



Lifeline or Loophole? Municipal Bond Tax Exemption Faces a Year of Scrutiny

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Summary

The current U.S. presidential administration has turned its focus towards a sweeping tax reform proposal that aims to reduce tax rates while eliminating numerous tax breaks, raising fears that the reforms could include a change to the tax-exempt status of municipal bonds or include other measures that negatively impact the investor appeal for tax-exempt bonds.¹ Changes could range from a full repeal to establishing a cap on the value of the tax exemption. This fear stems from the stated objective of the Trump plan to “eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers.”² Many detractors view the exemption as falling squarely into this category, as a benefit for the wealthy.³ However, a bipartisan group of more than 150 House members and, most recently, President Trump’s Treasury Secretary Steven Mnuchin have voiced strong support for the tax exemption.^{4,5}

Tax-exempt bonds are a mainstay of public financing and revoking their tax-exempt status will increase borrowing costs for state and local governments, authorities and other non-profit bond issuers. PFM believes that active support for the exemption is critical. The use of the budget reconciliation process means that a repeal of the exemption is possible with significantly less support and debate than a full bill. Speaker of the House Paul Ryan confirmed that budget reconciliation is, “the preferred process”⁶ to achieve tax reform. House Ways and Means Committee Chairman Rep. Kevin Brady said in a December 2016 meeting at the Heritage Foundation that he was open to the idea of a repeal but wanted to hear opinions about it from the public and other lawmakers.⁷

A Century of Construction and Contention

The municipal bond tax exemption dates back to 1913 and has faced controversy throughout its 104-year history. The rule was originally created as a response to potential constitutional conflicts regarding taxing income related to state and local government activities. Its current detractors point out that subsequent Supreme Court rulings have cleared the way to taxing interest on municipal bonds, but Congress has yet to exploit this avenue.⁸ The preservation of the exemption may be due to municipal bonds’ long history as the primary capital financing tool for state and local governments, authorities and non-profit entities. As shown on the following page, projects funded by municipal bonds quite literally make up the landscape of most, if not all, communities. Over just the past decade (2006 to 2016), municipal bonds have provided funding for \$4.2 trillion of new money projects and refinancing issuances, according to Thomson Reuters.

The costs of taxing these bonds would ultimately be borne by state and local governments, authorities and other non-profit bond issuers. In a June 2013 report, Moody’s estimated that a repeal would increase

1 <http://www.reuters.com/article/us-usa-congress-taxation-idUSKBN16V2S0>

2 https://www.bondbuyer.com/news/administration-tax-plan-would-eliminate-most-tax-deductions-loopholes?utm_campaign=intraday-c-Apr%2026%202017&utm_medium=email&utm_source=newsletter&eid=12a6d4d069cd56cfddaa391c24eb7042

3 <http://thehill.com/policy/finance/313408-gop-expected-to-take-aim-at-local-tax-deductions>

4 <http://www.pbs.org/newshour/rundown/as-trump-eyes-infrastructure-local-leaders-say-save-muni-bonds/>

5 <https://www.bondbuyer.com/news/mnuchin-administration-wants-to-preserve-muni-bond-tax-exemption>

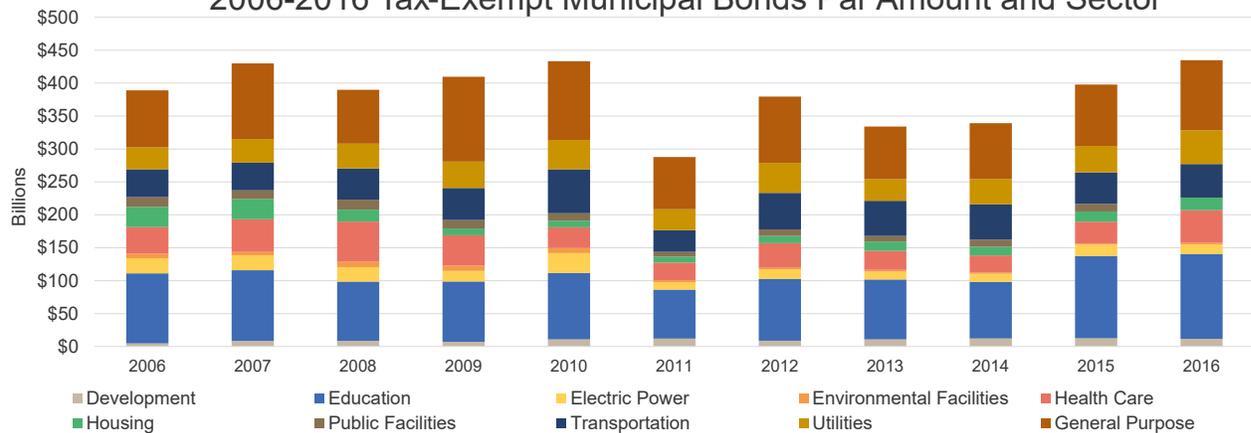
6 <https://www.bloomberg.com/news/articles/2017-04-26/white-house-unveils-trump-s-opening-bid-for-biggest-tax-cut>

