Bond Case Briefs

Municipal Finance Law Since 1971

Trump's Tax, Infrastructure Plans Jeopardize Exemption for Munis.

WASHINGTON — Donald Trump's presidency and the Republican-controlled Congress set the stage for historic tax reform and increased spending on infrastructure next year, which has the potential to jeopardize the tax exemption for municipal bonds, according to market participants.

Both Trump and House Republicans are pushing for tax reform plans that would lower individual and corporate tax rates and broaden the tax base, repealing or restricting tax deductions and exemptions.

"The win, because it means that the GOP will control the executive office and both houses of Congress, almost surely means the next Congress will act on major tax legislation focused on cutting rates," said Frank Shafroth, director of the Center for State and Local Government Leadership at George Mason University. "I would guess it will be the most significant, early bill signed into law by the new president."

"They're going to strike while the iron is hot," agreed Chuck Samuels, a partner at Mintz Levin.

They could propose tax reform legislation that would be the most significant since the 1986 Tax Reform Act, which contained major restrictions for municipal bonds, said Shafroth.

The Trump and House Republican plans do not contain many details and do not specify what deductions might be repealed. Market participants worry that the exclusion on interest for tax-exempt bonds could be capped or eliminated to raise revenue for other tax reforms or increased infrastructure spending.

"In the last 24 hours, tax exemption under possible tax reform in 2017 or 2018 has gone from a concern/priority to 'hair on fire,'" said John Vahey, managing director of federal policy for Bond Dealers of America.

Charlie Henck, a partner with Ballard Spahr here, said it's a given that the tax exemption for municipal bonds will be on the table during the tax reform debate. "In the years I've been watching Congress and all of the new administrations, you can take it as a given that the economic folks at the Treasury Department and the Joint Committee on Taxation will put the tax exemption for munis on their hit list," Henck said. "It's generally thought by those folks to be an inefficient incentive."

Henck said he expects state and local groups to rally together to maintain the tax-exemption for muni bond interest, which is currently excluded from taxes.

Infrastructure

Trump's victory speech placed heavy emphasis on his plans to shore up the nation's infrastructure. "We are going to fix our inner cities and rebuild our highways, bridges, tunnels, airports, schools, hospitals," he said. "We're going to rebuild our infrastructure, which will become, by the way, second to none. And we will put millions of our people to work as we rebuild it."

Trump has proposed a $1 trillion, 10-year infrastructure plan. While that would normally be strongly supported by state and local governments and bankers, there is some uncertainty about the plan's reliance on $137 billion of tax credits that Trump would ask Congress to authorize.

"The little we know about Trump's plan is that it focuses on tax credits," said Jessica Giroux, BDA's general counsel. "Our concern is that it says nothing about munis. But with lowering individual rates under tax reform we wonder if munis are going to be as attractive anymore."

Trump's lack of detail in how he would raise revenue for his proposed infrastructure spending as well as other unspecified changes to deductions is concerning, said Vahey.

"This is going to be a very big item for the muni market in the coming years," he added. "With a unified executive branch and legislative branch, it's a whole new ballgame."

Trump advisors Wilbur Ross, a billionaire private-equity investor, and Peter Navarro, a professor at the University of California at Irvine, said the infrastructure plan's tax credits could be used by investors to leverage $167 billion in private funds.

Companies taking advantage of the tax credits would be able to borrow money on the private market at low interest rates to finance $1 trillion of projects without the need for any new taxes, they said.

"Trump's plan will harness market forces to help raise construction funds by incentivizing private sector investors through tax credits, thereby revolutionizing American infrastructure finance," Navarro said.

Companies would be able to bring overseas earnings back to the U.S. at Trump's proposed reduced tax rate of 10% rather than the current 35%. With the credits, companies could avoid any tax liability by investing $122 million of the repatriated profits in infrastructure projects, Ross and Navarro said.

Repatriation would take away a significant amount of tax revenue available for tax reform, thereby increasing the pressure on Congress to look even harder at cutting tax deductions and exemptions.

The Joint Committee on Taxation has estimated that American companies hold a total of $2.6 trillion of foreign income in overseas banks.

Transportation groups also have some concerns about Trump's infrastructure plan. Bud Wright, executive director of the American Association of State Highway and Transportation Officials, said tax credits are not a long-term solution.

"We're sort of agnostic about the tax credits," Wright said. "We're not opposed to the idea, but it is not the long-term funding solution that we need to repair the deficit in the Highway Trust Fund."

Federal tax credits are not transportation user fees, he said.

"A one-off, short-term type of program like that would be useful but it does not do anything for the long-term sustainability of federal transportation funding," Wright said. "Corporate tax reform is not really a transportation issue either, but in some circles it has been linked to infrastructure funding as well. Again, it's not something we oppose but it is not a solution."

However, Wright concedes that Increases in the federal gasoline tax are not likely. "The fuel tax is the best understood and most administratively effective revenue source there is but it is about as politically volatile as any issue I've seen in Washington," he said. "That goes for Democrats as well as Republicans. There's just a knee-jerk reaction to oppose it."

Jim Tymon, chief operating officer and director of policy at AASHTO, said, "I think we'll see an infrastructure package coming out of Congress, probably not quickly but certainly within the first year."

As always, the sticking point will be how to pay for increased infrastructure spending, he said. "We'll have to see what sort of pay-fors and offsets are available and acceptable," Tymon said.

Regulatory Moratorium

Trump has also proposed a moratorium on new regulations, which could thwart the Municipal Securities Rulemaking Board initiatives on markup disclosure, pre-trade price transparency, and syndicate practices. He has also joined Republicans in calling for a rollback of some existing laws and rules, such as the Dodd-Frank Act, which provided more funding for the MSRB from the enforcement of muni rule violations and subjected muni advisors to federal oversight and regulation.

The moratorium and rollback raise questions about whether the Securities and Exchange Commission and MSRB will continue to move forward with muni market initiatives, said Vahey.

"As of right now, if you look at the types of things that have been impacting the muni market, especially on the retail and regulatory side, they're all born out of the 2012 [Report on the Municipal Market]," he said. The report came out of the SEC with bipartisan support, but the expected changeover in the administration raises questions about whether such support will continue.

Vahey said that from BDA's perspective, the biggest issue with regulation specifically in the muni market has been its scope, pace, and the amount of change that has come in the last five years.

"Could dealers use a breather from reg compliance changes and time to adapt to a new environment? Yes," Vahey said. "Is there at the same time some potential negatives out there to a regulatory moratorium across the entire economy? Potentially, yeah."

Matt Fabian, a partner with Municipal Market Analytics, said that it is easier to imagine Trump would appoint industry-friendly individuals to fill the chair and vacant commissioner slots at the SEC. Mary Jo White is expected to step down as chairwoman.

Uncertainty

But one of the biggest concerns about Trump, reflected in the plummeting financial markets Tuesday night and Wednesday, is the uncertainty surrounding him.

Fitch Ratings said Trump's policies would be "negative for U.S. public finances" because of uncertainties about the detail of his proposals, the degree to which he'll promote them, and his ability to implement them. Senate Democrats will still be able to filibuster Republican legislation they don't like, the rating agency pointed out.

Samuels stressed that Trump is a "great unknown" for the municipal market because of his campaign's overall lack of detail regarding economic advisors and plans. "We really don't understand who will be running economic and tax policy," he said. "The situation is very unclear."

Vahey said, "He's not an in-the-box Republican, adding, "He doesn't have a voting record and is very light on details.”

The Bond Buyer

By Evan Fallor, Jack Casey, Jim Watts, and Lynn Hume

November 9, 2016