United States House of Representatives
Committee on Ways and Means

Comments to Tax Reform Working Groups:

Debt, Equity and Capital
Financial Services
Charitable/Exempt Organizations

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Bond Dealers of America (BDA) is pleased to submit this statement to the United States House of Representatives Committee on Ways and Means as a part of the written record of the tax reform working groups.

BDA strongly supports the continued exemption from federal taxation for interest earned on municipal bonds. Our comments will focus on the potential impact on the municipal market, investors, and state and local governments if the tax exemption for municipal bonds is altered, replaced or eliminated.

The BDA, with fifty-six members headquartered coast to coast, is the Washington, DC, based organization that represents securities dealers and banks focused on the U.S. fixed income markets. The BDA is the only organization representing the unique interests of national, middle-market, sell-side, fixed-income dealers. In addition to federal advocacy, the BDA hosts a series of meetings and conferences specific to domestic fixed income, and spearheads industry cooperation on economic surveys and on market practice documents. Additional information about the Bond Dealers of America can be found at www.bdamerica.org. BDA is also a member of the Municipal Bonds for America (MBFA), a non-partisan coalition of municipal bond issuers and state and local government officials combined with municipal market professionals working together to explain benefits of the municipal bonds market and the importance of the tax-exempt bond model.

Bond dealers are a bridge between the issuers of bonds to finance infrastructure that serves the public day in and day out, and investors who seek financial security in purchasing the bonds that make public works possible. From assisting school districts in structuring bond issuances that minimize interest costs, to financing new transit systems and critical sewer system improvements, bond dealers and the state and local governments they serve touch nearly every aspect of public life. If the bonds are issued with the prudent advice on the structuring, marketing and liquidity that BDA's members provide, governments and their citizens can make the most desirable economic choices at a local level while enjoying the benefits of public infrastructure.

The Municipal Market and Municipal Bonds have Served Issuers and Investors Well

2013 is the 100th anniversary of the Revenue Act of 1913 that created the first federal tax code in which federal tax-exempt status was granted to interest earned on municipal bonds. This anniversary was recently commemorated in bipartisan House Joint Resolution 112 by Reps. Lee Terry (R-NE) and Richard Neal (D-MA). BDA commends these members for its introduction and encourages Members of Congress to cosponsor this resolution.

The municipal bond interest exemption was granted in recognition of the federal and state separation of powers and buttressed by the 1895 U.S. Supreme Court decision in *Pollock v.*

Farmers' Loan & Trust Co.,[1] which held that federal taxation of interest earned on certain state bonds violated the doctrine of intergovernmental tax immunity. Although in 1988 the Supreme Court concluded in *South Carolina v. Baker* that the Constitution does not explicitly protect municipal bonds from imposition of federal tax,[2] Congress has repeatedly preserved the tax-exempt status and, in doing so, has enabled critical infrastructure to be financed in a cost-effective manner. Intergovernmental tax immunity remains an important principle so that state and local governments may continue to raise capital and make local infrastructure decisions without interference from the federal government.

BDA believes past Congresses made the correct decision to preserve the tax-exempt status for interest earned on municipal bonds and the present Congress and Administration should not use the politically-charged atmosphere of federal tax reform—and any desire to generate significant federal revenues to offset tax cuts or spending increases—to limit or eliminate this valuable exemption.

Municipal bonds are the key mechanism used by state and local governments to finance the nation's infrastructure needs. Three-quarters of the total United States investment in infrastructure is accomplished with tax-exempt bonds, which are issued by over 50,000 state and local governments and authorities. Nearly four million miles of roadways, 500,000 bridges, 1,000 mass transit systems, 16,000 airports, 25,000 miles of intercoastal waterways, 70,000 dams, 900,000 miles of pipe in water systems, and 15,000 wastewater treatment plants have been financed through tax-exempt municipal bonds.[3] Nearly all long-term tax-exempt bonds are issued to finance capital expenditures.