7 <http://thehill.com/policy/finance/313408-gop-expected-to-take-aim-at-local-tax-deductions>

8 <https://taxfoundation.org/reexamining-tax-exemption-municipal-bond-interest/>



2006-2016 Tax-Exempt Municipal Bonds Par Amount and Sector



Source: Thomson Reuters

cumulative municipal borrowing costs by \$175.6 billion over the next decade (from 2014 to 2024).⁹ The extra cost could lead to increases of state and local taxes or higher user-fees and rates as municipal bond issuers will need to provide higher rates of return to reliably access capital on a taxable basis. It could also hurt many smaller or infrequent issuers' ability to access the capital markets. Issuers generally rely on the tax exemption to attract investors to smaller, more illiquid credits that could get overlooked in the larger taxable market.

Reconciliation May Railroad Rhetoric

Despite vocal and bipartisan support, many experts do not expect the exemption to make it through 2017 entirely unscathed. One of the biggest reasons is the legislature's option for using the budget reconciliation process. This procedural process allows for any budget legislation to become law through an expedited debate limited to 20 hours and a simple majority in the Senate (51 votes) and passage in the House. Speaker Ryan mentioned reconciliation as the ideal method for passing tax reform, allowing for the passage of major policy initiatives with a simple majority and process rules. In short, even despite strong opposition, Congress could quickly enact significant changes, provided there are the requisite number of votes.

President Trump has many legislative items that could tempt lawmakers to raid the tax exemption. The most recent tax reform outline calls for a simplified tax code with the removal of all tax breaks, barring a few seen as benefiting small businesses and middle class families (see the next page).¹⁰ The municipal tax exemption is not mentioned explicitly in the tax reform outline. This omission could be taken as a proposed elimination or as confirmation that a repeal is not being considered. If the exemption stands through the latest push for tax reform, there are still other policy objectives to follow closely including expanded funding for infrastructure and the military — all projects and proposals that have yet to secure funding and that will likely leave Congress searching for funding sources. Furthermore, other proposed reforms to the tax code could carry negative implications for municipal bonds.

Our View

Leading members of both political parties have proposed or considered changes to the tax exemption in recent history, which suggests support could be found even if there is bipartisan opposition to any change. As the municipal bond tax exemption is likely to continue to be discussed as major spending and policy decisions are made throughout 2017,¹¹ we remind readers that the most effective way to share your support of or opposition to any proposed federal legislation is to reach out directly to your local Congressional representatives.

⁹ <https://www.nga.org/files/live/sites/NGA/files/pdf/2013/1311MoodyReport.pdf>

¹⁰ https://www.bondbuyer.com/news/administration-tax-plan-would-eliminate-most-tax-deductions-loopholes?utm_campaign=intraday-c-Apr%2026%202017&utm_medium=email&utm_source=newsletter&eid=12a6d4d069cd56cfddaa391c24eb7042

¹¹ <http://www.bondbuyer.com/news/washington-taxation/what-you-need-to-know-about-tax-reform-and-infrastructure-1127836-1.html>



Available Details of the Trump Tax Plan

Individual Tax Reform

1. Consolidate tax brackets from seven (ranging from 10.0% to 39.6%) to three (10%, 25%, 35%). No detail provided on how income level thresholds would apply.
2. Elimination of itemized deductions including the ability to claim deductions from reportable income for state and local income and real estate taxes. Charitable contributions and mortgage interest deductions would remain intact.
3. Increase the standard deduction from the current \$12,700 (\$6,350 for individual filers) to \$25,400 (\$12,700 for individual filers).
4. Eliminate the individual allowance for personal exemptions, currently set at \$4,050 per each filer, spouse and dependent.
5. Eliminate Alternative Minimum Tax (“AMT”), Estate Tax and the Affordable Care Act Tax (3.8%).

Corporate Tax Reform

1. Reduce corporate tax rate from 35% to 15%. This reduced rate would be a unified rate, applicable to both corporate (paid by corporations) and individual earned business income. Any business income reported on an individual return (such as income from S-Corporations or partnerships) would be subject to this reduced rate of 15%.
2. Eliminate ongoing taxes applied to U.S. corporate overseas profits; replaced with a one-time assessment of a tax (rate TBD), applied over several years (timeframe TBD), on these profits.

Source: <https://www.bloomberg.com/news/articles/2017-04-26/white-house-unveils-trump-s-opening-bid-for-biggest-tax-cut>

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