

**WRITTEN TESTIMONY  
OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION  
REGARDING  
H.R. 3244, THE "DISTRICT OF COLUMBIA ECONOMIC RECOVERY ACT"**

**FOR  
THE SUBCOMMITTEE ON THE DISTRICT OF COLUMBIA  
OF THE HOUSE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT  
104TH CONGRESS  
ON  
JULY 31, 1996**

**PRESENTED BY  
KENNETH J. KIES  
CHIEF OF STAFF  
JOINT COMMITTEE ON TAXATION  
U.S. CONGRESS**

**JCX-45-96**

**July 31, 1996**

## I. INTRODUCTION

This document<sup>1</sup> represents the written testimony of the Joint Committee on Taxation at the hearing held on July 31, 1996, by the Subcommittee on the District of Columbia of the House Committee on Government Reform and Oversight concerning H.R. 3244, the "District of Columbia Economic Recovery Act."

This testimony first describes the bill as introduced by Delegate Eleanor Holmes Norton on April 15, 1996, and discusses certain issues raised by the bill. These include compliance and administrative issues, residency issues, technical issues, and federalism and other issues. Finally, it discusses the revenue analysis of H.R. 3244 prepared by the staff of the Joint Committee on Taxation, and reviews certain behavioral and other assumptions underlying the revenue estimate.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Written Testimony of the Staff of the Joint Committee on Taxation Regarding H.R. 3244, the "District of Columbia Economic Recovery Act"* (JCX-45-96), July 31, 1996.

## **II. DESCRIPTION OF H.R. 3244, THE "DISTRICT OF COLUMBIA ECONOMIC RECOVERY ACT"**

### **Summary of the key features of H.R. 3244**

- Individual taxpayers who reside in the District of Columbia (the "District") for at least 183 days a year would be subject to Federal income tax on their District source income at a rate of no greater than 15 percent.
- District taxpayers would be entitled to an exemption amount of \$30,000 for taxpayers filing joint returns and surviving spouses, \$25,000 for heads of household, and \$15,000 for single taxpayers and for married taxpayers filing separate returns. In addition, these taxpayers would be entitled to claim a charitable deduction and a deduction for qualified residence interest.
- District taxpayers would pay no tax on their District source capital gain income.
- District taxpayers would pay the lower of the tax calculated under the bill or under present law. Thus, for example, low income taxpayers would continue to receive the earned income tax credit under the present Federal income tax system.

### **Description of the bill**

H.R. 3244, the "District of Columbia Economic Recovery Act," would allow individuals who reside in the District of Columbia for at least half the taxable year to calculate their Federal income tax liability according to a modified flat tax schedule. These taxpayers would then be liable for the lesser of the modified flat tax or their regular Federal income tax (plus alternative minimum tax, if applicable) after credits. In general, District taxpayers would be subject to tax at a rate not in excess of 15 percent on their District source income and at present-law Federal tax rates for their non-District source income.

To qualify for the modified flat tax, a taxpayer must use as a residence a place of abode in the District of Columbia (and must be physically present at the abode) for at least 183 days in the taxable year. The taxpayer must also file a District of Columbia income tax return for the taxable year.

To calculate the modified flat tax liability, the individual must determine his or her District source income and non-District source income. The tax liability is the sum of pieces calculated separately with respect to income from the two sources. The individual would be liable for a 15-percent tax on District source income in excess of the exemption amount (which would be \$30,000 for taxpayers filing joint returns and surviving spouses, \$25,000 for heads of household, and \$15,000 for single taxpayers and married taxpayers filing separate returns). On non-District source income, the individual would be liable for tax at a rate equal to the ratio of the sum of the individual's regular tax liability and alternative minimum tax liability to the

individual's taxable income, where this ratio is calculated with respect to the regular Federal income tax. The exemption amount does not apply to the non-District source income.

Under the modified flat tax, none of the present-law individual credits, such as the earned income credit or the dependent care credit, apply to either District source or non-District source income tax liability calculations. A taxpayer does not lose entirely the ability to claim these credits, since the credits would be available to the extent allowed under present law if the taxpayer elects to pay Federal income tax under present law rather than under the modified flat tax.

The bill defines District source income as adjusted gross income ("AGI") less (1) net capital gain determined by taking into account only the gains and losses sourced in the District of Columbia, (2) the deduction for charitable contributions (regardless of the location of the donee), (3) the deduction for qualified residence interest (regardless of the location of the residence), and (4) gross income from sources outside the District of Columbia reduced (but not below zero) by adjustments to AGI allocable to such income. The effect of this formula is to provide (1) that capital gains from District of Columbia sources receive a zero percent marginal tax rate, (2) that District taxpayers are entitled to deductions for charitable contributions and qualified residence interest against their District source income, and (3) that income from non-District sources is subject to tax under the regular Federal tax system.

