District of Columbia – Emergency legislation brings significant changes to business, individual, sales and other taxes

July 16, 2014

In brief

On July 14, 2014, the District of Columbia Council (Council) voted 12 to 1 to approve a motion to override Mayor Vincent Gray's veto of the FY 2015 Budget Support Emergency Act (the Emergency Act), which makes significant changes to the business franchise tax, the individual income tax and the sales tax provisions. The Mayor delivered his veto on Friday July 11, 2014.

The Emergency Act does not need Congressional approval and is effective immediately and remains in effect for no longer than 90 days.[FY 2015 Budget Support Emergency Act of 2014 (6/24/14)]. The Emergency Act is comprised of the same language of the FY 2015 Budget Support Act (the Permanent Act). The Emergency Act is in effect to cover the period until the Permanent Act is approved by Congress. The Permanent Act, also known as Bill 20-750, passed the required two votes from the Council. In order for the Permanent Act to become law it must be sent to the Mayor. If he signs the Permanent Act or his veto is overridden by the Council, it will be sent to the US Congress for a 30 day review period before becoming law.

In detail

Tax reform background: The DC Tax Revision Commission

The District of Columbia Tax Revision Commission (Commission) was created in 2011, consisting of 11 members appointed by the Mayor and the Chairman of the DC Council. From the fall of 2012 through the end of 2013, the Commission explored different options to improve the District's tax system and help residents and businesses prosper. On December 18, 2013, the Commission voted on final recommendations and, on February 12, 2014, the Commission presented its recommendations in testimony to the Council. See our analysis of the recommendations here. In May 2014, the Commission published its full report.

Tax reform procedure and priority

The Council accepted a majority of the Commission's recommendations and adopted a plan that phased-in the tax revisions over a five year period. On May 28, 2014, the Council discussed and voted on the first draft of the Permanent Act. Under DC law the Permanent Act required two votes by the Council before sending to the Mayor for his consideration.

Unlike the first version of the Permanent Act, the implementation of the tax reform measures of the second version are driven by budget triggers rather than dates on the calendar. Consequently, the phased-in implementation of some of these changes may occur only if revenue targets in the next few years are met.

The Council approved the Emergency Act on one required vote and the Permanent Act on their second of two required votes on June 24, 2014, before submitting the Emergency Act to the Mayor for his signature or veto. The Mayor vetoed the Emergency Act and requested lawmakers to defer their recess in order to create a budget that they could all agree upon. However, the Council overrode the veto on July 14 in a vote 12 to 1 to move forward with the Emergency Act.

Business franchise tax

Reducing the tax rate

The Emergency Act phases in a reduction of the franchise tax rate on corporations and unincorporated businesses, whether domestic or foreign, from 9.975% to 8.25%. For the taxable year beginning after December 31, 2014, the rate will be 9.4% for all corporations and, subject to availability of funding in subsequent years, the rate will be further reduced to 9.0%, 8.75%, 8.5%, and 8.25%.

Apportionment changes

The Council also adopted two significant changes to the franchise tax apportionment method: the adoption of a single weighted sales factor formula, which is effective for tax years beginning after December 31, 2014; and a market-based sourcing method for sales of other than tangible personal property. The Emergency Act substantially adopts the approach to market sourcing proposed by the Multistate Tax Commission and requires that sales of other than tangible personal property be sourced to the District if the taxpayer's market for the sales is in the District. A taxpayer's market is located in the District to the extent the service is delivered to a location in the District. For intangible property, sales are sourced to the District to the extent such property is used in the District. The Emergency Act requires that, if the sales are sourced to a state in which the taxpayer is not subject to tax, they must be excluded from the sales factor.

Exempting investment funds through the creation of a 'trading safe harbor'

The Emergency Act also adopts the Commission's recommendation to exempt certain investment funds' income from the Unincorporated Business Franchise Tax ('UBFT') via a 'trading safe harbor.' The Emergency Act has no express effective date and we understand that there will be a technical correction stating it will be for tax years beginning after December 31, 2014. Currently, the District exempts business firms that derive 80% gross income from personal services, such as accounting, law and engineering firms, from the UBFT. However, an investment fund's 'trading' business does not qualify for this exemption and, therefore, capital gains, dividends, and interest income relating to the 'trading' business are subject to the current UBFT 9.975% tax rate. The Emergency Act provides that unincorporated entities that 'purchase, hold, sell or enter, maintain or terminate positions in, stocks, securities, or other commodities for the taxpayer's own account' are not subject to the UBFT. However, the Emergency Act excludes from this exemption:

- Taxpayers that hold property, or maintain positions, as stock in trade, inventory, or for sale to customers in the ordinary course of the taxpayer's trade or business,
- Taxpayers that acquire debt instruments in the ordinary course of the trade or business for funds loaned or services rendered, or
- Taxpayers that hold any of the following that is not traded on an established market; stock in a real estate investment trust, or a partnership interest.

Individual income tax reform

The Emergency Act makes several changes to the individual income tax regime, which includes adding a new income tax bracket, decreasing the income tax rates for some taxpayers, increasing the standard deduction and increasing the personal exemption. Similar to the corporate and unincorporated business taxes, some of the individual tax reform measures are tied to fiscal triggers in future years and will only be adopted if those funds are available.

Sales tax

The Council rejected the Commission's recommendation that the general sales tax rate be increased from 5.75% to 6%, which brings it in-line with the tax rates imposed by both Maryland and Northern Virginia. However, the Emergency Act adopts the Commission's recommendation to broaden the general sales tax base to include certain bottled water consumption, storage of household goods, carpet cleaning, and health clubs, tanning studios, car washes, bowling alleys and billiard parlors.

Local services fee on employers

The Council did not adopt the Commission's recommendation of the creation of a local services fee on employers to offset the fiscal impact on the Home Rule Act, which denies the ability of the DC Council to impose a tax on the personal income of any non-resident individual of the District. The Home Rule Act allows many non-residents to commute into and work in the District without being subject to the District's individual income tax. The local services fee would have required employers to pay a $25 per employee fee every quarter, but would have excluded employers with four or fewer employees.

The takeaway

The Council adopted a majority of the recommendations from the Commission to provide tax relief to the middle class while also creating a more tax friendly tax environment for local businesses with a reduction in the franchise business tax rate, single sales factor apportionment and market based sourcing. The District has been attempting to become more competitive from a business tax perspective in line with its neighboring jurisdictions, Maryland and Virginia.

Let's talk

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