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STOP REWARDING THE WRONG BEHAVIOR: DC SHOULD ELIMINATE ITS TAX BREAK FOR INVESTING IN OTHER STATES' BONDS

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The District of Columbia currently provides an income tax break to DC residents who invest in bonds issued by other cities and states. This tax exemption is not advisable, however, since its main effect is to encourage DC residents to support bond-funded infrastructure projects outside of the District. Most states do not offer this kind of tax break — only Indiana does, in fact — because they do not want to create such an incentive.

The District could improve its tax system and raise a significant amount of revenue by eliminating the income tax exemption for interest earned on out-of-state bonds. This would raise as much as $10 million per year and could be used to address the city's ongoing fiscal problems. Since most of the DC residents who invest in state and local bonds are high-income households, eliminating this tax break also would be a progressive tax reform.

Some have argued that the District should continue this exemption because the city is small and does not offer many opportunities to invest in District-issued bonds. Yet there are many other small states in a similar situation that nonetheless limit their tax exemption to in-state bonds, including Vermont, Delaware, Montana, Hawaii and Maine.

DC's Current Tax Break for Out-of-State Bonds Creates An Unnecessary Incentive to Support Infrastructure Projects in Other Cities and States

Bonds that cities and states issue to support infrastructure projects, like roads and schools, are federally tax exempt. That means that the people who invest in those bonds pay no federal income tax on the interest they earn.

In addition to the federal tax exemption, every state provides a <u>state</u> income tax exemption for the interest residents earn from government bonds issued within the state. This creates an incentive for residents to invest in the state's infrastructure projects. Most states do not, however, extend that tax break to bonds from other states, because that would create an incentive to support infrastructure projects in other states.

The District and Indiana are the only jurisdictions with an income tax that allow residents to claim this exemption when they invest in bonds from other states. The fact that most states do not offer such a tax break reflects the fact that states do not want to lose tax revenue for a tax exemption in which the benefits go to other states.

The importance of preserving the authority to offer tax preference to in-state bonds but not out-of-state bonds for tax purposes became apparent in 2007, when the state of Kentucky's income tax exemption limited to in-state bonds was challenged in the Supreme Court.[1] Numerous state and local organizations — including the National Governors' Association and the U.S. Conference of Mayors — submitted briefs in support of Kentucky's position. The state groups argued that offering an exemption only for interest earned on in-state bonds helps limit the cost of the exemption while also encouraging residents to purchase their state's bonds. The Supreme Court sided with Kentucky.

The incentive DC provides for residents who invest in DC's college savings plan is a useful analogy that helps explain why the District should limit its bond tax exemption to bonds issued by the city. Residents receive a tax break if they save money through DC's college savings plan, but they do not receive any tax benefit if they save using another state's college savings plan. This is intended to create an incentive to save using DC's college savings plan rather than using another state's.

Eliminating The Tax Exemption For Out-Of-State Bonds Is A Progressive Tax Change

The DC residents who invest in tax-exempt bonds tend to be high-income. In 2005, some 70 percent of the tax-exempt interest received by DC resident went to taxpayers with incomes of $200,000 or more, according to IRS figures. Eliminating this tax break thus would largely affect high income residents.

By contrast, the revenue increases adopted to address the District's budget shortfall over the past year generally have been regressive, falling most heavily on lower-income households.[2] For example, the amended FY 2010 budget adopted in July 2009 included an increase in DC's sales tax, and it eliminated annual inflation adjustments in DC's standard deduction, an income tax benefit used almost exclusively by low- and moderate-income households.

Residents Would Keep Important Federal Tax Benefits Even If The DC Income Tax Exemption Were Eliminated

Households that invest in state and local bonds do not pay federal income tax on the interest they receive, and this would remain even if the DC income tax exemption is eliminated. Because federal income tax rates are higher than DC income tax rates, the federal tax exemption is the most significant tax advantage from investing in these bonds. For most DC families that invest in state and local bonds, more than three-fourths of the tax benefits come from the federal tax exemption[3]

[1] Department of Revenue of the Commonwealth of Kentucky v. George W. Davis and Katherine V. Davis (No. 06-666)
[2] See, for example, DC Fiscal Policy Institute, *Tax and Revenue Issues in the FY 2010 Budget*, September 2009.
[3] For DC residents in the 25 percent federal tax bracket, 75 percent of the benefit from the tax exemption for interest on state and local bonds comes from the federal tax exemption. For residents in the 35 percent federal tax bracket, 80 percent of the tax exemption benefits comes from the federal tax break.

Other Considerations

Some who support eliminating the out-of-state bond tax exemption suggest that it should apply only to new investments and not to current investments. While the intent seems reasonable — to not affect current investors, this suggestion raises several concerns. The first is that it may be hard to administer, both for residents and the District. It would require residents to keep track of investments made before and after the change in this provision, which may be complicated if a resident makes regular contributions to a municipal bond mutual fund. It also would require the District's tax forms to explain the different tax treatment based on the timing of the investment, and may require additional tax worksheets or forms.

Given this complexity, few tax changes are grandfathered in this way. Instead, most tax changes apply both to existing income and to future income, rather than applying only to future economic activity.