Thus, the first step in calculating tax liability under the bill is for the individual to calculate his or her Federal income tax liability under present-law rules. This step is required to obtain the tax rate to be applied to non-District source income. It also serves as an upper limit for determining ultimate Federal income tax liability -- the individual would choose to pay the modified flat tax only if that liability is less than the liability under the present-law calculation. That is, under H.R. 3244, a District of Columbia resident can never have a larger tax liability than under present law. Once the Federal return is completed, the individual then allocates his or her income to District and non-District sources and applies the modified flat tax rules to District source income and the average tax rate to non-District source income, as described above. Examples of the calculation of the modified flat tax liability are provided at the end of this section.

### **Sourcing rules**

**Personal service income**--Employee compensation (other than retirement income) and net income from self-employment would be sourced where the individual performs such services. Services performed in the Washington/Baltimore Consolidated Metropolitan Statistical Area or in St. Mary's County, Maryland, would be considered to have been performed in the District of Columbia. If at least 80 percent of the individual's hours of wage and self-employment service during the taxable year are performed (or are considered to have been performed) in the District of Columbia, then all such hours of service would be treated as performed in the District of Columbia.

**Interest**--For interest paid during a calendar year by a business that was required to file (and did file) a District of Columbia franchise tax return for the business's taxable year ending with or within the prior calendar year, the interest recipient would treat the District of Columbia percentage of such interest (as shown on the franchise tax return) as District-sourced if the business provides the percentage in a statement to the recipient on or before January 31 following the year of payment. For new businesses (that would not have been required to file a franchise tax return for the prior calendar year), all interest paid during the calendar year by the business would be District-sourced if the business is required to file (and does file) a District of Columbia franchise tax return for the business's taxable year ending during such calendar year.

For interest paid by a debtor who was required to file (and did file) a District of Columbia income tax return for the debtor's taxable year ending during the prior calendar year and who was not required to file a District of Columbia franchise tax return, all such interest would be District-sourced.

For all other interest received or accrued during the individual taxpayer's taxable year, the first \$400 per return would be treated as District source income and the rest would be non-District-sourced.

**Dividends**--For dividends paid during a calendar year by a corporation that was required to file (and did file) a District of Columbia franchise tax return for the corporation's taxable year ending during the prior calendar year, the dividend recipient would treat the District of Columbia percentage of such dividends (as shown on the franchise tax return) as District-sourced if the corporation provides the percentage in a statement to the recipient on or before January 31 following the year of payment.

For all other dividends received or accrued during the individual taxpayer's taxable year, the individual would treat the first \$400 per return as District-sourced and the rest would be non-District-sourced.

**Dispositions of tangible property**--Income, gain, or loss from the disposition of tangible property would be sourced to the property's location at the time of the disposition.

**Dispositions of intangible property**--Income, gain, or loss from the disposition of the property would be District-sourced to the extent any portion of the most recent income attributable to such property received or accrued before such disposition was from District of Columbia sources. Otherwise, income, gain, or loss from the disposition of the intangible property would be non-District-sourced.

**Rents**--Rents from property would be sourced to the property's location.

**Royalties**--Royalties would be non-District-sourced.

**Income from sole proprietorships**--Income from a business that is a sole proprietorship

(other than income included in the individual's net income from self-employment) generally would be treated as non-District-sourced. If, however, the individual is required to file (and does file) a District of Columbia franchise tax return with respect to a sole proprietorship for the taxable year, then the District of Columbia percentage of such income would be District-sourced.

**Income from partnerships**--Income from a business that is a partnership (other than income included in any partner's net income from self-employment) generally would be treated as non-District-sourced. If, however, the partnership was required to file (and did file) a District of Columbia franchise tax return for the partnership's taxable year ending with or within the individual's taxable year, then the District of Columbia percentage of the individual's distributive share of such income would be District-sourced. For partnerships not required to file a District franchise tax return for the partnership's taxable year ending with or within the individual's taxable year, the portion of the individual's distributive share of income that the individual would otherwise treat as District-sourced (under the sourcing rules) would be District-sourced.

**Retirement income**--Individuals would treat retirement income (generally as defined in 4 U.S.C. 114(b)(1)) as District-sourced.

**Income in respect of a decedent and income from an estate**--Such income would be sourced at the place where the decedent was domiciled at the time of death.

