DC FISCAL POLICY INSTITUTE

Independent Research. Poverty Solutions. Better DC Government.

Testimony of Ed Lazere, Executive Director
At the Public Hearing on Bill 22-0667, The District of Columbia Education Charitable Donations Amendment Act of 2018
DC Council Committee on Finance and Revenue
July 6, 2018

Chairperson Evans and members of the Committee, good morning and thank you for the opportunity to speak today. My name is Ed Lazere and I am the Executive Director of the DC Fiscal Policy Institute. DCFPI is division of the nonprofit Center on Budget and Policy Priorities that promotes opportunity and widespread prosperity for all residents of the District of Columbia through independent research and thoughtful policy solutions.

I am here today to testify in support of the Education Charitable Donations Amendment Act, which will accomplish two things. It will assist residents hurt by the limit on state and local tax deductions in the 2017 federal tax legislation. The bill also will raise revenues for the District to support education and other purposes. DCFPI supports this legislation but also recommends revisions to it. Those will be discussed below.

Background on Federal Tax Legislation and Impact on DC Residents

The major federal tax legislation adopted in 2017 reduces taxes for most DC residents, even when changes to DC taxes are factored in. Federal tax cuts for DC residents total $617 million, while DC incomes for DC residents' taxes will increase $56 million, as a result of connections in DC's income tax to the federal income tax. Five of six DC tax filers will see a net reduction in their combined federal and DC taxes, according to the DC Chief Financial Officer. The largest tax cuts go to residents with the highest incomes.

Even though most DC households face a net decrease in their taxes, the federal tax bill included some changes that will increase taxes compared with prior tax law. One of these changes is a new federal limitation on the deductibility of State and Local Taxes (SALT). Whereas previously taxpayers could fully deduct their state and local income and property taxes from their taxable income on their federal returns, the total deduction is now limited to $10,000 per tax filing unit per year. This means that some taxpayers are losing significant federal tax benefits. Many DC households affected by this change still will experience a net tax cut, because of other provisions of the federal tax legislation, but a small number of DC households will see a net increase in federal taxes due to the new limit on the SALT deduction. The households affected by the new limit have relatively high incomes, since only higher-income households have state and local tax obligations this high.

Several States Have Adopted "SALT Workarounds" that Assist Households Affected by the New SALT Limit, while Also Raising State Revenues

A number of states, including New York, have adopted tax changes to address the new SALT limit. The changes, known as "SALT workarounds," take advantage of the fact that charitable contributions remain fully deductible for federal tax purposes.

The SALT workarounds operate by allowing taxpayers to make charitable contributions to special funds that support state services, and then claim a state income tax credit for the donations to those funds. A taxpayer who participates would see an increase in their charitable contributions, which they can deduct when computing their federal taxes, while seeing a reduction in their state incomes, which are no longer fully deductible for federal tax purposes. The workarounds in effect substitute deductible charitable contributions for non-deductible state income taxes.

The states that have adopted SALT workarounds have set the credit at a very high level, but less than 100 percent. In New York, the tax credit equals 85 percent of the contributions to the new state fund. If the tax credit were 100 percent of the new contributions to the state fund, it would fully restore the deductibility of state and local tax deduction. This is not needed, however, in part because nearly all taxpayers affected by the SALT limit faced a net cut in federal income taxes thanks to other provisions.

This structure of setting the SALT workaround tax credit at less than 100 percent has two practical effects.

- First, it allows many taxpayers to reclaim a portion of their lost SALT tax benefits. In New York, for example, if a taxpayer facing a marginal federal tax rate of 35 percent makes a $20,000 contribution to the new state charitable fund, they would claim $7,000 in federal tax benefits because of the deductibility of the contribution. At the state level, they would pay $3,000 more at the state level when both state income taxes and the contribution to state charitable fund are considered. The net effect is a savings of $4,000 for the taxpayer.

- Second, the structure increases total revenues available to the state. Because the taxpayer would make a contribution of $20,000 to the state fund and claim a tax credit of $17,000 against state income taxes, total payments to New York would grow $3,000.

This creates a win-win situation, where taxpayers reclaim a portion of their lost SALT deduction and the state experiences a net increase in revenue.

The DC Education Charitable Donations Amendment Act Is a Win-Win Like Other SALT Workarounds

The Education Charitable Donations Amendment Act would create a Public Education Investment Fund, managed by the DC Chief Financial Officer, with all donations being used to support public education in DC. Residents contributing to the fund would be able to claim a DC income tax credit equal to 90 percent of their contributions. The bill would be advantageous to residents affected by the new limits on SALT deductions.

Like the credit in New York, the new DC credit would help taxpayers and raise DC revenues. If a resident facing a federal tax rate of 35 percent makes a contribution of $20,000 to the Public Education Investment Fund, they would see federal tax benefits of $7,000 while paying $2,000 more to the District ($20,000 donation to the Fund and a $18,000 reduction in income taxes paid).

The legislation is likely to raise $100 million in revenue for the District, which could be devoted to education or other purposes.

Recommendations and Considerations

Because this bill would both help taxpayers and raise revenue for the District, it should be adopted.

That said, DCPPI recommends altering the bill by lowering the rate of the tax credit, which would raise more revenue for the District while still helping taxpayers. The tax credit could be set at 85 percent, like in New York, or even lower.

There is a chance that the IRS will rule against such workarounds, or that Congress will adopt legislation to disallow these kinds of workarounds by not allowing contributions to state funds to be considered as charitable contributions. There are some indications that this will not happen, given that such funds already existed before any SALT workaround credits were created. If the workarounds are disallowed, the District would not face any financial penalty and simply would lose out on the chance for additional revenue. In other words, there is no risk to the District.

One other impact of this bill is that it would limit DC's income tax revenues, which in recent years have been used to guarantee DC's general obligation bonds. This has helped get a good bond rating and low interest rates on those bonds. Reducing income taxes substantially would make it somewhat harder to back bonds in this way, but not necessarily, which could affect bond ratings and raise interest rates the District pays on the bonds it issues. If so, the District would need to find other ways to back its bonds. Given that the bill overall improves DC's finances, it seems like there should be ways to maintain a strong bond rating even under this change.

Thank you again for the opportunity to testify. I am happy to answer any of your questions.