DC Fiscal Policy Institute

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TAX AND OTHER REVENUE ISSUES IN THE FY 2012 BUDGET

The FY 2012 budget includes $163 million in additional revenues to help address the city's ongoing budget problems. Some $130 million was devoted to address part of a $322 million gap between expected revenues and the costs of maintaining services, and the remainder was intended to address shortfalls in the District's fund balance.

Roughly half of the new revenue in the budget — $86 million — would come from tax and fee increases, including elimination of the out-of-state bond tax exemption, an increase in the tax charged at parking garages, and an increases in the minimum tax paid by corporations and other businesses.

The budget also raises $77 million from provisions that do not raise rates or fees. This will come primarily from increasing the amount of income tax withheld from paychecks of employed DC residents and by increasing the withholding from residents who pay estimated quarterly income taxes. For many people, the additional withholding will be returned as part of a tax refund when they file a 2012 tax return in 2013. The budget also extends the hours that alcohol can be sold in stores and enhances the city's access to the bank accounts of delinquent taxpayers, among others.

Mayor Gray's proposed budget included $81 million in new taxes and fees and $77 million raised without changes in rates or fees. The DC Council accepted most of the Mayor's tax proposals, but it rejected some and adopted other new revenue increases. In particular, the Council rejected an increase in income taxes on income above $200,000 and instead eliminated an income tax exemption for interest on out-of-state bonds. The Council also rejected a mayoral proposal to broaden the sales tax to tickets for live performances and instead chose to expand the sales tax to security services, armored car services, and

SUMMARY

MAYOR'S BUDGET PROPOSAL

- The proposed FY 2012 budget included $81 million in new taxes and fees and $77 million raised without changes in rates or fees.
- This included $35 million in income taxes on higher-income households, $19 million from increases in taxes on corporations and other businesses, and $18 million from increasing the tax at parking garages.
- The $77 million in other revenues primarily reflects an increase in income tax withheld from employed District residents.
- The budget implements "combined reporting," a policy that prevents multi-state corporations from sheltering income and avoiding paying taxes to the District.

FINAL BUDGET VOTE, JUNE 14

- The Council rejected a proposed income tax rate for income above $200,000 and instead eliminated a tax exemption for interest on out-of-state bonds.
- The Council rejected a mayoral proposal to expand the sales tax to live theater and instead expanded it to several services.
- The Council increased a tax on hospitals to help maintain Medicaid payment rates to hospitals.
- The Council approved an increase in the residential parking permit fee.
- The net effect of these changes results in a $163 million revenue increase, slightly more than proposed by the Mayor.

private investigation services. Finally, the Council adopted an increase in a tax on hospitals, to generate revenues that could support Medicaid payments to hospitals, and to raise the residential parking permit fee to support transportation services.

The net effect of the Council actions was to add modestly to the revenues proposed by the Mayor. Even with these increases, tax collections in 2012 would remain $70 million lower than in 2008, when the recession began.

Finally, the budget includes legislation to implement a corporate tax provision initially adopted in 2009 — called "combined reporting" — that limits the ability of large multi-state corporations from sheltering income and avoiding paying tax on profits in DC. This will generate $23 million but was already assumed in DC's revenue projections because it was approved in 2009.

Taxes and Fees

The FY 2012 budget will raise $86 million through a variety of tax and fee increases, primarily income taxes and taxes on parking at lots and garages.

Income tax changes — $30.1 million

Eliminate Exemption for Interest on Out-of-State Bonds: Currently, the District offers an income tax exemption when DC residents invest in state and local bonds, all of which are also federally tax exempt. Most states offer a tax exemption for these bonds, but only to bonds issued within the state. The District is the only jurisdiction that provides this tax exemption for bonds issued by other cities and states.

The DC Council proposed and adopted a provision to end this exemption, which

TABLE 1: REVENUE INCREASES IN THE PROPOSED FY 2012 BUDGET

	Proposed Budget (In $ Millions)	Final Budget (In $ Millions)
Taxes and Fees		
Income tax- itemized deduction limit	$35.4*	$16.7
Income tax- 8.9% rate above at $200,000		$0
Income tax – eliminate exemption for interest on out-of-state bonds	$0	$13.4
Increase in minimum corporate income tax	$12.0	$12.0
Double-weight sales in corporate income Tax apportionment formula	$7.2	$7.2
Increase parking tax to 18%	$18.2	$18.2
Increase sales tax on alcohol to 10%	$2.9	$2.9
Extend sales tax to live theater	$2.3	$0
Extend sales tax to security, armored car, and private investigation services	$0	$4.9
Increase various motor vehicle fees	$3.0	$3.0
Increase hospital per-bed tax from $2,000 to $3,800	$0	$7.1
Increase residential parking permit fee	$0	$1.0
Non-Tax increases		
Increase income tax withholding for wage Earners	$41.0	$41.0
Increase income tax withholding for others	$24.0	$24.0
Apply cigarette tax at wholesale rather than retail level	$1.1	$1.1
Extend hours for alcohol sales	$2.4	$2.4
Lease Carnegie Library to Convention Center Authority	$5.0	$5.0
Allow advertising on Capital Bike Share	$0.5	$0.5
Increase access to delinquent taxpayers bank accounts	$3.0	$3.0

* The revenue from the income tax rate increase and itemized deduction limit were reported as a single item in the proposed budget.

would raise $13 million in 2012.