**Income from a trust**--Individuals would treat income from a trust (other than retirement income) as from the same sources as the trust income to which it is attributable.

**Other income**--Any income not otherwise specified would be treated as District-sourced. Thus, for example, S corporation income would be District-sourced.

For purposes of the sourcing rules for interest, dividends, sole proprietorship income and partnership income, the "District of Columbia percentage" of such income would be determined by dividing the net income taxable in the District of Columbia (as shown on the original franchise tax return for the relevant taxpayer's taxable year) by the total net income from all sources (as shown on such franchise tax return).

### **Effective date**

The bill would be effective for taxable years ending after the date of enactment. Thus, if the bill were enacted before January 1, 1997, the changes would apply to tax year 1996.

### **Examples**

The following examples illustrate the operation of certain provisions of H.R. 3244.

### Example #1

Assume a married couple filing a joint return residing in the District of Columbia in 1996 has wage income of \$100,000, interest income of \$5,000, and dividend income of \$5,000. Also assume that the wages were earned by employment in the Washington metropolitan area and \$1,000 of the interest income is "District source" interest income, but that none of the dividend income is District-sourced. Further assume that the couple pays \$8,500 in District income taxes, but has no other expenditures that can be claimed as itemized deductions. Under the regular Federal tax system, the couple's AGI would be \$110,000 (wages plus interest plus dividends). The couple would itemize deductions of \$8,500 as this exceeds the value of the standard deduction for married taxpayers filing a joint return and, after claiming two personal exemptions (\$2,550 per exemption for 1996), the couple would have a taxable income of \$96,400 and a Federal income tax liability of \$21,779.

Under the bill, the couple could elect to source all of its wage income to the District of Columbia. The couple also could claim as District source \$1,400 of interest income (\$1,000 of reported "District source" interest plus \$400 of other interest) and \$400 of dividend income. The couple's total District source income would be \$101,800 (wages plus District source interest and dividends). The couple's non-District source income would be \$8,200 (the remaining interest and dividend income).

Under the bill, the couple would compute its total Federal tax liability as follows. The couple could claim a \$30,000 standard deduction against total District source income of \$101,800 yielding a net District source taxable income of \$71,800. The \$71,800 is then taxed at a flat 15-percent rate creating a tax liability from District source income of \$10,770. The couple also would compute tax on its \$8,200 of non-District source income. The rate of tax applicable to non-District source income is determined as the ratio (rounded to the nearest whole percent) of the couple's regular Federal income tax liability (\$21,779) to the couple's regular Federal taxable income (\$96,400). In this example, that ratio is 23 percent. This rate of tax applied to the couple's non-District source income produces a liability of \$1,886 (0.23 times \$8,200) on non-District source income. The couple's total Federal tax liability under the bill would be \$12,656 (\$10,770 plus \$1,886).

### Example #2

Assume a single individual residing in the District of Columbia in 1996 has wage income of \$50,000 and capital gain income from the sale of real property located in the District of Columbia of \$10,000. Also assume that the wages were earned by employment in the Washington metropolitan area. Further assume that the individual has mortgage interest expense of \$5,000, makes \$1,000 of charitable contributions, and has \$1,000 of other expenses that may be claimed as itemized deductions under present law. The individual's AGI would be \$60,000 (wages plus capital gain). The individual would choose to itemize deductions of \$7,000 (mortgage interest, charitable contributions and other deductions) as this exceeds the value of the standard deduction for single taxpayers. The individual's taxable income would be \$50,450

(AGI less itemized deductions less one personal exemption (\$2,550)). The individual's tax liability would be \$11,006.

Under the bill, the individual could elect to source all of his or her wage income to the District of Columbia. Because the individual's capital gain is from the sale of District of Columbia property it would not be included in District source income, nor would it be non-District source income. Thus, the individual has no non-District source income.

Under the bill, the individual would compute his or her total Federal tax liability as follows. The individual could claim a \$15,000 standard deduction against total District source income. The individual could also claim his or her \$5,000 of mortgage interest expense and \$1,000 of charitable contributions against total District source income. The individual's taxable District source income is \$29,000 (\$50,000 minus \$15,000 minus \$5,000 minus \$1,000). The \$29,000 is then taxed at a flat 15-percent rate creating a tax liability from District source income of \$4,350. Because the individual has no non-District source income, his or her total Federal tax liability would be \$4,350.

