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U.S. Tax Reform Poses More Risks for State and Local Governments.

CHICAGO/NEW YORK — State and local governments could suffer hits to revenue collections under the tax reform bills being considered in the U.S. Senate and House because of the potential loss of a federal subsidy applied to bond issues and because a proposed increase in the standard taypayer deductions would affect some states.

These additional risks to state and local governments are coming to light as lawmakers and experts sift through the bills before the two chambers.

State and local governments have already been grappling with the potential revenue-raising risks of provisions in the two bills that would eliminate or cap taxpayer deductions of state and local income, sales and property taxes from their federal tax bills.

Analysts on Wednesday said that the U.S. House of Representatives bill, which was unveiled Nov. 2, could knock out a federal subsidy applied to billions of dollars of bonds sold by states and local governments in the aftermath of the Great Recession.

The threat to the subsidy was disclosed in correspondence this week between the Congressional Budget Office and Representative Steny Hoyer, a Democrat who was seeking more details about the effects of the House tax bill.

Build America Bonds (BABs) were created under an economic stimulus law that allowed municipal issuers to sell for a limited time taxable debt with the federal government contributing 35 percent of interest costs. Between April 2009 and the end of 2010, $181.5 billion of BABs were sold in 2,351 issues.

The future federal subsidy on the $13.5 billion of BABs sold by California, the biggest issuer of the debt, totals $6.7 billion, according to the state treasurer's office.

"Rather than follow through on an earlier Congressional commitment to reimburse states for the costs of issuing Build America Bonds, which were used to jumpstart our Great-Recession-decimated economy, Congress instead wants to allow our nation's wealthiest tycoons to feed deeper at the public trough," California Treasurer John Chiang said in a statement.

"As a result California taxpayers will be on the hook for $6.7 billion that could otherwise be used for education, public safety, and other vital public programs," he added.

The U.S. government's payment on BABs became subject to federal across-the-board spending cuts known as sequestration, resulting in subsidy cuts that ranged from 8.7 percent in 2013 to 6.6 percent in the current fiscal year, according to the Internal Revenue Service.

The Congressional Budget Office said this week that the estimated $1.5 trillion increase over 10 years in the federal budget deficit under the House tax bill would, in fiscal 2018, wipe out funding for many programs subject to sequestration under federal law.

That would leave BABs issuers without a federal subsidy, according to Bill Daly, governmental affairs director for the National Association of Bond Lawyers.

But Congress has the ability to protect the BABs' subsidy.

"Seems to us it's entirely a budgeting problem and all the Congress has to do is say the deficit will not be subject to sequestration," said Philip Fischer, municipal research strategist at Bank of America Merrill Lynch.

So far in 2017, BABs have notched total returns of 7.17 percent, outpacing other fixed-income classes including U.S. Treasuries and corporate bonds, according to Bank of America Merrill Lynch indexes.

In addition, big increases in federal standard deductions in both the House and Senate bills could cause revenue problems for eight states unless they take preemptive legislative action.

For Colorado, Idaho, Minnesota, Missouri, North Dakota, South Carolina, Utah and Vermont a rise in the federal deduction would automatically increase the state deduction, decreasing tax collections, according to Ron Alt, senior manager of research at the Federation of Tax Administrators.

By REUTERS

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