacts on revenue pledges may have negative impacts on District credit ratings

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Impact of Charitable Contribution Credit on Income Tax Secured Municipal Bonds

In October of 2008, the Income Tax Secured Bond Authorization Act of 2008 authorized the District to issue municipal bonds secured from a pledge of individual income taxes and business franchise taxes to bond holders for the repayment of a debt issued under the credit and created covenants or pledges to the bondholders.

Currently the District has $3.8 billion in outstanding Income Tax Secured Bond, approximately 38% of the District's debt portfolio rated AAA by S&P, AA+ by Fitch and Aa1 by Moody's

The District has pledged that individual withholding taxes will always be at least 2 times the debt service payment to prevent default (impairment test)

No new bonds may be sold if pledged revenue is not at least 3 times maximum annual debt service (additional bonds test)

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Income Tax Secured Bonds
Coverage Tests For Various Scenarios

DEBT SERVICE COVERAGE TEST UNDER SCENARIOS FOR CHARITABLE CONTRIBUTION CREDIT - CURRENT DEBT

Maximum Annual Debt Service (MADS) (FY2023) = $376M

(Coverage Formula = Tested Revenue/Maximum Annual Debt Service)

($ Millions)		NORMAL YEAR (5 year average revenue)				STRESS TEST - SEVERE RECESSION			
		TEST 1: Additional Bonds Test (3x)		TEST 2: Impairment (2x)		TEST 1: Additional Bonds Test (3x)		TEST 2: Impairment (2x)	
		PLEDGED REVENUE		WITHHOLDING ONLY		PLEDGED REVENUE		WITHHOLDING ONLY	
Current Law		2,297	6.1x	1,568	4.2x	1,608	4.3x	1,098	2.9x
Proposal	Reduction in revenue from tax credit								
1 SALT credit - no cap	(863)	1,433	3.8x	1,136	3.0x	1,003	2.7x	796	2.1x
2 $50,000 cap on SALT credit	(664)	1,632	4.3x	1,236	3.3x	1,142	3.0x	865	2.3x
3 $25,000 cap on SALT credit	(554)	1,743	4.6x	1,291	3.4x	1,220	3.2x	904	2.4x
4 $15,000 cap on SALT credit	(449)	1,847	4.9x	1,344	3.6x	1,293	3.4x	940	2.5x
5 $10,000 cap on SALT credit	(360)	1,937	5.1x	1,388	3.7x	1,356	3.6x	972	2.6x
6 $5,000 cap on SALT credit	(221)	2,075	5.5x	1,457	3.9x	1,453	3.9x	1,020	2.7x

Assumptions:
1. Pledged Revenue = Individual Income, Corporate Franchise, & Unincorporated Business Franchise taxes
2. Severe recession assumes 30% decline in all pledged revenue; similar to stress test likely considered by rating agencies.
3. Tax credit amount assumes full participation of eligible taxpayers.
4. Withholding adjustment equal to 50% of total credit.

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Impact on District Credit Rating

The Income Tax Credit is highly rated primarily due to the District's strong pledges related to non-impairment and additional bonds test. The analysis indicates caps above $10,000 on the charitable deduction would not fare well in a stress test and would likely be a credit negative.

Due to the ratings reliance on high debt coverage levels and dedicated income tax pledges, it is unclear whether reductions in current levels would not trigger a downgrade. As a result, even a cap at $10,000 or lower would require a formal analysis by the ratings agencies.

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Impact on District Credit Rating

Moody's, in a May 2018 report updating the credit rating on the Income Tax Secured Bonds stated:

"Factors that could lead to a downgrade…

» Revenues that weaken beyond current and historical patterns that result in material declines in debt service coverage

» Large additional leverage that materially dilutes coverage…"

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Potential Risks

1. IRS issues guidance clarifying acceptable charities that excludes state charities
   - The IRS has already warned taxpayers and tax preparers to be cautious about contributing to these funds and will be issuing formal guidance later this year
   - This would likely invalidate other state credits for donations to charities like the private school scholarship credits used in many states
2. IRS audits individuals
   - IRS may audit individuals and declare deductions invalid and assess penalties for underpayment. We assume this risk will reduce the participation in the DC program initially
3. Congress enacts clarifying legislation prohibiting these state run funds
   - The reduction in federal revenue and increase in federal debt may push Congress to amend TCJA
4. If the deduction is disallowed by the IRS, the District is unable to return the donations.

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Other State Programs/Legislation

ENACTED

- **New York**
  - 85% credit on charitable contributions to either education or health care fund (95% for NYC income tax).
  - Had to double income tax bond pledge from 25% of revenues to 50%
- **New Jersey**
  - Authorizes local governments to set up funds and provide 90% property tax credit for contributions.
- **Connecticut**
  - Authorizes local governments to establish "community supporting organizations" and allows up to 85% credit against residential property tax.

PROPOSED

- **California**
  - Proposed 85% credit for donations to Local Schools and Colleges Voluntary Contribution fund.
- **Illinois**
  - Proposed 85% credit for donations to Illinois Education Excellence Fund.

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Summary of Analysis

- Approximately 49,000 DC Taxpayers who chose to pay the District as a charitable contribution could see lower federal taxes if the action is allowed by the IRS or the Federal government
- Assuming full participation by District taxpayers, federal tax payments could be reduced by as much as $330 million
- Full participation levels without a cap on the contribution amount would likely result in a negative impact on the District's credit rating due to impairment of bond covenants, particularly during a recession
- A cap of no more than $10,000 per taxpayer may not have a negative impact, but would require a credit evaluation by the rating agencies