### Example #3

Assume a married couple filing a joint return residing in the District of Columbia in 1996 has wage income of \$20,000. Also assume that the wages were earned by employment in the Washington metropolitan area. Further assume that couple has two dependent children and claims the standard deduction (\$6,700 for 1996). The couple's AGI would be \$20,000 and after claiming the standard deduction and four personal exemptions (\$2,550 per exemption for 1996) the couple would have a taxable income of \$3,100 and a Federal income tax liability of \$465. The couple would also be eligible for an earned income credit of \$1,789, which would eliminate their tax liability and result in a refund of \$1,324.

Under the bill, the couple could elect to source all of their wage income to the District of Columbia. The couple's total District source income would be \$20,000. The couple's modified flat tax liability would be zero, since the couple could claim a \$30,000 standard deduction against total District source income to yield a net District source taxable income of zero. The couple would have no non-District source income.

Because the modified flat tax liability of zero is greater than the Federal income tax liability after credits (a \$1,324 refund), the couple would not choose to pay the modified flat tax and would receive a \$1,324 refund under present-law rules.



### **III. DISCUSSION OF ISSUES**

#### **A. Compliance and Administrative Issues**

The proposed modified flat tax under H.R. 3244 could raise a number of compliance and administrative issues. Tax filing may be more complex for many District of Columbia residents, since they would have to complete at least two returns to calculate their Federal income tax liability in addition to their District of Columbia income tax return. For Federal income tax purposes, District of Columbia residents would first fill out their Federal income tax return as under present law to obtain the tax rate to be applied to non-District-source income. Once the Federal income tax return is completed, the taxpayer would turn to the modified flat tax return, segregating income by its source and performing separate tax calculations for District-source and non-District-source income. This second step must be done to determine whether the modified flat tax would reduce the individual's Federal tax liability.

The modified flat tax could also make the current tax withholding system more complex for District of Columbia-resident taxpayers. The withholding system is geared to the current Federal income tax liability; altering it to reflect the modified flat tax could complicate it. In order to obtain the benefits of any reduction in tax liability under the modified flat tax throughout the year, rather than in a lump sum at the time the return is filed, a taxpayer would have to modify either his or her withholding or estimated tax payments. Calculating the appropriate reduction in either withholding or estimated tax payments could be complicated for individual taxpayers. For example, taxpayers would need to go through the exercise of allocating their income to District and non-District sources and projecting what their average Federal income tax rate will be (in order to apply that rate to non-District-source income). Requiring employers of District of Columbia-resident taxpayers to modify wage withholding could also be complex or burdensome for those employers. For example, employers would have to adjust their computer programs that currently compute wage withholding to take into account of the different rules applicable only to District residents.

The modified flat tax would allow individuals a deduction for charitable contributions in the calculation of District-source income, regardless of whether the individual claimed itemized deductions on the Federal income tax return. Thus, all District of Columbia residents would have to maintain records on charitable contributions if they intended to claim them on their modified flat tax return.

Because District of Columbia residents would need to allocate their capital income to District and non-District sources in the modified flat tax calculation, all businesses who file District of Columbia franchise tax returns and pay interest, dividends, or distributive shares of income would need to report the District of Columbia percentage of those payments to the payees. The calculation of the District of Columbia percentage would be straightforward (the ratio of net income taxable in the District to the business's total net income from all sources), but the information returns provided to individuals would represent an added burden. In addition, the businesses may have an incentive to allocate income to the District of Columbia in order to

increase their District of Columbia percentage. The business would have to balance the benefit in Federal individual income tax reduction for its shareholders, creditors, and owners against any increased District of Columbia franchise tax liability. These incentives to reallocate income are similar to those that some businesses face under current Internal Revenue Code section 482, relating to domestic and foreign sources of income.

### **B. Residency Issues**

Only District of Columbia residents are eligible to compute their tax liability under the modified flat tax schedule provided in H.R. 3244. Under the bill, an individual is treated as a "resident" of the District of Columbia for a taxable year if the individual satisfies the following two tests: (1) the individual uses a residence in the District of Columbia as a place of abode (and was physically present at such place) for at least 183 days of such taxable year, and (2) the individual files a District of Columbia income tax return for such taxable year.

To satisfy the residency requirement, individuals could either establish their sole residence in the District of Columbia or establish a second residence in the District of Columbia while maintaining a primary residence elsewhere (e.g., Virginia or Maryland). In the former case, the individual likely would relocate from some other jurisdiction, causing a reduction in that jurisdiction's tax base. A similar reduction might also occur in the second case, although it is possible for an individual to be a "resident" of two different jurisdictions for tax purposes. For example, an individual who is domiciled in Maryland on the last day of the taxable year is considered a "resident" for Maryland tax purposes. The same individual could have lived in the District of Columbia for 183 days during the same taxable year and have filed a District of Columbia tax return; thus, the individual would also be a resident of the District of Columbia under the bill.

