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States to Battle White House for Tax Deduction, Muni Exemption.

States and cities are fighting to preserve a deduction for taxes paid to local governments after the White House's tax plan said it would jettison the popular tool.

Local governments say elimination of the deduction amounts to double taxation of its residents. Supporters of the president's plan, however, say states are protecting a deduction for the wealthy, and elimination of the alternative minimum tax would offset losing the deduction.

President Donald Trump's tax proposal, announced April 26, calls for an end to all itemized deductions for individual taxpayers, with the exception of mortgage interest and charitable contributions.

It fails to mention the tax exemption given for the interest earned from municipal bonds, the popular funding source for public projects like bridges and roads that appeal to investors.

But since the proposal was unveiled, many states and cities said they feel attacked by the White House's plan.

'Extremely Concerned'

"We are extremely concerned that President Trump's proposal includes eliminating the deductibility of state and local taxes," said a statement from the Big Seven, a coalition of state and local government groups. "The state and local tax deduction and tax-exempt municipal bonds were part of the original tax code in 1913 and have long served to meet critical needs in our communities."

Representatives of local and state governments around the country immediately began calling members of Congress after the White House's tax plan was announced, according to a staff member of a ranking Republican member of the House.

"I'd be very surprised if either the deduction" or the municipal bond exemption "were seriously in danger, but you never know," he told Bloomberg BNA. "If the president wants this, the president will lose, I think."

Wealthier states, such as New York and California, will press the hardest to protect the deduction for state and local taxes, Jared Walczak, policy analyst for the conservative-leaning Tax Foundation, told Bloomberg BNA. Those states largely voted Democratic in November.

"Any meaningful program of tax reform will have to take on deductions, credits and exemption that some people really like," he said, "and there's no doubt that high-income taxpayers who benefit from the state and local tax deduction are a powerful constituency."

Big Apple Deductions

New Yorkers claimed $68 billion in itemized deductions for state and local taxes in 2014, according to an analysis by the conservative Empire Center for Public Policy. The average deduction in New York for state and local taxes was $21,038 that year.

The hardest-hit New Yorkers will be those earning $1 million or more, E.J. McMahon, Empire Center's founder and research director, said in a blog post.

Elimination of the deduction "would do serious damage" to New York City, city Comptroller Scott Stringer said in a statement. "This isn't a plan to deliver growth, it's a recipe to destabilize our economy and widen the gaps between the wealthiest and those most in need," he said.

Analysis conducted by the comptroller's office showed that almost 40 percent of the city's single parents would face an increased tax bill, Stringer said. That includes 47 percent of single parents who make $25,000 to $50,000 and 75 percent of those who make $50,000 to $100,000, he said.

More than 95 percent of city taxpayers with income between $500,000 and $1 million, and almost 92 percent of those with income above $1 million, would pay the same or less in taxes than they do today, according to the preliminary analysis.

On average, the tax bills of the city's millionaires would decrease by $200,000 under Trump's plan, Stringer said.

More than one-third of city taxpayers with incomes between $50,000 and $250,000 would pay more in taxes if the broad White House plan were enacted, he said.

California 'Calculus'

California taxpayers would also be injured by the Trump proposal, state Sen. Robert Hertzberg (D) told Bloomberg BNA.

"It has changed the calculus tremendously," he said. "It's going to require us to modernize our tax code."

Hertzberg favors a sales tax on services—or what he calls a consumption tax—that would be deductible. The pressure the Trump plan would put on state and local governments to reduce their own tax burdens creates an opportunity to enact wholesale changes such as those he proposes, Hertzberg said. Business and labor representatives are telling the senator that they would be more open to his proposal if the Trump plan is enacted.

More than 30 percent of federal returns from California taxpayers claim the state and local tax deduction, with an average claim of $17,100, according to 2014 data compiled by the Tax Policy Center at the Urban Institute and Brookings Institution. Only Connecticut, New Jersey and New York have more claims with higher average amounts.

Maryland was home to the greatest percentage of deduction takers. Forty-five percent of Marylanders claimed the deduction in 2014, according to the Tax Policy Center. The average deduction was $12,400.

Double Taxation?

Individuals who claim the deduction will face double taxation if the White House plan becomes law, according to the Big Seven, which represents the National Governors Association, the National Association of Counties, National League of Cities, the U.S. Conference of Mayors, Leaders at the Core of Better Communities, the National Conference of State Legislatures and the Council of State Governments.

Elimination could “effectively increase marginal tax rates and shrink disposable income, potentially harming the U.S. economy,” the Big Seven said in the statement. “Further, any alterations to the deduction would upset the carefully balanced fiscal federalism that has existed since the permanent creation of the federal income tax over 100 years ago.”