The Council rejected a mayoral proposal to create a new tax bracket of 8.9 percent for taxable income (income after deductions) above $200,000. This leaves DC's current top tax income tax rate at 8.5 percent, starting at $40,000 of taxable income.

Limit Amount of Itemized Deductions for Higher-Income Households: The budget limits the amount of itemized deductions that can be claimed by families with incomes above $200,000. The disallowed amount equals 5 percent of income above $200,000. For example, if a family has income of $300,000, the reduction in allowed itemized deductions will be $5,000 — 5 percent of $100,000 ($300,000 minus $200,000). If the family's total itemized deductions were $30,000 before the limit, the new provision will reduce the deductions to $25,000. With fewer deductions, the family's total taxable income would be $5,000 higher. At a tax rate of 8.5 percent, this family would pay $425 more in taxes.

This provision is similar to a provision that had existed in the federal income tax until a few years ago – and that was mirrored in DC's income tax. The federal itemized deduction limit was eliminated as part of tax breaks passed under President George W. Bush. Because DC had coupled to the federal provision, this also meant that the itemized deduction limit also was eliminated in the DC income tax.

Business Income Tax Changes — $19.2 million

The budget increases business taxes in two ways – by raising the minimum corporate franchise tax and by changing the formula by which multi-state corporations determine the share of their profits that are taxable in the District. The budget also increases business income tax collections by $23 million by closing corporate tax shelters that currently allow large multi-state corporations to avoid paying taxes to the District.

Minimum Franchise Tax — $12 million: Under DC's corporate income tax, businesses pay a minimum tax — currently $100 — even if their tax would be lower than that after deductions. Although the city's corporate income tax rate is set at 9.975 percent of taxable profits, two of three corporations pay just the minimum tax because they qualify for a variety of exemptions, deductions, and credits. DC's minimum corporate tax of $100 has not been adjusted for 28 years, meaning that it has lost significant ground to inflation.

The approved budget increases the minimum tax to $250 for corporations with gross receipts under $1 million, which will mainly adjust the minimum for inflation since it was last raised in 1983. (Simply adjusting for inflation would set the rate at $211.) For corporations with receipts of more than $1 million, the minimum franchise tax will be increased to $1,000 in 2012.

Double-Weighted Sales in Apportionment Formula — $7.2 million: Under every state's corporate income tax law, corporations that operate in multiple states must determine their profits nationally and then apportion a share of those profits to each state where they do business. The apportionment formula for a given state usually takes into account the share of a company's sales, property and personnel in that state. Under current DC law, those factors are weighted evenly. Mayor Gray proposed, and the Council approved, a proposal that will provide double weighting to the share of a company's sales that occur in DC. This will increase taxes on companies that sell a lot in the District but have most of their property and workforce outside the city. It will reduce taxes for companies that have a high share of their property and staff in DC but where a relatively low share of their sales occurs in DC. As such, the increases will likely fall mostly on out-of-state corporations with a physical presence that is outside of the city.

Combined reporting — $22.6 million: The approved 2012 budget includes legislation to implement a corporate tax provision, known as "combined reporting," that was passed by the DC Council in 2009. Combined reporting, which is required in 23 of the 45 states that have a corporate income tax, prevents large multi-state corporations from using corporate subsidiaries to shift profits to states with low or no corporate income tax. Implementing combined reporting will allow the District to collect $22.6 million in additional taxes in fiscal year 2012. These revenues are not reflected in tables in the FY 2012 budget because the revenues have been reflected in revenue projections since the legislation was adopted in 2009.

However, revenue collections from combined reporting will be weakened in future years as a result of a tax deduction passed by the DC Council during the final vote on the FY 2012 budget. The Council passed a provision that would give businesses subject to combined reporting a tax deduction worth approximately $35 million a year for seven years. The provision was designed to look like it would not have an official "fiscal impact" on DC's mandatory four year financial plan by starting the deduction just outside the four year financial plan window.

Other Taxes and Fees

Parking Tax - $18.2 Million: The budget raises the tax charged on parking garages and lots from 12 percent to 18 percent.

Expand the Sales Tax Base — $5 million: The budget adopted by the Council rejected a proposal from Mayor Gray to expand DC's 6 percent sales tax to include live performances such as dance and theater. (Currently, the tax applies to events at the Nationals Ballpark and the Verizon Center, but not to other live performances.) Instead, the Council voted to expand the sales tax to security services, armored car services, and private investigation services.

