By Ed Oswald

Anyone picking up a newspaper today is likely to find an article on federal tax reform. Such articles range from a description of limited corporate tax changes to comprehensive tax reform for both business and individuals. In any event, proposed changes to the existing tax code are being discussed in Washington D.C. on a frequent basis. Much of the current debate regarding the need to change the existing tax system centers around enhancing economic growth, equity for the middle class, efficiency, return of offshore capital, corporate inversions, job creation and investments. If you listen to the debate regarding investments, you will observe that both political parties in Congress are focused on the growing need to rebuild the nation’s aging infrastructure. This need should not be a surprise to anyone who drives a car, takes mass transit or travels by air. Indeed, the 2013 American Society of Civil Engineers report provided the United States with an overall infrastructure grade of D-plus, noting that upwards of $3.6 trillion of investment is needed by 2020 to obtain an overall “B” infrastructure grade.

Investing in infrastructure also is a priority for the Obama Administration. The Build America Investment Initiative, the Interagency Infrastructure Finance Working Group and a proposed assortment of State and local government financing tools in the 2016 budget are examples of the Administration’s commitment to this policy area. Among other things, the 2016 budget includes a re-proposal of America Fast Forward Bonds (a form of direct-pay bonds similar to Build America Bonds), and new Qualified Public Infrastructure Bonds (an improved version of qualified private activity bonds which may be used for financing certain governmental-ly-owned infrastructure).

Importantly, the 2016 budget also includes a number of tax simplifications which benefit State and local governments. One such example is a proposal to establish a bright line 10% private business use test. Under existing law, the permitted amount of private business use may be reduced to as low as 5% if the private business use financed by the governmental issue is either “disproportionate and/or unrelated” to the governmental purpose of the issue. Despite the merit of this proposal, a bright line 10% private business use test cannot be fully achieved without the repeal of both $15 million limits implemented as part of the Tax Reform Act of 1986 — one of which applies to governmental utility bonds and the other to all types of governmental bonds. In the alternative, at a minimum, these specific dollar limitations should be adjusted to today’s dollars to reflect inflation since 1986 and, thereafter, for annual inflation.

Despite these helpful public finance initiatives, the Administration’s 2016 budget also re-proposed a limit on the tax value of specified deductions and exclusions from adjusted gross income to 28% for high-income taxpayers. As in recent Administration budgets, the interest on tax-exempt bonds is among the specified exclusions. Given the Administration’s focus on infrastructure investment, a partial tax on the primary tool that State and local governments utilize to finance capital projects appears to be misplaced. One can only speculate that perhaps the exclusion of interest
on tax-exempt bonds was initially grouped with other tax preferences without reflection of its primary purpose and history. Nevertheless, like many things in political Washington, it is difficult to take something off the table once it has been offered. In the current legislative environment, with an increased focus on middle class fairness and a search for additional tax revenue, it’s not hard to imagine that increasing taxes in this stealthy manner on higher-income taxpayers might prove to be the path of least resistance.

As the winds of tax reform and infrastructure spending swirl in Washington, the time is right for a frank discussion of the comprehensive restrictions on the use of tax-exempt financing and the legacy of the 1986 Tax Reform Act. These tax law restrictions can frustrate other federal policy priorities and can harm State and local governments more than such restrictions might benefit the federal treasury. As national transportation, energy and infrastructure policy is being formulated, it is time to reassess the complexity of the existing tax regime regarding State and local financing. Much of the existing tax policy governing municipal finance was born in the early to mid-1980’s. There can be little doubt that the United States, its domestic investment needs, the forces of global economic competition and matters of homeland security, including the need for public asset resiliency and design redundancy, have changed significantly since that time period. Tax-exempt bonds, a primary tool needed to meet the present day challenge of modernizing and maintaining critical infrastructure assets, should not be governed by laws and policies reflecting priorities and concerns of a different time and age. To properly address these evolving concerns, a new spirit of cooperation is needed between federal, State and local governments. This improved level of cooperation should emphasize and facilitate public-private partnerships and other arrangements financed with tax-exempt bonds to permit State and local governments to more fully benefit from private capital and the efficiencies of participating with the private sector.

The dialogue at the present time provides an opening for State and local governments to educate members of Congress and their staff about municipal bonds, how they work and what they do. One might assume that policymakers are fully informed regarding the nature of the domestic capital markets, the nature of the tax rules governing municipal bonds, the purposes for which they can be issued and the role that such instruments play in financing infrastructure. In my experience, outside of the various tax committee assignments, that is often not the case. Moreover, it would be folly to assume that most policymakers are aware of the historical underpinning of the interest exclusion — the doctrine of reciprocal immunity.

In the halls of Washington lawmaking, a discussion of tax-exempt bonds can quickly shift to budget scoring, the theoretical inefficiency of the interest exclusion and suggestions that untested and more complex debt instruments, such as tax-credit bonds, are an appropriate replacement. Often lost in these discussions, however, is the fact that State and local governments are partners in our system of constitutional government.

Political and policy movements generally do not move in the same direction and are often at cross-purposes. Nevertheless, as time passes, it is inevitable that the nation will need to face the challenge of rebuilding its infrastructure and the associated costs. Facing this challenge will give rise to changes in the tax code (whether or not Congress falls short of comprehensive tax reform).

At this time of transition and introspection here in Washington, other industries, sectors and interest groups are assembling to meet with policymakers and join the battle. For State and local governments, opportunity knocks.

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