The historical stability of the municipal market and municipal bonds as an investment vehicle for millions of citizens is also a key consideration supporting retention of the tax-exemption. Currently, there is $3.7 trillion worth of capital in the municipal market, with roughly 70% of outstanding bonds held by individuals either through direct investment or indirectly through mutual funds. 2010 IRS data regarding individual income tax returns reveals that 60% of interest income on tax-exempt bonds is reported by taxpayers over the age of 65, and the majority of tax-exempt interest is earned by taxpayers with gross incomes under $250,000. Municipal bonds are the cornerstone of retirement portfolios for many Americans seeking a safe and consistent return on their investments.

<u>The Potential Impact of Proposed Changes in the Tax Laws Governing Municipal Bonds</u>

Recently proposed changes to the tax-exempt status of municipal bonds will have immediate and long-term impacts on issuers, investors and financing costs absorbed by state and local

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[1] *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429, 15 S. Ct. 673, 39 L. Ed. 759 (1895)
[2] *South Carolina v. Baker*, 485 U.S. 505, 108 S. Ct. 1355, 99 L. Ed. 2d 592 (1988).
[3] Council of Development Finance Agencies, "Built by Bonds," 2011.

governments and their citizens. This testimony discusses the impact of two of these proposals – (1) proposals to cap or limit the value of the municipal tax exemption, such as the President's 28% limit on the value of exemptions and deductions, and (2) proposals to expand the utilization of direct-pay or tax credit bonds as a replacement for tax-exempt bonds. As illustrated by the examples below, Congress must be mindful that policies affecting municipal bonds should not be created in a vacuum that denies the current existence of an efficient marketplace that provides the ready source of capital and liquidity needed by state and local governments to find investors for their bonds.

Tax laws and regulations governing municipal bonds have remained largely consistent over the past few decades since the Tax Reform Act of 1986 made sweeping changes to that market, both in terms of the restrictions imposed on issuers of tax-exempt bonds and on investors in those bonds. At the same time, dramatically increased regulation since 1986 on broker-dealers and the municipal securities market, most recently under Dodd-Frank, has lent stability and transparency to the marketplace. In the name of increased market transparency that benefits issuers, investors and taxpayers, broker dealers, fully regulated by the SEC, FINRA and MSRB, must comply with rules governing such issues as comprehensive disclosures to investors, pay-to-play restrictions, licensing requirements, record retention, requirements for fair dealing and many more.

The municipal market has relied on solid regulations and consistent tax law treatment to build a vibrant trading platform that provides effective financing for issuers of every size and type and stable returns for investors. However, economic and political crises trigger volatility in the markets that harm all market participants. The onset of the 2008 fiscal crisis provides an example of the type of turmoil that can occur. In late 2008, economic uncertainty sparked a demand for higher yields on municipal bonds as investors began to incorporate a risk factor into their investment considerations. Such volatility and uncertainty cause needlessly higher bower costs for state and local governments, and policies that invite these elements to the marketplace should be avoided, as explained below.

Proposals to Limit the Value of the Municipal Exemption Damage the Market

Political debate also has tremendous power to stir market turmoil. Recent proposals, such as the President's budget proposal to limit the value of the municipal exemption to the 28% tax rate, have served to inject an element of uncertainty that resulted in a "domino effect" of increased yield demands by investors, increased financing costs to issuers, and reduced valuations of existing bonds. For a period in December 2012, when investors first perceived that the cap could be enacted, municipal bond funds experienced net cash outflows and increases in tax-exempt interest rates. The increase in tax-exempt yields for municipal bonds was 14-40 basis points greater than the increase in Treasury yields at that time.

