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Municipal Bonds are a Mainstay of Public Finance That Must Be Preserved

As the tax-writing committees in the House and Senate advance revenue-neutral tax reform legislation, many of the largest annual federal tax expenditures could be significantly curtailed to raise revenue to offset the cost of lowering tax rates.

For the reasons detailed below, the Investment Company Institute (ICI) urges Congress to preserve the current tax exemption for municipal bond interest.

Municipal Bonds and the Fund Industry

Investment funds provide average retail investors with professionally-managed, diversified portfolios that individuals cannot replicate on their own. The funds represented by ICI provide an efficient and cost-effective means for individual investors to obtain municipal bonds and are a critical part of the municipal bond market.
At the end of the third quarter of 2016, investors held, in the aggregate, nearly $1 trillion of municipal bonds through hundreds of registered investment companies, including municipal bond funds and tax-exempt money market funds. Individual investors held another $1.6 trillion of municipal bonds directly.[1]

Municipalities Benefit From the Tax Exemption

State and local governments accrue the benefits of the tax-exemption upon issuing municipal bonds. State and local governments pay municipal bond holders lower interest rates on their investments, since municipal bonds produce interest payments that are exempt from tax. Investors accept the lower interest rates because the after-tax return is comparable to a taxable bond.

The lower interest rates paid to investors in municipal bonds issued by state and local governments have a long history of providing crucial support for the development and maintenance of essential facilities and services in American communities. State and local government bonds have been tax-exempt since the codification of the federal tax code in 1913.

Retroactive Taxation is Unjust

Proposals to cap or eliminate the tax benefit for municipal bonds—such as the Obama administration's proposal to cap the value of the exemption for municipal bonds at 28 percent[2]—would impose an onerous and retroactive tax on existing bond investments.

Investors in municipal bonds paid an implicit tax on their securities by accepting a lower interest rate when they purchased their investments. Imposing a retroactive tax on their existing investments' interest payments imposes a tax burden for a

[1] At the end of the third quarter of 2016, individual investors held 25 percent of the municipal bond market through mutual funds and nearly 42 percent directly.
[2] The Obama administration proposed a "cap" on the value of certain tax deductions and exclusions—including municipal bond interest—at 28 percent. Neither the House blueprint nor President Trump's tax plan specifically address the taxation of municipal bond interest.

benefit such investors did not receive. It is unfair to impose retroactive taxation on investors, many of whom are seniors, on the basis of an economic benefit that flowed to the states and localities that issued the bonds.

Seniors hold a substantial amount of all outstanding municipal bonds. More than 60 percent of income from municipal bonds is earned by taxpayers over the age of 65.[3] Targeting investors with a punitive retroactive tax on a benefit that they did not receive is inappropriate, especially for investors in their retirement years who may be reliant on the interest paid by their municipal bonds.

The losses imposed on existing investors in municipal bonds would be significant, as repealing or limiting the tax exemption would cause an immediate decline in the value of all outstanding municipal bonds. Experts estimate that a 28 percent cap, such as the one proposed by the Obama administration, would destroy over $200 billion of existing tax-exempt bonds' market value.[4] Seniors would bear almost $120 billion of these losses.

Moreover, retroactive taxation could trigger mandatory redemption provisions in $150 billion of existing municipal bonds. Many municipal bond indentures were written with provisions that force municipalities to immediately redeem any bonds whose tax-exempt interest becomes taxable by operation of a change in the tax laws. Mandatory redemptions of existing bonds will require municipalities to immediately refinance outstanding debt at higher rates.

<u>Necessity of the Municipal Bond Tax Exemption</u>

The $3.8 trillion municipal bond market is the primary financing tool used by states and counties to finance three-quarters of the total U.S. investment in infrastructure, including in schools, roads, bridges, hospitals, sewer and water systems, and other projects that provide essential services. Without the tax-exemption, state and local governments either would pay far more to raise capital—a cost that ultimately would be borne by taxpayers, through higher taxes—or be forced to reduce infrastructure spending.

A study released by four of the major trade organizations that represent states and municipalities reveals the potential impact of limiting or repealing the tax exemption for municipal bond interest. The study found that if the tax exemption was not in place from 2003 to 2012, states and municipalities would have paid nearly $500 billion more in financing costs. If the Obama administration's proposed 28 percent cap had been imposed over this same period, state and local communities would have paid added interest charges of $173 billion.[5]

<u>Conclusion</u>

ICI believes that retaining the current tax exemption for municipal bond interest is consistent with Congress' goal of improving and simplifying the tax code in a manner that spurs economic growth.

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[3] IRS Statistics of Income Division, 2014.

[4] George Friedlander, Mikhail Foux, and Vikram Rai, *US Municipal Strategy Special Focus: The Case for the Tax Exemption Remains Strong, Even As Threats Grow*, Citi Research (October 2012).

[5] The Government Finance Officers Association, *Protecting Tax-Exempt Bonds for Infrastructure and Jobs*, February 2013.