UNDERSTANDING THE 2014 DC TAX REVISION COMMISSION'S RECOMMENDATION TO ELIMINATE CERTAIN INDIVIDUAL INCOME TAX EXPENDITURES

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before the

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Council of the District of Columbia

B24-0071 – THE "PENSION EXCLUSION RESTORATION AND EXPANSION ACT OF 2021"

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* The views expressed are our own and should not be attributed to the Urban-Brookings Tax Policy Center or to the Urban Institute, its trustees, or its funders.

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Chairperson Kenyan McDuffie and members of the committee, thank you for inviting us to this hearing to discuss the "Pension Exclusion Restoration and Expansion Act of 2021" and the 2014 DC Tax Revision Commission. We were both honored to be a part of the 2014 DC Tax Revision Commission and are happy to answer questions about its research, deliberations, and recommendations.

The views we express today are our own and should not be attributed to the Urban-Brookings Tax Policy Center or to the Urban Institute, its trustees, or its funders. In addition, while we will present the unanimous recommendations of the commission as highlighted in its 2014 final report, our comments on specific policy choices represent our own opinions and not necessarily those of the other commissioners and staffers.

Our remarks today will cover two major points:

1. The 2014 DC Tax Revision Commission was tasked with making the District's tax system fairer, simpler, and more competitive. The commission ultimately approved a package of reforms, with some recommendations working in concert. While the commission recommended eliminating some specific tax expenditures, it simultaneously recommended increasing the District's standard deduction and personal exemption because this trade-off more effectively helped District residents.

2. Introducing or restoring specific tax expenditures may be appropriate due to changing circumstances, but it is important to understand each proposal's cost and benefits as it interacts with the District's larger tax system. Specifically, because the District now provides a generous standard deduction, many pension recipients who benefited from the previous deduction would not benefit from a new one, and most of the proposal's benefits would go to relatively high-income households.

The 2014 DC Tax Revision Commission[1]

The DC Tax Revision Commission was authorized by the Council of the District of Columbia on September 14, 2011, as an independent body to prepare comprehensive recommendations to the DC Council and the mayor.[2] Specifically, the commission was tasked with proposing recommendations which

1. provide fairness in apportionment of taxes;
2. broaden the tax base;
3. make the District's tax policy more competitive with surrounding jurisdictions;
4. encourage business growth and job creation; and
5. modernize, simplify, and increase transparency in the District's tax code.

While jurisdictions often establish tax commissions to address fiscal crises or to lay foundations for raising new revenues, the DC Council created the DC Tax Revision Commission during a time of fiscal and economic progress, and asked the commission to

[1] This testimony is largely based on the 2014 DC Tax Revision Commission Final Report, which is available online at https://www.dctaxrevisioncommission.org/.
[2] Amendment to the Code of the District of Columbia, "Tax Revision Commission — Council Findings," § 47-461.

analyze the District's tax system and propose innovative approaches to meet future challenges.

From the fall of 2012 through the end of 2013, the commission held 26 meetings and three public hearings. National and local experts in state and local tax policy assisted the commission's work. Members analyzed the District's taxes, compared them with other localities and states (both regionally and nationally), and studied reform options.

On December 18, 2013, the commission unanimously approved a set of recommendations designed to improve the District's tax system and help its residents and businesses prosper. In the spring of 2014, the commission published its final report.

The commission structured its recommendations as a package, with many of the recommendations working in concert. For example, base-broadening recommendations helped fund tax-relief recommendations.

The commission made numerous recommendations—including lowering individual income tax rates and expanding the District's earned income tax credit for childless workers—but two recommendations are central to today's discussion:

1. Raising the District's standard deduction and personal exemption amounts by conforming with the federal amounts.
2. Eliminating four of the District's individual income tax expenditures.

In tax year 2013, the District's standard deduction was $4,100 for all filers and its personal exemption (per person on the filer's return) was $1,675, while the federal standard deductions were $6,100 for single filers and $12,200 for married filers and its personal exemption (per person on the filer's return) was $3,900.

Thus, the commission argued the District could reduce many residents' District taxable income by thousands of dollars by moving to the federal levels.

The DC Council accepted the commission's recommendation but the legislation "phased in" these tax reductions. As a result, the District's standard deduction and personal exemption amounts increased each year after enactment but did not immediately jump to the federal levels. Later, after the District "conformed" with the federal amounts, the District's standard deduction nearly doubled but its personal exemption went to $0 because Congress made changes to the federal levels in the 2017 Tax Cuts and Jobs Act (TCJA).[3] In tax year 2021, the District's standard deduction was $12,550 for single filers and $25,100 for married filers, and its personal exemption was $0 (all amounts mirroring the federal return, which increases annually with inflation). Filers ages 65 and over received an additional $1,700 (if single) on their standard deduction amount on both their federal and District returns.