Because, under H.R. 3244, an individual's Federal income tax liability depends on satisfying the tests for District of Columbia residency, it is particularly important to be able to enforce such requirements. From a compliance standpoint, it would be difficult, if not impossible, for the Internal Revenue Service to determine if an individual satisfies the 183-day residency test, although it would be fairly straightforward to ascertain whether an individual filed a District of Columbia income tax return. The issue is particularly critical because of the likelihood that higher-income taxpayers would establish nominal second residences in the District, while maintaining a primary residence in a neighboring jurisdiction, to take advantage of the lower Federal tax rate.

### **C. Technical Issues**

The statutory language of H.R. 3244 presents several technical issues. Among the more significant issues are those relating to the treatment of S corporations and personal service corporations.

For Federal income tax purposes, a corporation generally is subject to tax at the corporate

tax rates on its income as the income is earned and the corporation's shareholders are subject to tax at the individual tax rates when the income is distributed to them as dividends. An exception to this dual-level system of taxation is provided for qualified small business corporations that elect to be treated as S corporations. The income of an S corporation is taxed to the individual shareholders of the corporation as the income is earned; distributions of such income are not subject to tax. Thus, for Federal income tax purposes, S corporations and their shareholders are provided treatment that is similar to that provided to partnerships and their partners or sole proprietorships and their owners. H.R. 3244 provides explicit rules for the treatment of partnerships and sole proprietorships, but not S corporations. It would seem appropriate that the partnership rules of H.R. 3244 apply to S corporations.

For Federal income tax purposes, a personal service corporation ("PSC") generally is a corporation, the principal activity of which is the performance of personal services by owner-employees of the corporation. Because a PSC may be viewed as an "alter ego" of its owners, various provisions of the Internal Revenue Code deny certain tax benefits to PSCs. For example, Section 269A of the Internal Revenue Code allows the Secretary of the Treasury to reallocate items of income, deduction, credits, exclusions and other allowances between a PSC and its employee-owners where the principal purpose of the formation or use of the PSC is the avoidance or evasion of Federal income tax. H.R. 3244 provides different treatment for different types of income (e.g., all royalties would be treated as non-District sourced). It would seem appropriate that the bill provide that these allocation rules could not be avoided by use of a PSC or other similar device.

#### **D. Federalism and Other Issues**

##### **Definition of Federal tax base**

The provisions of H.R. 3244 would operate in such a manner that the District of Columbia would be making determinations as to the Federal tax base. Under the bill, the proportion of interest and dividend income that is treated as District source, and therefore subject to the modified flat tax, would be based on the percentage of the payor's income that is reported on its District of Columbia franchise tax return. Thus, decisions by the District of Columbia regarding the parameters of its franchise tax would determine the characterization of amounts for purposes of the Federal income tax base. While present law contains exemptions and deductions (e.g., the State and local income tax deduction) that are determined by local law, the Federal government generally has not ceded to State or local jurisdictions fundamental determinations with respect to the Federal tax base.

##### **Application of the Uniformity Clause**

The provision of special tax treatment to residents of the District of Columbia as contemplated in H.R. 3244 raises a potential constitutional issue. Because H.R. 3244 provides preferential tax treatment based on a geographic classification, it would be subject to potential challenge as a violation of the requirements of the Uniformity Clause of the United States

## Constitution.

Pursuant to the Constitution, Congress has broad powers to impose taxes. However, the power to tax is not without limits. In particular, the Uniformity Clause requires that taxes "be uniform throughout the United States."<sup>2</sup> The Uniformity Clause operates to prevent the Congress from exercising the power to tax with the purpose of providing undue preferences for one region of the country over other regions.<sup>3</sup>

The requirement of uniformity in taxes extends not only to the States, but also to the District of Columbia. In considering the application to the District of Columbia of Congress' power to tax and the limiting requirement of uniformity, the Supreme Court noted that "the [D]istrict of Columbia . . . is not less within the United States, than Maryland or Pennsylvania...."<sup>4</sup> The Supreme Court revisited this issue in Downes v. Bidwell, 182 U.S. 244 (1901), a case involving the question of the application of the revenue clauses of the Constitution to the territories of the United States. In Downes, the Court cited with approval the earlier determination in Loughborough that the power to tax and the related requirement of uniformity are applicable to the District of Columbia, noting that such result is consistent with the fact that the District of Columbia had been part of the States of Virginia and Maryland: "[i]ndeed, it would have been a fanciful construction to hold that territory which had been once part of the United States ceased to be such by being ceded directly to the Federal government."<sup>5</sup>