Increase the assessment on licensed hospital beds — $7.1 million: The DC Council added a provision to increase a tax on hospital beds, from $2,000 per licensed bed to $3,800, which would raise $7 million in local funds and generate $16 million in federal Medicaid matching funds. The revenues will offset a similar level of cuts to Medicaid hospital reimbursement rates implemented this year.

Increase the Tax on Liquor for Off-premises Consumption — $2.9 million: The current tax on alcohol purchased at a store for off-premises consumption is 9 percent, while the tax on liquor purchased at a restaurant or bar is 10 percent. The Gray budget proposed setting the tax at 10 percent for all sales, and the Council approved it.

Implement Various DMV Fee Increases — $3 million: Fees will be increased for duplicate licenses, knowledge and road tests, and some other vehicle services.

Continue the General Sales Tax Rate at 6 Percent — no effect in 2012: In addition to these changes, the budget eliminates a planned reduction in the sales tax rate to 5.75 percent in 2013. Under legislation passed in 2009, the sales tax was raised from 5.75 percent to 6 percent, with the increase was set to expire in 2013. The Mayor's budget proposed – and the Council approved -- eliminating the planned sunset, leaving the rate at 6 percent in 2013 and beyond. This will increase revenues by $16 million starting in 2013.

Increase Residential Parking Permit Fee — $1 million: The budget raises the permits residents receive for parking in their ward to $35, with a $25 rate for residents 65 and older. The current permit fee is $15.

Reduce Parking Meter Rates (if city tax collections rise sufficiently — $3 million: The approved budget has a provision to reduce parking meter rates from $2 an hour to $1 an hour, but only if the city's tax collections rise above a target amount in 2012.

Non-Tax, Non-Fee Increases in Revenues

The fiscal year 2012 budget will raise roughly $77 million in general revenues through a variety of changes that do not alter tax or fee rates. The largest portion — $65 million — will come from increasing income tax withholding rules for DC residents.

Increase Income Tax Withholding — $65 million: Working DC residents have a portion of each paycheck withheld to cover their income tax liability. Income tax withholding helps ensure that residents do not owe large amounts of income tax when they file a tax return, and it also provides a steady stream of revenue to the District.

Residents who receive substantial amounts of income outside of employment — such as retirees and others with substantial investment income — also are subject to a withholding requirement. They are required to make estimated tax payments each quarter.

Mayor Gray proposed, and the Council approved, changes that will increase the withholding amounts for both groups. For working DC residents, withholding will be increased by $160 each year, raising $41 million in 2012.[1] While residents are able to adjust withholding, which means that any worker who does not wish to have the additional $160 withheld can do so, the budget assumes that virtually no workers will make this adjustment.

The policy rationale for these withholding changes appears to be fairly limited, beyond raising revenues in 2012. The large majority of DC households receive a tax refund when they file a return, which suggests that the withholding amounts are sufficient for most workers under current law. This also means that for most families, the additional withholding in 2012 will be returned as a tax refund in 2013. (For this reason, the withholding provision is not expected to provide substantial revenues in future years.) No official reason has been provided for the increase in withholding, although some DC finance officials have noted that an increase in withholding would improve tax compliance.

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[1] This would occur by altering the income tax withholding formula to not take into account DC's $4,000 standard deduction.

Some residents who owe substantial taxes, including back taxes, do not file a tax return. The additional withholding would help collect more of the taxes owed by these non-compliant residents.

While the added withholding for working DC residents would be relatively small, the impact could be significant for low- and moderate-income workers who already may face challenges meeting their basic needs. Moreover, the rationale for taking additional withholding from these workers is small, since 84 percent of filers under $50,000 already receive refunds under current withholding rules.

Alter the Application of the Cigarette Tax — $1.1 million: In addition to a tax of $2.50 per pack, cigarette sales also are subject to a 6 percent sales tax. The budget includes a provision to levy this tax on wholesalers rather than retailers, which is expected to improve collections. It would not alter the effective tax on cigarettes.

Extend Hours for Alcohol Sales — $2.4 million: The budget will lengthen the amount of time that liquor could be sold in the District. The expected increase in sales will lead to an increase in tax collections.

Payment from the Washington Convention and Sports Authority — $5 million: Under the budget, WCSA will transfer $5 million to DC's general fund to reflect its use of the Carnegie Library. Because WCSA is a DC government entity, this is a fund transfer and not a fund increase.

Greater Access to Bank Accounts of Delinquent Taxpayers — $3 million: The budget includes a provision that gives the DC Chief Financial Officer greater access to bank accounts of delinquent taxpayers, resulting in greater tax collections.

Advertising in the Capital BikeShare Program — $0.5 million: The District will raise an anticipated $500,000 from selling advertising space through the bicycle sharing program.