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Lawmakers Target the Tax-exemption for Municipal Bonds……..Again.

The Internal Revenue Code and corresponding Treasury Regulations encourage taxpayers to participate in various activities by using subsidies (including deductions, exclusions, and other tax preferences) often referred to as "tax expenditures."[1] For example, there is a strong federal policy in favor of employer-provided health insurance. To accomplish this, employer contributions to pay for employee health insurance plans are not taxed as income to the employee, but the employer is still permitted to deduct the expense as an ordinary and necessary business expense. Likewise, there is a strong federal policy in favor of permitting low-cost financing options for certain borrowers (e.g., municipalities, tax-exempt organizations) and for certain projects (e.g., airports, docks and wharves, etc.). In furtherance of this policy, interest on certain types of debt is exempt from federal income taxes.

The Tax Foundation periodically compiles a list of the largest tax expenditures, and I have included the list from 2014 here.

Any expenditure on this list would, if eliminated, result in increased tax revenue for the federal government. As a result, the majority of expenditures on this list are periodically challenged by lawmakers. Not surprisingly, certain expenditures are more assailable than others.

Unfortunately, lawmakers have targeted (see previous post for one such instance) the exclusion of interest on state and local bonds as an expenditure that may be able to be eliminated (or limited by an interest rate cap) without sacrificing political capital. Interestingly, the expenditure has been targeted notwithstanding the fact that its elimination would only result in an additional $34 billion in revenue for the U.S. Treasury.

The Blueprint Heard Round the World

On Friday, June 24th, House Republicans released a blueprint for tax reform. Although the blueprint does not reference municipal bonds, it does mention repealing unnamed special-interest provisions which could be interpreted as calling into question municipal bonds' tax-exemption. Over the last few years, the President and various members of Congress have proffered proposals to eliminate or cap the tax exemption for interest on municipal bonds, all of which have been scrapped amid a slew of criticisms. In addition, the blueprint put forward by Speaker Ryan calls for a reduction of the corporate income tax rate to 20%; a reduction in individual tax brackets to three from seven and a reduction of the top rate to 33%; and a repeal of the Alternative Minimum Tax ("AMT").[2]

Very generally, it is cheaper for issuers to finance eligible expenditures using proceeds of tax-exempt debt because the yield on tax-exempt debt is less than the yield on taxable debt. The reason for this spread is that bondholders do not pay tax on the interest from the debt; therefore, bondholders are able to earn the same return as taxable debt without needing to be compensated for any tax liability. All things held equal (they aren't but let's imagine that they are), a bondholder that is subject to U.S. tax is indifferent as to whether it will invest in tax-exempt or taxable debt because the bondholder's return will be the same.

Because the spread in yields between tax-exempt and taxable debt is primarily to compensate the bondholder for taxes, the spread is correlated with federal income tax rates. As income tax rates go down, the spread also decreases, making tax-exempt debt less attractive to investors. Therefore, the overall reduction in the corporate and individual income tax rates suggested in the blueprint could cause the yields on tax-exempt debt to increase in the future to attract investors.

However, one of the proposals in the blueprint is extremely positive for municipal bond issuers – the blueprint proposes to eliminate the Alternative Minimum Tax ("AMT") in its entirety. Although interest on tax-exempt bonds is excluded from the federal income tax, the interest on many types of bonds (e.g., exempt facility bonds) remains subject to the AMT for many bondholders. Many bondholders and potential bondholders are subject to the AMT. In effect, for these bondholders, they have unexpectedly taxable bonds. Therefore, eliminating the AMT would increase the value of the tax-exemption for certain bonds and decrease the borrowing costs for municipal issuers. An elimination of the AMT would be a positive development for municipal bonds, but only so long as the exclusion for municipal bond interest is not repealed. If it is repealed, then the repeal of the AMT becomes a moot point.The blueprint contains only broad goals for reducing tax rates across the board. There are many significant issues that must be addressed and specifics that must be explained before the plan has a chance of becoming law. The blueprint should be watched to follow how the proposed plan develops and what tax expenditures, if any, the House of Representatives ultimately decide should be eliminated.

[1] While this blogger appreciates that the complexities of the federal tax laws are viewed by many as overly burdensome, one has to marvel at the ability of the federal tax laws to manipulate the US economy by influencing the spending habits of US Citizens.

[2] A more comprehensive discussion on the blueprint can be found here.

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