In contrast to its application to the District of Columbia, the Uniformity Clause is not necessarily applicable to the U.S. territories. In the case of the territories, its application depends upon the status of the particular territory. The Supreme Court in Downes concluded that the Uniformity Clause is not applicable to those territories that are not explicitly incorporated into the United States.<sup>6</sup> On this basis, the Court held that the Uniformity Clause did not bar the imposition of duties on imports from Puerto Rico.<sup>7</sup> Because the Uniformity Clause is not applicable to the Commonwealth of Puerto Rico, the special tax provisions of present law for residents of, and corporations doing business in, Puerto Rico do not give rise to issues under the

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<sup>2</sup> Article I, section 8, clause 1.

<sup>3</sup> Although there historically has been some debate over the application of the Uniformity Clause in the case of income taxes, there is now a consensus that income taxes are within the scope of the Uniformity Clause. See Brushaber v. Union Pacific Railroad Co., 240 U.S. 1 (1916).

<sup>4</sup> Loughborough v. Blake, 18 U.S. 317, 319 (1820).

<sup>5</sup> Downes at 261.

<sup>6</sup> Downes at 286-7.

<sup>7</sup> Downes at 287.

## Uniformity Clause.

The Uniformity Clause does not require that a tax must have an equal or proportionate effect in every State and the District of Columbia. Rather, the Supreme Court has stated that "a tax is uniform when it operates with the same force and effect in every place where the subject of it is found."<sup>8</sup> Thus, the imposition of a tax on tobacco, for example, is not forbidden under the Uniformity Clause, notwithstanding the fact that tobacco is grown in some States but not in others. On the other hand, a tax that applies only to tobacco grown in a particular State would raise a potential issue under the Uniformity Clause.

Explicit geographic distinctions in Federal tax statutes are not necessarily invalid under the Uniformity Clause. In United States v. Ptasynski, the Supreme Court first considered the issue of whether the Uniformity Clause represents a *per se* prohibition on Congress defining the subject of a tax in geographic terms. In a unanimous opinion, the Court concluded that the Uniformity Clause does not prohibit Congress from fashioning legislation to address "geographically isolated problems."<sup>9</sup> If a tax provision is framed in geographic terms, the Court "will examine the classification closely to see if there is actual geographic discrimination."<sup>10</sup>

In Ptasynski, the Court considered whether the exemption from the crude oil windfall profits tax for certain Alaskan oil violated the Uniformity Clause. The Court concluded that the special treatment for Alaskan oil was justified based on neutral factors, citing the disproportionate costs and difficulties involved in oil extraction in the particular region.<sup>11</sup> The Court noted that there was no evidence that Congress intended to grant an undue preference to Alaska.<sup>12</sup> The exemption at issue applied not to all oil produced in Alaska, but only to a relatively small percentage of such oil; moreover, the exemption was not limited to Alaska, but applied also to oil produced in certain offshore territorial waters. In this regard, the Court stated that

[t]he exemption thus is not drawn on state political lines.

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<sup>8</sup> United States v. Ptasynski, 462 U.S. 74, 82 (1983) (quoting Head Money Cases, 112 U.S. 580, 594 (1884)).

<sup>9</sup> Ptasynski at 83-84.

<sup>10</sup> Ptasynski at 85. In this regard, a commentator has suggested that "[b]y 'actual geographic discrimination,' the Court apparently had in mind a situation in which the geographic distinctions were intended simply to benefit one state or region at the expense of others (or to harm one state or region to the benefit of others), rather than to address 'geographically isolated problems.'" Zelenak, "Are Rifle Shot Transition Rules and Other Ad Hoc Tax Legislation Constitutional?", 44 *Tax Law Review* 563 (1989).

<sup>11</sup> Ptasynski at 85.

<sup>12</sup> Ptasynski at 85-86.

Rather it reflects Congress' considered judgment that unique climatic and geographic conditions require that oil produced from this exempt area be treated as a separate class of oil.<sup>13</sup>

Like the windfall profits tax exemption at issue in Ptasynski, the preferential tax treatment that would be provided to residents of the District of Columbia under H.R. 3244 is couched in geographic terms. Accordingly, the provisions would be subject to scrutiny under the Uniformity Clause. The Uniformity Clause analysis with respect to H.R. 3244 would turn on whether the provision of special tax treatment to District of Columbia residents could be justified on the basis of neutral factors. Because of the few judicial decisions in this area, the actual level of scrutiny a court would apply is not clear.<sup>14</sup> Indeed, it should be noted that no Federal tax statute has been invalidated under the Uniformity Clause.