The impacts would be more severe if a cap -- essentially, a tax -- were to actually be enacted. Analysts predict that the imposition of a retroactive, 28% cap could cause an increase in borrowing costs of approximately 70 basis points. Part of that increase is attributable to a new world in which investors are uncertain what the future tax rate could be of a municipal bond that was once wholly tax-exempt. In other words, if Congress can act once to tax municipal bonds, couldn't it act again in the near-term with an even higher tax, as revenue pressures dictate? And it is state and local government borrowers -- not the wealthy-- who will pay the high price for this uncertainty, with borrowing costs increasing by 15 percent.[4] Those costs could climb even higher depending upon the market's perception of the future tax risk. In essence, investors will demand higher yields to compensate for the cap and to address the uncertainty – and the costs will be borne by the issuers. These higher costs to issuers will result in increased taxes, utility rates, and user fees – and conversely, if these increases are untenable to voters, the higher costs will result in the deterioration of the nation's infrastructure. Beyond borrowers, investors will face significant deterioration of the value of their tax-exempt bonds under a retroactive cap. As mentioned above, many of these investors are seniors who rely upon fixed income for living expenses, with almost 60% of tax-exempt interest earned by taxpayers over 65 years old.

Direct-Pay and Tax Credit Bonds are Not Acceptable Substitutes

Direct-pay bonds (such as, Build America Bonds and recently proposed America Fast Forward Bonds), and tax credit bonds, provide considerably less certainty and flexibility than tax-exempt bonds, and should only be viewed as an alternative or complement to tax-exempt bonds – not a substitute. An overview of direct-pay and tax-credit bond programs, and concerns with those programs, is provided in Appendix A.

By way of background, direct-pay bonds appear to bondholders similar to corporate, taxable bonds. Bondholders receive principal and interest payments from the issuer, and the interest payments are taxable. These interest payments are higher than what the issuer would need to pay to the bondholder if the interest had been tax exempt. Since the interest payments are higher, the Federal government provides the state and local government issuer a subsidy to reimburse them for all or part of the interest payments. Depending on the portion of the interest paid by the federal government, direct-pay bonds can provide an overall borrowing cost to issuers that is greater than, less than or equal to the borrowing cost obtained through tax-exempt bonds.

From the outset, state and local governments and the market as a whole had concerns with direct-pay bonds. For example, many issuers were concerned that the direct-pay subsidy could be reduced due to federal "offsets" for amounts that the federal government, rightly or wrongly, believed that an issuer of direct-pay bonds owed under other unrelated programs. The deeper concern was that the federal government could change the direct pay rate on outstanding bonds.

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[4]National Association of Counties, National League of Cities, United States Conference of Mayors, "Protecting Bonds to Save Infrastructure and Jobs 2013," 2013

Such potential risks were a part of the disclosures to investors and part of the analysis by issuers, but investor and issuer concerns were just that – concerns, with no precedent.

Investor and issuer fears have now been borne out. The market's perception of direct-pay bonds has been dealt a significant blow under sequestration, because the federal government has reneged on its promised subsidy by reducing reimbursement payments by 8.7 percent. (The same negative perception will affect tax credit bonds wherein the bondholder essentially receives a tax credit from the federal government in lieu of interest from the issuer). Sequestration's impacts will have a lasting negative effect on the desirability and marketability of direct-pay bonds, tax credit bonds or any other bonds requiring a federal payment as a component, as issuers and investors will take into account the fact that the federal government has acted in the past to reduce the subsidy. In the future, this very real risk will have to be borne by the issuer or the investor, creating costs and risks for BABs that are not present in tax-exempt bonds.

Compounding this issue is the fact that some direct-pay bonds were issued with provisions that make the bonds callable in the face of federal actions that alter the subsidy. The trading of such direct-pay bonds, under threat of being called, encountered significant headwinds in the marketplace under both the threat and reality of sequestration. This can been seen quite graphically in the example in Appendix B with respect to Columbus, Ohio general obligation Build America Bonds. Investors demanded a huge premium with the specter that the bonds could be called by issuers at par, and uncertainty around the future of the federal subsidy. Spreads between the BABs and relatively stable taxable municipal bonds widened nearly 200 basis points, with the investors demanding a significant premium to buy the bonds – essentially freezing the market for such bonds, and cutting off the flow of capital.

