



## **PUBLIC POLICY STATEMENT**

### **Federal Tax Policy and Preserving the Tax-Exempt Status of Municipal Bonds** **(2005) (DEBT)**

Background. The Government Finance Officers Association has consistently defended the exemption of municipal bond interest from Federal and applicable state income taxation. This historic exemption from taxation of interest on state and local government bonds reinforces our nation's federal system and provides major advantages to communities across America, including:

- Lower costs to fund government infrastructure and services. Hindrance of state and local governments' ability to fund vital public infrastructure and services through tax-exempt financing would require other methods of raising revenues to offset increased financing costs, (increased property, sales, and other local taxes), and/or a reduction in essential services;
- Tax-exempt financing grants state and local governments freedom from the uncertainties of the annual Congressional appropriations process in funding capital needs or any portion of their interest costs; and
- Efficient access to capital markets without delay or interference from the Federal government;
- Although the primary beneficiaries of a particular bond issuance are the citizens of the issuing community, the nation as a whole has a vital interest in maintaining adequate and safe public facilities to support a dynamic economy. The national interest is well served by keeping state and local government borrowing costs low, thereby providing an incentive for public investment in infrastructure.
- GFOA has opposed efforts that curtail the use and attractiveness of tax-exempt bonds. Congress has enacted measures, most notably in the late 1960s and in 1986 that placed severe restrictions on the use of tax-exempt bonds, and these laws continue to apply today. Additionally, many IRS regulations have been adopted that cause enormous administrative, and thus costly, burdens to those entities issuing tax-exempt debt.

Additionally, GFOA supports the following basic principles concerning federal tax laws and proposals that relate to tax-exempt financing:

- No federal tax should be imposed, either directly or indirectly, on the interest paid on state and local government obligations issued to provide services to the public. Examples of direct or indirect taxation are the imposition of the individual minimum tax on the interest on state and local obligations and the inclusion of tax-exempt interest in the income base of social security recipients.
- The GFOA opposes any federal legislation that diminishes the value or impairs the use of tax-exempt bonds. Federal law should not undermine the municipal securities marketplace, nor threaten the tax-exempt status of these investment instruments in any direct or indirect manner.
- The investment of bond proceeds at market rates for a reasonable period of time pending their application for the purposes of the bond issue is efficient financial management. Arbitrage is the term used to describe the interest earned on invested bond proceeds in excess of the interest being paid on the bonds. It reduces the cost of public projects by reducing the total amount of bonds outstanding for a project. State and local governments should not be penalized for practicing good financial management by being required to "rebate" such investment earnings on the proceeds of tax-exempt bonds to the U.S. Treasury or by the imposition of other restrictions. While current law dictates that local and state governments may not earn more interest on their bond proceeds than the interest rate of the bonds, we believe greater flexibility should be adopted, as arbitrage regulations are far too complicated and cumbersome, and increase debt issuance and administrative costs.
- The GFOA has long recognized the federal government's interest in preventing abusive tax-exempt bond transactions. However, the imposition of restrictions on tax-exempt bonds whose sole purpose is to achieve objectives totally unrelated to the proposed restrictions is an inappropriate use of federal regulatory power. Such restrictions would serve only to jeopardize state and local projects and increase project costs.
- Tax credit bond initiatives should be used to enhance the ability for local and state governmental entities to attract new capital, but should not be a replacement for nor be used in a manner that diminishes the value of tax-exempt bonds.
- Regulatory and enforcement action must take into account the costs incurred by local and state governments in complying with such actions.

#### Recommended Policy

The GFOA, in concert with other local and state government associations has long fought for changes in the Tax Code. We support the following initiatives, and encourage Congress and the Department of the Treasury to embrace these proposals when determining the content of tax reform measures as well as proposing new regulations or altering current regulations:

- remove or modify restrictions affecting the issuance of municipal bonds that are overly burdensome and costly such as the arbitrage rebate requirement, and do

not make changes to the Treasury's State and Local Government Securities (SLGS) program that would hinder its use and efficiency;

- recognize a new type of public-purpose, tax-exempt bond or eliminate current law restrictions on tax-exempt financing to permit and encourage public-private partnerships. Treasury should look to provide for greater flexibility of the 10% private use rule, to encourage public/private partnerships. Additionally, private activity restrictions should be relaxed for public use facilities (e.g., airports),
- create incentives for individuals and institutional investors to purchase municipal bonds,
- modify existing federal tax policies related to the alternative minimum tax,
- modify the bank interest deduction to attract a broader base of traditional investors--individuals, banks and corporations--to the municipal bond market,
- modify federal tax policies that impede the development and functioning of state bond banks and bond pools and other state credit assistance programs,
- ensure that federal government enforcement actions with respect to Tax Exempt Bonds are conducted fairly and are directed at the responsible party. Additionally, either through regulatory or legislative means, an independent system should exist for Issuers to access when they are in disagreement with decisions made by federal governmental entities (e.g., IRS, SEC), and
- allow for an additional advance refunding of bonds.

We believe that the federal government should work in partnership with state and local governments to achieve mutually beneficial outcomes, with minimum disruption to these entities and the tax-exempt bond marketplace. We continue to urge Congress, the US Department of the Treasury, and the Internal Revenue Service to engage in meaningful discussions with state and local officials about proposals and concerns they have in the tax-exempt bond marketplace, and always urge public hearings to be held on matters that impact local and state governments.

Approved by the GFOA Executive Board, March 2005.