Unlike the exemption that was approved by the Supreme Court in Ptasynski, the preferences provided in H.R. 3244 are drawn precisely on political boundaries. H.R. 3244 would provide preferential tax treatment to all residents of the District of Columbia with respect to income from sources within the District of Columbia. The applicability of this special tax treatment would be based solely on a taxpayer's place of residence, without regard to the taxpayer's economic circumstances or income level. Individuals who are not resident in the District of Columbia, and income from sources outside the District of Columbia, would not be eligible for the lower rate of Federal income tax. On its face, such special tax treatment could be viewed as the kind of preference for one jurisdiction over another at which the Uniformity Clause is aimed. The fact that the classification under H.R. 3244 is defined by a political boundary may heighten a court's scrutiny of whether the geographic classification serves as an appropriate proxy for a neutral, nongeographic classification.

The special tax treatment provided under H.R. 3244 can also be contrasted with the present-law provisions providing tax benefits for areas designated as empowerment zones or enterprise communities which were enacted in 1993 and which have not been challenged under the Uniformity Clause. In order to be eligible to be selected as an empowerment zone or enterprise community, an area must meet specified criteria, which include poverty, unemployment and economic distress, and must be nominated by a State or local government. Unlike the special tax treatment of H.R. 3244, which applies exclusively to the District of Columbia, the special tax treatment applicable to empowerment zones and enterprise communities potentially was available to any area that met the specified criteria (subject to a limit on the number of areas that could be designated following a competitive application process). Moreover, unlike the special tax treatment provided in H.R. 3244 for all residents of the District of Columbia with respect to District-source income, the tax benefits provided to

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<sup>13</sup> Ptasynski at 78.

<sup>14</sup> For a discussion of the level of scrutiny to be applied in light of the decision in Ptasynski, see Zelenak, supra, at 590-591.

empowerment zones and enterprise communities are specifically targeted at employment and investment within such zones or communities. A credit is provided for certain wages paid to an empowerment zone resident employed within the zone (even if the employer may not otherwise have a presence in the zone), more generous expensing allowances are permitted for certain business property used in an empowerment zone, and a special category of tax-exempt financing is available for use to finance certain business property within an empowerment zone or enterprise community. Although the tax benefits of the empowerment zone/enterprise community provisions are provided only to certain geographic areas, the eligible areas are defined in terms of economic factors and the tax benefits provided are closely targeted at addressing such economic factors.

The special tax treatment provided in H.R. 3244 is defined in purely geographic terms. As such, the provisions would be subject to scrutiny by a court in determining whether the tax preferences provided are consistent with the requirements of the Uniformity Clause. However, because a case involving tax preferences drawn precisely on political boundaries would be a case of first impression for the courts, the level of scrutiny and the degree of deference that would be applied is unclear. In anticipation of a Uniformity Clause challenge, a clear record would have to be made that Congress determined that the preferential tax treatment provided to residents of the District of Columbia under H.R. 3244 is necessary to address specific unique circumstances existing with respect to the District of Columbia that justify such preferential treatment. The stronger and more detailed the record is on these issues, the more likely a court is to give deference to the judgment of Congress in enacting legislation providing preferential tax treatment for residents of the District of Columbia.

#### IV. REVENUE ANALYSIS

The staff of the Joint Committee on Taxation estimates that H.R. 3244 would reduce fiscal year Federal budget receipts by \$12.8 billion for fiscal years 1996 through 2006. Assuming that the date of enactment occurs before January 1, 1997, decreases in Federal income tax liability begin at \$675 million for calendar year 1996, when few behavioral effects are expected, and increase to \$1.8 billion in calendar year 2006, by which time it is expected significant behavioral responses will have occurred. These figures may be compared to projected 1997 Federal tax receipts from District of Columbia residents under present law of approximately \$1.70 billion, which is slightly less than the District of Columbia individual income tax liability of \$1.73 billion reported by the Internal Revenue Service for 1994.

The District of Columbia has experienced an accelerating out-migration of population in the past decade. Between 1980 and 1990, the District's population declined by 31,000; between 1990 and 1994, it declined by another 37,000. Comparable figures for Maryland and Virginia show an increase in population of 1.4 million from 1980 to 1990, and increase of 600,000 from 1990 to 1994. Similarly, between 1987 and 1992, the number of Federal individual income tax returns filed from the District of Columbia dropped by six percent. Between 1992 and 1994, District of Columbia returns dropped another eight percent. By contrast, the number of Federal individual income tax returns filed from Maryland and Virginia increased by seven percent from 1987 to 1992, and by one percent from 1992 to 1994.