Beyond sequestration, direct-pay bonds and tax credit bonds create a slippery slope for issuers (who are concerned about receiving the subsidy payments) and investors (who may demand a premium for the associated credit and redemption risks). Congress could intervene to lower the reimbursement subsidy in tax bills any time federal budgetary pressures dictate. A basic measure of local control and decision-making about financing local needs would now be shared with the federal government, creating a back-door opportunity to tax state and local governments. State and local governments generally swallowed these concerns in the context of Build America Bonds with their 35% subsidy rate – but at a "revenue neutral" subsidy rate, direct pay bonds are not a better tool for issuers when compared to tax-exempt bonds.

An additional concern about replacing tax-exempt bonds with direct-pay bonds is that direct-pay bonds are sold as taxable bonds in the global financial markets that are dominated by the largest and most highly rated and well-known issuers. Small issuers and lower-rated issuers would not be able to access the marketplace on a cost effective basis as they can with tax-exempt bonds. Simply put, direct pay bonds would cost all issuers more than tax-exempt bonds, and smaller and lower-rated issuers would be cut out of the market unless they dramatically increase interest rates paid to investors.

Tax-credit bonds fare even worse than direct-pay bonds when considered as a replacement for tax-exempt bonds. Among investor concerns are the fact that Treasury sets the tax credit rate (rather than the marketplace); the bond maturity is set by statutory formula; and there is a far more narrow market of investors who have a tax appetite and who want to purchase a novel type of bond.

BDA believes that tax-exempt municipal bonds must remain the cornerstone of the municipal market and that drawbacks associated with other bond products and proposals make them unacceptable if they are proposed substitutes for tax-exempt bonds. Direct-pay and tax credit bond programs should be considered only as additional options. While some policymakers argue that alternative programs are more efficient mechanisms for the federal government subsidy, BDA believes that the market-driven nature of tax exempt bonds without federal interference will be in the big picture, the most efficient model.

A Federal Infrastructure Bank is Not an Acceptable Substitute

Beyond alternative bond programs, a variety of bills and budgets have featured federal infrastructure banks as the solution to infrastructure finance. These entities must be kept in perspective as they cannot meet the significant and growing infrastructure needs nationwide. Federal infrastructure banks strip state and local governments of local control and decision-making authorities – holding local infrastructure needs hostage to federal political whims and federal agency bureaucracy. It is simply inconceivable that a new federal entity will be able to deal effectively with the many thousands of governmental infrastructure projects that are financed each year. In just one example - the federal Transportation Infrastructure Finance and Innovation Act program provides federal credit assistance to finance surface transportation projects. It is perhaps the most successful federal infrastructure program, and yet it finances only a few transportation projects each year.

Bank Qualified Bonds

Small issuers would bear the brunt of increased costs of financing of any proposals to replace tax-exempt bonds with taxable bonds, or limit the value of the interest exemption on municipal bonds. And even under the current tax code, small issuers are sensitive to the costs of issuing bonds and marketing lesser-known bonds to investors. In any update to the tax code through tax reform, the Committee should be mindful of mitigating disproportionate impacts to small issuers.

One update to the Code that useful in this regard is “bank-qualified bonds.” Bank-qualified bonds were established in the 1986 Tax Reform Act to give small municipal issuers of no more than $10 million in bonds in a year more affordable access to capital by helping them to sell tax-exempt bonds directly to local, community banks. This saves small municipal issuers that provide public infrastructure (such as schools, hospitals and roads) higher marketing and professional services costs normally connected with selling their bonds.

Local banks understand the infrastructure needs of local issuers and are willing to purchase their bonds. The tax-code, however, presents a barrier because typically, if a bank borrows money to purchase tax-exempt debt from a municipal issuer, it cannot deduct the interest it pays to borrow that money. Banks, therefore, have a disincentive to buy tax-exempt debt but for the bank-qualified provision, which permits banks to deduct the interest for these small issues.

