Municipal Bond Legislation and Regulation

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The tax-exemption is under threat.

1 The political agenda is dominated by deficit and debt reduction and tax reform.

2 House and Senate tax writers are drafting tax reform legislation.

3 The tax exemption is facing threats from both sides.

4 Mini “fiscal cliffs” could still be a threat.

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Numerous proposals have been floated to curtail or eliminate the tax-exemption for municipal bonds.

1. The Obama administration's FY2014 budget would impose a 28-percent cap on the benefit to taxpayers of tax-exempt interest, including all outstanding bonds.
2. Rep. Camp's Tax Reform Act of 2014 would impose a partial tax on municipal interest for some taxpayers and eliminate certain types of financing.
3. The Bipartisan Tax Fairness and Simplification Act of 2011 (S. 727, the "Wyden-Coats bill") would replace new tax-exempt bonds with tax-credit bonds and prohibit advance refundings.
4. The National Commission on Fiscal Responsibility and Reform ("Simpson-Bowles") proposed eliminating the tax-exemption on all new issues of municipal bonds.
5. The Bipartisan Policy Center's Debt Reduction Task Force ("Domenici-Rivlin") proposed eliminating the tax-exemption on all new issues of private-activity bonds.
6. The Obama administration's deficit reduction framework proposed a contingent cap on the benefit of tax-exempt interest, including outstanding bonds, based on whether certain debt-to-GDP targets are met.
7. The Joint Committee on Taxation's tax reform "experiment" document would repeal the tax-exemption for new issues after 2012.
8. The Congressional Progressive Caucus' "People's Budget" would replace tax-exempt bonds with direct-pay bonds.

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Rep. Camp's Tax Reform Proposal

1 On Feb. 26, House Ways and Means Committee Chairman Dave Camp released a draft of the Tax Reform Act of 2014.

2 Key provisions affecting the tax-exempt bond market:

- 10-percent tax on tax-exempt income earned by couples with "modified adjusted gross incomes" greater than $450k and individuals greater than $400k. Applies retroactively.
- Prohibition on advance refundings.
- Prohibition on private-activity bonds (broad definition).
- Elimination of bank qualified bonds.
- Elimination of tax deferral for market discount bonds.

President Obama’s Budget

1. 28-percent cap is back, based on tax rates. Begins at $226,850 of taxable income for couples (33-percent bracket for 2014).
2. “Buffet Tax” would not affect tax-exempt interest.
3. America Fast Forward Bonds: Build America Bonds with 28-percent subsidy rate. 501(c)(3)s would be eligible.
4. Market discount changes would have implications for issuers.
5. Repeal remaining elements of $150 million cap for non-hospital 501(c)(3) borrowers.
6. Arbitrage simplification: Eliminate yield restriction and expand small issuer exemption.
7. Permit private use of bond-financed research facilities.
8. Permit up to 35 percent of private activity bonds to be used for land acquisition.
9. Others.

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Political landscape

1. Tax-exemption being characterized more as a benefit for wealthy taxpayers and less as a benefit for state and local governments.
2. Sense that all must "bear some pain" to address fiscal issues.
3. "Sacred cows" eroding.
   - Mortgage interest deduction
   - Charitable contribution deduction
4. Tax reform may be coming in 2015.
   - Focus will be lower rates and fewer preferences.

Tax-exemption: Key Talking Points

1. The tax-exemption has existed since the first federal income tax in 1913. It is not a loophole.
2. Eliminating tax-exempt finance would raise borrowing costs 200-300 basis points for state and local governments.
3. Investors already pay an implicit tax on municipal interest by receiving a lower pre-tax rate of return.
4. The administration's proposal to impose a 28-percent cap on the tax-exemption would raise state and local borrowing costs by 50-100 basis points.
5. Tax-exempt bonds have financed trillions of dollars of the nation's public infrastructure. Infrastructure is underfunded, and raising the cost will result in less investment.
6. A tax on municipal bond investors would be borne not by those taxpayers but by state and local governments in the form of higher borrowing costs.

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SEC Municipal Advisor Rule

1. The SEC's Municipal Advisor Rule was finalized in September 2013, takes effect on July 1, 2014.
2. Municipal advisors will be subject to a fiduciary duty.
3. Rule will also affect investment banking activity. A dealers could be considered municipal advisors unless:
   - The dealer is "engaged" by the bond issuer;
   - The issuer certifies that they have engaged an "independent, registered municipal advisor" and are relying on the advisor for advise; or
   - The dealer is responding to a request for proposals.
4. A dealer could also become a municipal advisor if providing advice on the investment of bond proceeds.

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What to expect as the MA effective date approaches

1 Dealers may request to be “engaged.”
2 Dealers may request “IRMA letters.”
3 Dealers may request an acknowledgement that you have issued a RFP.
4 Dealers may ask you to certify that deposit and investment accounts do not contain bond proceeds.

MSRB Rulemaking for MAs

1 New proposed MSRB Rule G-42
  - Would prohibit “principal transactions” for municipal advisors;

2 Supervisory responsibilities

3 Qualifications and testing

4 Political contributions and gifts