[3] For more on federal-state tax conformity and the Tax Cuts and Jobs Act, see Richard C. Auxier and Frank Sammartino, "The Tax Debate Moves to the States: The Tax Cuts and Jobs Act Creates Many Questions for States That Link to Federal Income Tax Rules" (Washington, DC: Urban-Brookings Tax Policy Center, 2018) https://www.taxpolicycenter.org/publications/tax-debate-moves-states-tax-cuts-and-jobs-act-creates-many-questions-states-link.

Providing substantial tax relief to low- and middle-income residents was one goal for increasing the District' standard deduction and personal exemption. In fact, these changes were a major reason why the DC Office of Revenue Analysis projected the commission's recommendations would reduce District taxes by hundreds of dollars for most households earning less than $200,000.[4] However, that estimate was based on the pre-TCJA federal standard deduction and personal exemption. With the elimination of the personal exemption, because of how the federal changes interacted with the District tax system, there is a chance some filers who itemize their deductions (i.e., do not benefit from the larger standard deduction) now pay higher District tax bills than before the commission's recommendations.

But a second consideration was simplifying the District's tax code by eliminating more narrowly targeted tax expenditures without increasing the net District tax bill of residents. That is, while a resident may no longer benefit from a specific eliminated tax expenditure, most would still pay less in District tax, overall, because of the larger District standard deduction and (at the time) larger personal exemption.

Professor Robert Buschman of Georgia State University, a national expert on individual income taxes, provided the commission a report and testimony on the District's individual income tax expenditures.[5] Bushman suggested that the District should eliminate numerous deductions and exclusions because these tax expenditures either (a) provided an unequal benefit to certain taxpayers (i.e., eliminating them would improve "horizontal equity," the idea that similar taxpayers should be taxed similarly) or (b) benefited very few taxpayers. Eliminating tax expenditures would also increase tax revenue and thus allow the commission to recommend broader tax relief without significantly reducing the District's tax revenue.

In its final report, the commission recommended eliminating four income tax expenditures:

- Low-income credit
- District government employee first-time homebuyer credit
- Long-term care insurance deduction
- District and federal government pension exclusions

In recommending the elimination of these individual income tax expenditures, the commission concluded, as written in its final report, that it was better to provide District residents "broad-based tax relief through the increased standard deduction and personal exemption rather than more targeted tax relief."

[4] See "Distribution table for individual income tax package for tax year 2015," from the DC Tax Revision Commission's report, also available as a single document on the 2014 DC Tax Revision Commission's website at https://www.dctaxrevisioncommission.org/final-report.

[5] See Robert D. Buschman, "The District of Columbia Individual Income Tax: Structure, Competitiveness, and Potential Improvements" (Washington, DC: DC Tax Revision Commission, 2013, https://www.dctaxrevisioncommission.org/_files/ugd/ddda66_868aea6b66afa90d471779ec907c76eb.pdf.

The Pension Exclusion Restoration and Expansion Act of 2021[6]

In general, an individual income tax system should reflect a jurisdiction's budget, priorities, and values. While income tax expenditures are often maligned as "special interest carveouts," a deduction, exclusion, or credit can be incredibly valuable to residents who need assistance if the expenditure is well designed and fiscally responsible.

For example, the earned income tax credit (EITC) is a simple and cost-effective poverty-fighting tool, and the District has by far the most generous state-level EITC in the nation.[7] The District also provides a generous property tax credit (Schedule H)—notably to both homeowners and renters—that helps many residents, but specifically seniors, who may struggle to make property tax payments. Both of these policies are tax expenditures that narrow the District's tax base, but they also deliver significant benefits to residents who need support at an affordable revenue cost.

Thus, the questions for any new tax expenditure proposal are who will benefit, who will not benefit, and is that trade-off in line with the proposal's cost?

Bill 24-0071, "The Pension Exclusion Restoration and Expansion Act of 2021," would allow District residents to exclude from District tax up to $10,000 or $20,000 (depending on the filer's age) of income from a public pension, military retirement pay, or an annuity if it was received from the District of Columbia or the federal government. The bill that is before the committee today would not exempt income from private pensions, other governments' public pensions, individual retirement accounts, and the taxable portion of Social Security income. Each member of a married couple may independently claim the deduction, but each spouse can only claim up to $10,000 or $20,000 for his or her specific retirement income (i.e., a couple cannot claim a $40,000 deduction if only one filer has taxable retirement income).