In an effort to assist smaller jurisdictions, and recognizing that the original $10 million limit was never indexed for inflation, in 2009, Congress increased the annual dollar limit for bank-qualified bonds from $10 million to $30 million. Congress also made 501(c)(3) organizations such as hospitals and small colleges eligible for the provision. Furthermore, in order to facilitate pooled borrowings (where for efficiency, the borrowings of several different issuers are combined), the limitation was applied at the borrower level (rather than the total size of the aggregate issue). These provisions, however, expired on December 31, 2010; at that time, the annual limit reverted to $10 million and the additional improvements expired.

In 2011, a bipartisan bill to permanently re-instate the $30M annual limit, facilitate pooled borrowings, and index the limit it for inflation was introduced by Sens. Bingaman (D-NM) and Crapo (R-ID) and co-sponsored by Sens. Kerry (D-MA), Cardin (D-MD), Grassley (R-IA) and Snowe (R-ME). (Similar, bipartisan bills were introduced in 2008 and 2010). A companion bill was introduced in the House -- H.R. 5705 by Reps. Reed (R-NY) and Neal (D-MA). BDA is hopeful that the tax reform working groups will look to these bills as they examine aspect of the Code that, nearly 30 years after the last tax reform initiative, should be updated.

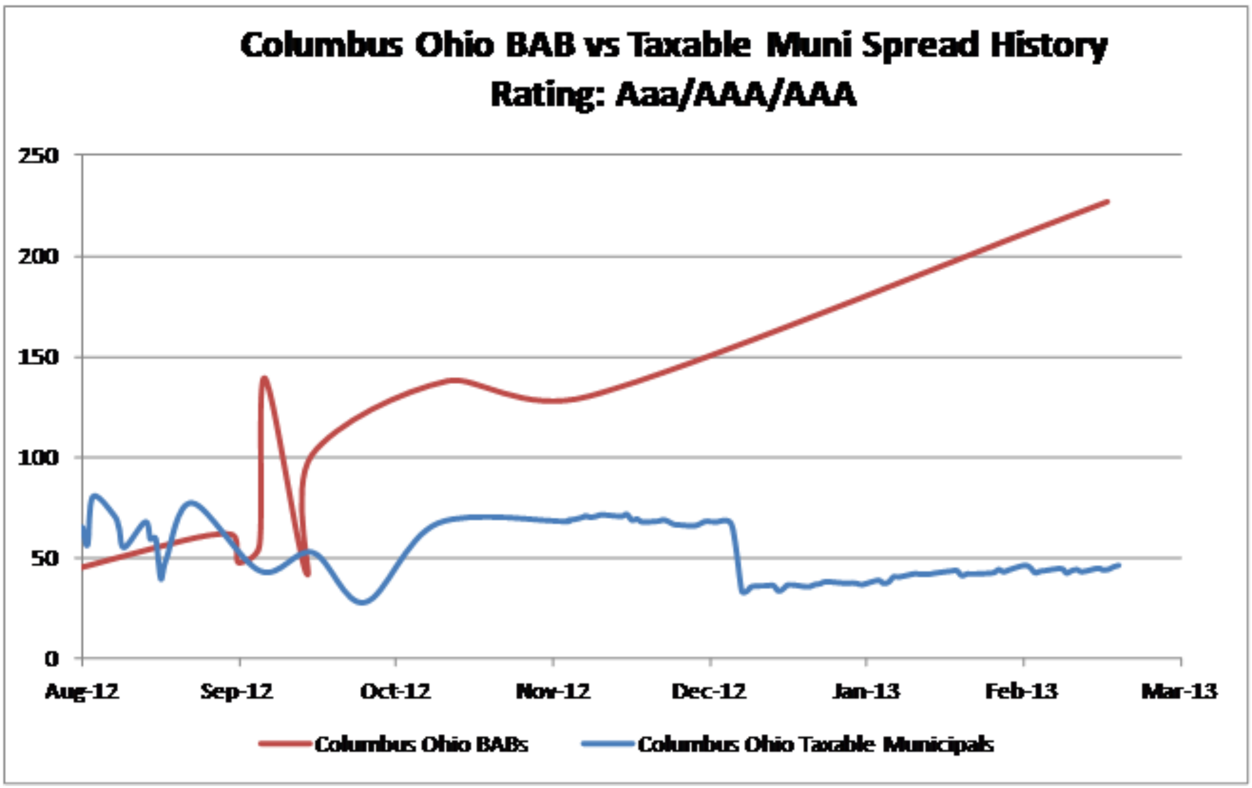
Summary

The municipal market and tax-exempt municipal bonds are the backbone of state and local government finance and a key component in a vibrant federal economy. Congress and the Administration must continue to recognize the vital role that tax exempt municipal bonds play in providing state and local governments with cost-effective financing for capital projects, including roads, bridges, schools, affordable housing, community health and higher education facilities. Ensuring that issuers can continue to fund capital projects by effective means reduces the burden on every taxpayer and all levels of government. Bond Dealers of America urges Congress to reaffirm nearly 100 years of federal tax law by retaining the current tax law treatment of municipal bonds.

APPENDIX A – Marketplace Reacts to Direct-Pay Bond Sequestration

This chart depicts trades on Columbus, Ohio General Obligation Bonds that were issued as direct-pay, Build America bonds and contained par-call provisions. The red line depicts pricing on the several BAB trades related to those bonds; the blue line depicts pricing on Ohio taxable municipal bond trades, which would be unaffected by sequestration.