The Joint Committee staff anticipates that H.R. 3244 would result in a reduction in the rate of decline in population in the District of Columbia. The staff also anticipates that some out-migrating middle-income residents would be replaced by higher-income residents. The net effect of these changes in population movements would be a stabilization of existing population, and a substantial relocation of high-income residents from the metropolitan suburbs to the District of Columbia. These changes in residential location would be accompanied by a relocation of some businesses that tend to locate near their customers, and a rise in property values and economic activity in the District of Columbia.

While these relocations would improve the economy and income and property tax bases of the District of Columbia, they would cause a contraction in the economies and tax bases of surrounding suburbs. The revenue estimate does not assume any net increase in national income as a result of this proposal.

In addition, the Joint Committee staff assumes that there will be a substantial number of higher-income taxpayers in the District of Columbia metropolitan area who would establish (or claim to establish) second residences in the District of Columbia and change their official place of residence to the District of Columbia for the purpose of taking advantage of the provisions of H.R. 3244. This activity would result in an additional increase in the individual income tax base for the District of Columbia, and a decrease in the income tax bases of surrounding jurisdictions, without resulting in any additional changes in economic activity in the District of Columbia. As discussed in Part III.B., above, it would be very difficult for the Internal Revenue Service to



determine exactly how much residential time a given taxpayer spends in the District of Columbia.

Particularly in the later years of the budget window, the Joint Committee staff also projects that there would be some relocation of certain types of businesses from other regions of the country to the District of Columbia. Businesses most likely to relocate from other regions would come from various service industries, such as certain financial services and advertising. Wages and salaries are typically a large fraction of costs in these businesses, and the services can be performed at a distance from potential clients. Like the relocation of residents within the metropolitan area, this relocation is not assumed to result in a net increase in national income.

The Joint Committee estimate assumes that certain changes will be made in the legislation to prevent the creation of certain significant unintended consequences in the form of tax loopholes. For example, the estimate assumes that treatment of S corporation income will be parallel to treatment of partnership income. It further assumes that the statute will be modified to clarify the status of income earned by personal service corporations and related taxpayers to ensure that royalty and other income cannot be recharacterized as labor compensation, and that taxpayers who, in fact, are not performing most of their services in the District of Columbia metropolitan area cannot claim that they are.

Although the revenue estimate does not assume that there is a net change in national income as a result of this tax proposal, it is possible that dramatically lower marginal tax rates could result in an increase in labor supply, which could lead to an increase in national income. This effect would be most likely to occur among higher-income people. However, in order for the increased labor supply to result in increased income, there must be sufficient demand for labor to take advantage of increased labor availability. The relatively high District of Columbia unemployment rate of eight percent raises the possibility that such absorption would be relatively slow, and net economic growth effects would be modest, particularly in the short run.

H.R. 3244 also provides tax relief for income from capital located in the District of Columbia, but only to District of Columbia residents. Employment and business activity in the District of Columbia is concentrated in non-capital intensive industries, primarily because the District of Columbia does not have adequate land and other natural resources to make it an attractive location for manufacturing. Therefore, this proposal is not expected to produce a large increase in net investment. However, there may be some additional investment, which would result in some growth in the District of Columbia's economy in the later years of the budget window.

The staff of the Joint Committee on Taxation is currently engaged in a study of the feasibility of including these macroeconomic effects in its revenue estimates. However, it is likely that any net economic growth and increased tax revenues resulting from the tax incentives would be quite small relative to the relocation effects of this proposal. The location-based nature of this proposal creates opportunities both for intensified economic development within the favored location in lieu of some other location, and for changes in tax liability due to

recharacterizations of place of residence. Therefore, increases in taxable income in the District of Columbia resulting from these behavioral responses would not be expected to be replicated in a nationwide application of this proposal.

**V. ESTIMATED REVENUE EFFECTS OF H.R. 3244,  
THE "DISTRICT OF COLUMBIA ECONOMIC RECOVERY ACT"**

**Fiscal Years 1997 - 2006**

*[Billions of Dollars]*

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1997-01	1997-03	1997-06
H.R. 3244, the "District of Columbia Economic Recovery Act".....	tyea DOE	-1.1	-0.9	-1.0	-1.1	-1.2	-1.3	-1.4	-1.5	-1.6	-1.8	-5.3	-8.0	-12.8

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Estimate is very preliminary and subject to change pending additional data.

Legend for "Effective" column: DOE = date of enactment

tyea = taxable years ending after