Currently, the District does not provide a specific exemption for pension or retirement income beyond those in the federal tax code that the District conforms with, such as the partial exemption for Social Security income. The District's previous public pension exemption, before its repeal, was $3,000.

Using the Tax Policy Center's state tax model, in preliminary estimates and assuming federal, military, and District pension income is distributed in the same proportion as all pension income, we find that more than two-thirds of the new pension exclusion's benefits would go to District households with an adjusted gross income over $75,000. Only about one-tenth of the proposed pension exclusion's benefit would go to households earning less than $50,000.

The benefit of the exclusion is concentrated among relatively high-earning households because many lower-income households do not have enough taxable income to benefit from it. In tax year 2021, a District resident age 65 or older received a $14,250 standard deduction if single and a $27,800 standard deduction if married (if both spouses were older than age 65) on their District tax return.

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[6] This discussion of pension exclusion income is largely based on work we did for a Colorado tax study group, which is summarized in a 2022 report. See https://www.taxpolicycenter.org/publications/colorados-2020-tax-study-group-overview-meetings-and-research.

[7] See Richard C. Auxier, "What States Can Learn from the District of Columbia's EITC Expansion," *TaxVox*, August 23, 2021, https://www.taxpolicycenter.org/taxvox/what-states-can-learn-district-columbias-eitc-expansion

Filers ages 65 and older would thus have to earn above these amounts—and possibly earn even more if they benefited from other deductions and credits—before they could benefit from the proposed public pension exclusion.[8] To be clear, the District's relatively high standard deduction is a beneficial policy for low- and middle-income seniors because it means many of these filers pay little or no District income tax, particularly due to many seniors having little or no taxable income (Social Security benefits are entirely or partially exempt on both the federal and District tax return). But as a result, the interaction of the new proposal with the District's existing tax system skews most of the benefit of the proposal to relatively high-earning households.

Many other states deduct or exempt at least a portion of retirement income from their state individual income tax, and some states totally exempt certain types of pension income. However, many of these states have relatively low standard deductions. As a result, low-earning seniors in these states would face a tax on their pension income without the specific pension deduction that similar seniors do not face in the District (because they have already benefited from the standard deduction).

This is why comparing a specific tax policy across states, like a pension exemption, is challenging. Any analysis would need to account for the government's other tax policies to understand where specific tax burdens are higher and lower.

There are also systemic issues (separate from state policy choices) that push retirement income tax benefits to relatively high-earning households. In general, those who had higher-paying jobs during their working careers are more likely to have both worked for an employer who offered a pension program or other form of retirement benefit and accumulated larger sums of retirement income.

In contrast, low-income workers typically have weaker labor force attachment (i.e., they change employment more often), are less likely to work for employers who offer retirement benefits, and are less likely to participate in retirement plans when eligible.

Thus, both access and participation in retirement benefits increase with income. As a result, relatively affluent households are more likely to earn retirement income and benefit from a jurisdiction's pension and annuity deduction. In contrast, all households are eligible for a standard deduction.

If the DC Council wants to better target the proposed pension exclusion to low- and moderate-income seniors, it could create an income-based eligibility limit. Missouri, Montana, Rhode Island, and Wisconsin use similar limits (at various levels of income) that prevent high-income households from claiming pension exemptions.[9]

Bill 24-0071 would also restore the deduction for long-term care insurance. The same dynamic between the new proposed deduction and the District's large standard deduction exists for this tax expenditure. Additionally, few residents benefited from the previous

[8] See Internal Revenue Service, "Dependents, Standard Deduction, and Filing Information," publication 501, January 28, 2022, https://www.irs.gov/pub/irs-pdf/p501.pdf.

[9] In Wisconsin, a single filer loses the benefit if their AGI is above $15,000 ($30,000 if married), while in Rhode Island, a single filer can claim the pension benefit as long as their AGI is below $81,900 ($102,000 if married). The formulas for these provisions also differ among these four states based on filing status and the type of pension (public or private), showing the range of options policymakers have when considering AGI-based limits.

deduction before its repeal (with a far smaller District standard deduction). A DC Tax Revision Commission memo noted that only about 4,000 taxpayers claimed it in 2008.[10]

In conclusion, some District residents would benefit from the proposed public pension exclusion. However, as with all tax expenditures, the DC Council has to contend with trade-offs and consider exactly who will benefit, who will not, and if that trade-off is worth the fiscal cost of the proposal.

[10] See Individual Income Tax Memo 20, "Eliminate the $500 Deduction for Long-Term Care Insurance," at "Commission Deliberations," DC Tax Revision Commission, accessed March 31, 2022, https://www.dctaxrevisioncommission.org/commission-deliberations.