As investors worried that sequestration would cause the bonds to become callable (red line), the market priced the direct-pay Build America Bonds far higher, when compared to the relatively stable marketplace for taxable municipal (blue line). Spreads widened nearly 200 basis points, with the investors demanding a significant premium to buy the bonds – essentially freezing the market for such bonds, and cutting off the flow of capital.[5]



[5] Source: MSRB Trade Data, Bloomberg BVAL Valuations, Piper Jaffray

APPENDIX B – Tax Credit Bonds and Tax-Exempt Bonds Compared

Type of Bond	Description	Example	Comments
Tax Credit Bond	Taxable bond issued with maturity set by IRS and reduced (or no interest). Investor receives a federal tax credit.	Qualified zone academy bonds	Limited market for tax credits creates real world inefficiencies for this method of borrowing.
Tax Credit Bond-Direct pay (maturity established by Treasury)	Taxable bond issued with maturity established by statutory formula and tax credit rate set under Treasury index. Issuer has a choice of selling it as a tax credit bond with reduced interest (as described above) or selling it as interest bearing but with the IRS paying an interest subsidy directly to the issuer.	New clean renewable energy bonds	The "one size fits all" approach of the Treasury tax credit rate setting process creates inefficiencies and higher borrowing costs. Limited market for tax credits creates real world inefficiencies for this method of borrowing.
Tax Credit Bond--Direct pay (terms set by issuer)	Taxable bond issued at market rates and maturity chosen by the issuer but the issuer has a choice of selling it as a tax credit bond with reduced interest (as described above) or selling it as interest bearing but with the IRS paying an interest subsidy directly to the issuer.	Build America Bonds	Risk of reduced payments due to sequestration or other change in law. Risk of reduced payments due to "offsets" for amounts that the federal government believes are owed by the issuer, even if in dispute. Smaller issuers and lower rated issuers generally incur higher borrowing costs using taxable direct pay bonds.
Tax Credit Bond-Refundable Credit	Taxable tax credit bond issued with reduced (or no interest). Investor receives a refundable tax credit.	Qualified Transportation Infrastructure Bonds	Tax committees are concerned about the precedent of a refundable credit delivered to tax-exempt organizations
Tax-Exempt Bonds	Interest on bonds is exempt to holder	Tax-exempt bonds	The tax exemption mechanism assures that the market, and not the federal government, dictates borrowing costs