Colorado Gov. John Hickenlooper (D) said on CNBC April 27 that the loss of the deduction would mean double taxation.

“We’ve never done that before,” he said. “This is kind of a contract we’ve had between the federal and local and state governments.”

New Jersey Gov. Chris Christie (R), who was among Trump’s top advisers during the campaign, told reporters he has concerns about the loss of the deductions, but wants to “look at the entire plan” before passing judgment.

Christie told a group of reporters after the Commerce and Industry Association of New Jersey‘s annual luncheon “I haven’t seen the whole plan yet, so we can’t jump to conclusions about it. It raises a concern for the governor of a higher tax state if you’re going to take away the deductibility of state and local taxes.”

The White House plan, a one-page document, was unveiled April 26 by Trump’s top economic adviser Gary Cohn and Treasury Secretary Steven Mnuchin.

Pushback Coming

While Christie’s response was measured, lawmakers from other parts of the country, including Missouri, expect to push back strongly if the drive to end the deduction picks up steam.

“Pushback is likely putting it mildly,” Mark Haveman, executive director of the Minnesota Center for Fiscal Excellence, told Bloomberg BNA. “It would be an all-hands-on-deck assault. We are very dependent on our very progressive income tax and that dependency is enabled by state tax deductibility.”

Minnesota taxpayers would be disproportionally impacted because a high percentage seek the deduction and the state and local burden is relatively high, Haveman said. Internal Revenue Service data shows 35 percent of taxpayers claimed the deduction in 2014, and the average deduction was 6.2 percent of adjusted gross income, placing Minnesota on the top 10 list of states benefiting from the deduction.

Regressive or Not

Walczak said the state and local tax deduction is one of the more “unusual features” of the otherwise highly progressive federal income tax code because “it represents a transfer from lower income individuals and lower tax states and localities to higher income individuals and higher tax states and localities.”

The issue, for Walczak, is what the deduction incentivizes. The cost of government in wealthier states is being “subsidized by the rest of the country.”

"If you think that this cheaper cost of government in higher income states and localities leads to more spending on social assistance for lower income individuals, maybe the system as a whole isn't that regressive even if the tax component is," he said.

Alternative Minimum Tax

Elimination of the deduction isn't the end of the story for taxpayers, McMahon said.

Trump's proposal to double the standard deduction would essentially offset the elimination of deductibility of state and local taxes for taxpayers in lower brackets, he said. And when it comes to high-income taxpayers, elimination of the alternative minimum tax would offset a large portion of the loss of the deductibility of state and local taxes for those earning between $200,000 and $500,000, according to analysis by the Empire Center.

The alternative minimum tax is a supplemental income tax in addition to baseline income tax for certain individuals, corporations, estates and trusts that have exemptions or special circumstances allowing for lower payments of standard income tax.

Thomas Shimkin, legislative counsel and director of the Multistate Tax Commission, told Bloomberg BNA that the alternative minimum tax strips out some or all state and local deduction when they represent too high a proportion of deductions or income.

"Of course, the answer will vary by individual tax situation," Shimkin said.

Municipal Bond Exemption

Meanwhile, states will continue to protect the exemption to interest earned from municipal bonds, even though the White House didn't mention it in the tax proposal, Susan B. Hirschmann, chief executive officer of the independent Washington lobbying firm of Williams and Jensen PLLC, told Bloomberg BNA.

"I've been in D.C. long enough to know that an initial Executive Branch proposal, regardless of the administration, is a very long way from what eventually becomes law," she said.

That means those interested in "preserving the current tax treatment of municipal bonds as the most effective and efficient way to fund infrastructure projects need to continue working with the Municipal Finance Caucus to ensure this important tax treatment is maintained," she said.

Michael Decker, managing director and co-head of the municipal securities division of the independent Securities Industry and Financial Markets Association, said that some top congressional and White House leaders have suggested that curtailing or eliminating some tax deductions and exclusions should be a component of tax reform.

"And while the tax exclusion for municipal bond interest brings important economic benefits, municipal bonds are the single most important source of capital for financing infrastructure," he told Bloomberg BNA.

Hickenlooper said the federal government appears to be moving toward cost shifting.

"In other words, shifting the burden of costs back onto municipalities and counties, you know, local governments, just at a time when the federal government is telling us, 'Well, you're going to have to raise more money to build your bridges and your roads,'" he said. "It doesn't seem wise to me on the surface."

Philadelphia Mayor Jim Kenney said ending the exemption would be misguided.

“Anything that takes away incentives for municipalities to invest in infrastructure would be moving in the wrong direction,” Mike Dunn, Kenney’s spokesman, told Bloomberg BNA in an email.

Bloomberg BNA

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April 28, 2017

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