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GOP Expected to Take Aim at Local Tax Deductions.

State and local governments are fighting to avoid becoming big losers in tax reform — and they hope President-elect Donald Trump will be an ally.

Trump and congressional Republicans are aiming to pass tax-reform legislation this year that lowers rates and curbs and eliminates tax breaks.

In the process, two key preferences important to state and local governments, the deduction for state and local taxes and the tax exemption for municipal bonds, may be on the chopping block.

The two preferences are among the most expensive provisions in the tax code. They are also viewed as disproportionately benefiting upper-income people.

Of the two, the state and local tax deduction, which tends to benefit areas that lean Democratic, looks to be more endangered.

A 2015 paper from the Tax Foundation found that the 10 counties that benefit the most from the deduction are located in New York, New Jersey, California and Connecticut.

House Republicans are currently drafting a bill based on a tax-reform blueprint they released in June. That plan would eliminate the state and local tax deduction, since it does away with all itemized deductions except those for mortgage interest and charitable giving.

House Ways and Means Committee Chairman Kevin Brady (R-Texas) said at a Heritage Foundation event in December that he thinks there's "merit" to eliminating the deduction while also lowering rates.

"The added benefit here is that the federal tax code will no longer subsidize higher taxes at the local level," he said. Brady acknowledged that eliminating the deduction would be a big change and asked the public to look at his plan and provide feedback.

The tax plan Trump released in September did not specifically mention the deduction but would cap itemized deductions at \$100,000 for individuals and \$200,000 for married couples.

Groups representing state and local governments are concerned about the elimination of the deduction because it could reduce the government's flexibility to make tax changes.

"We're big proponents of federalism and we feel this strikes at the heart of it," said Brett Bolton, principal associate for federal advocacy at National League of Cities.

Emily Brock, director of the Government Finance Officers Association's federal liaison center, said her group is asking Congress "to honor the commitment they've made which is the partnership between the federal government and state and local governments."

Max Behlke, director of budget and tax policy at the National Conference of State Legislatures, said

states with high income taxes are “very wary” about the deduction being eliminated. If the deduction is eliminated, the states could face pressure to lower their taxes.

It’s “definitely possible” that Trump could be sympathetic to keeping the deduction because he’s from a state with a high income tax. However, Trump may defer to Congress on taxes, Behlke said.

The municipal bond tax exemption is more likely to be preserved than the state and local tax deduction, and its preservation is the top tax reform priority for state and local governments.

The exemption allows state and local governments to have lower borrowing costs when they issue debt to finance infrastructure projects.

The House Republicans’ tax-reform blueprint and Trump’s tax plan are both silent on the municipal bond tax exemption, though the blueprint discusses eliminating tax breaks that benefit special interests.

But during a meeting at Trump Tower last month, Trump told a group of mayors that he supports the tax exemption.

While state and local governments are encouraged by Trump’s comments, they are still concerned that changes to the tax exemption will be made. Many of the details about what will be included in tax-reform legislation is unknown, and many of the policy positions of the incoming administration are not firm.

“It’s positive, but again, tax reform still has to go through Congress,” said David Parkhurst, general counsel of the National Governors Association.

Groups held a briefing for Capitol Hill staff on the municipal bond exemption in late November, and they are meeting with lawmakers on the Hill to educate them about the importance of the exemption.

On Tuesday, groups in a public-finance network sent lawmakers a letter in support of tax-exempt bonds.

“They are the best way to implement the infrastructure needs of each community effectively, as the decision to issue bonds for various projects is determined and approved by either the citizens themselves through bond referenda or their elected legislative bodies,” the groups said.

The exemption does have support on Capitol Hill, including from some Republicans. Last year, Reps. Randy Hultgren (R-Ill.) and Dutch Ruppersberger (D-Md.) launched a municipal finance caucus.

“Tax reform is complex and wrought with many pressures,” Hultgren said in a statement. “I hope to see this key financial tool, which has worked for more than a century, maintained in a much-needed comprehensive tax reform package.”

THE HILL

BY NAOMI JAGODA - 01/10/17