



Issue Brief: TAX REFORM

Updated March 2008

It is unlikely that Congress will attempt significant tax reform in the 110th Congress. While various legislative efforts have been introduced, the reality of reform during a presidential election year is dim, however, one must keep an eye on 2009.

Background

In 2005, President Bush's appointed an Advisory Panel on Federal Tax Reform to recommend options for making the tax code simpler, fairer, and more conducive to economic growth. In November 2005, that report was delivered to the Treasury Secretary with many proposals, the cornerstone being repeal of the Alternative Minimum Tax. The report also includes many provisions that would be harmful to state and local governments if they became law. Specifically, the Panel recommended eliminating the deductibility from federal taxation of state and local income, sales, and property taxes, and excluding corporations from deducting tax-exempt interest on municipal bonds holdings. Recommendations to exempt all dividend income and create greater retirement savings incentives were also included in the report.

Neither Congress nor the Administration have pursued enacting the Panel's recommendations.

Also in January 2005, the Joint Committee on Taxation released a report, *Options to Improve Tax Compliance and Reform Tax Expenditures* that contains over a dozen provisions that negatively impact state and local governments. Similar to the Panel's recommendations, the report has not become law. However, it is believed to be one resource where lawmakers may turn to when and if wholesale tax reform occurs. A briefing sheet on the report is attached to this issue brief.

Activity in the 110th Congress

To begin the long-term conversation on tax reform, House Ways and Means Chairman, Charles Rangel (D-NY), unveiled legislation, H.R. 3970, the *Tax Reduction and Reform Act of 2007*, in November 2007 that encompasses a variety of tax reform measures. Most importantly, and as was the case with the Advisory Panel's report, the hallmark of the proposal is to eliminate the Alternative Minimum Tax. The Alternative Minimum Tax was created in the late 1960s to ensure that very high income taxpayers pay their fair share of taxes and do not abuse various tax deductions. However, due to other tax law changes and the fact that the thresholds set for the AMT are not indexed to inflation, many *unintended* taxpayers have had to pay the AMT. To alleviate this, Congress has adopted 'patches' that increase the threshold amount, thus providing relief for millions of middle-class Americans. Rangel's bill would repeal the AMT entirely, at a cost estimated at \$1 trillion. H.R. 3970 contains provisions that both save and cost the government money, but in its totality it is revenue neutral. The Chairman's bill does not contain any provisions adverse to state and local governments.

Related Public Policy Statements (see www.gfoa.org)

- Deductibility of State and Local Property, Sales and Income Taxes (1984)
- Federal Proposals to Unify Compensation Plans (1997)
- Tax Treatment of Employee Contributions to Retirement Plans (1998)
- Federal Tax Policy and Preserving the Tax-Exempt Status of Municipal Bonds (2005)

Additional Resources

- Report: *Options to Improve Tax Compliance and Reform Tax Expenditures*, www.gfoa.org
- President's Advisory Panel on Federal Tax Reform, www.taxreformpanel.gov

Joint Committee on Taxation
Options to Improve Tax Compliance and Reform Tax Expenditures, January 2005
Summary: Impact on State and Local Governments

The staff of the Joint Committee on Taxation, at the request of Senate Finance Committee Chair Charles Grassley (R-Iowa) and Ranking Member Max Baucus (D-Montana), prepared and released in January 2005, a 400-page report entitled *Options to Improve Tax Compliance and Reform Tax Expenditures*. Both the Senate Finance Committee and the House Ways and Means Committee held hearings on the report's recommendations in the Spring of 2005, but no significant legislative effort was pursued. GFOA has led efforts among state and local government associations with regard to the tax-exempt bond provisions and is a key member of a broad coalition of national associations representing state and local governments, public employee unions, and public retirement systems who have sent letters and submitted testimony expressing opposition to any proposals that would modify current tax laws to weaken retirement savings in state and local government retirement programs.

Discussed below are some of the report's recommended changes that impact the public sector. The revenue estimates to the federal government are given for a 10-year period.

Tax-exempt Bond Provisions

To help educate Congress, the public, and issuers about the tax-exempt bond proposals included in the Joint Tax Committee's report, The Bond Market Association, in conjunction with GFOA and other issuer and industry groups, is hosting a Web site about the detrimental effects the provisions would have on state and local governments. The Web site - www.BuiltByBonds.org - features background information on the tax-exempt market and the proposed provisions, an automatic e-mail system for writing to members of Congress, state-by-state figures on outstanding debt, and a collection of industry letters against the provisions. The following are a brief snapshot of each of the provisions.

Eliminate advance refunding of governmental and 501(c)(3) bonds. The proposal would not allow issuers to have an advance refunding opportunity on future bonds, thus eliminating a powerful tool used by state and local governments use to minimize financing costs. Currently, issuers are allowed to advance refund a bond once have one opportunity throughout the lifetime of their bonds to advance refund the bonds. **Raises: \$10.5 billion**

Eliminate incentives for corporations and property and casualty insurers to purchase tax-exempt bonds. The proposal would significantly alter intricate tax calculations that corporations and property and casualty insurers use. This would, in effect, penalize these institutions for purchasing tax-exempt bonds. Property and casualty insurers are the single largest investors in tax-exempt bonds, holding nearly 12 percent of all outstanding bonds. **Raises: \$1.9 billion**

Impose new requirements on pooled financings. Smaller tax-exempt issuers often "pool" together their transactions to lower debt issuance costs. While there has been a tremendous crackdown by the IRS on abusive blind-pooled transactions, there are many benefits to pooled transactions for smaller issuers and state revolving fund programs. The proposal would add new restrictions to the conduit borrowing process by requiring the pooled bond issuer to obtain written loan commitments from each of the participating entities in the pool before issuing tax-exempt bonds. **Raises: \$500 million**

Create new reporting requirements for tax-exempt bonds issuers. In an effort to assist the IRS tax-exempt bond enforcement office and provide the IRS with documentation to compare against a filer's tax-exempt interest deductions, the proposal would create a new reporting requirement for all interest earned from tax-exempt bonds. The proposal is of great concern for many reasons, but most notably because it would require issuers to supply bondholder information to the IRS that they do not possess and could not collect without significant time and expense. **Raises: < \$10 million**

Eliminate the private payment test for stadium bonds. The tax-exemption on municipal bond interest only applies to private-activity bonds that meet certain tests and are used for qualified purposes. The proposal would eliminate these tests, which would, in effect, prohibit all tax-exempt financing for professional sports stadiums. **Raises: \$700 million**

Impose Immediate Taxation of Employee Contributions to State and Local Retirement Plans by Repealing “Pick-Up” Rules. This proposal would repeal the current “pick-up” rules contained in Internal Revenue Code section 414(h)(2); thereby prohibiting employee contributions to state or local government retirement plans to be made on a tax-deferred basis. Currently, such contributions are not tax-exempt, but instead are taxed when taken as retirement income— analogous to the tax treatment of employee contributions under 401(k)-type vehicles. If enacted, this JCT proposal would force public employees to pay federal taxes today on income they will not receive until retirement, overturning a policy established by Congress to equalize the tax treatment of public plan contributions, and imposing substantial costs on states and localities to restructure benefits and/or compensation. **Raises: \$4.8 billion**

Subject Grandfathered State and Local Government Employees to Medicare Payroll Tax. This proposal would overturn a long-standing agreement to transition all state and local government employees into the Medicare system, whereby only employees hired after March 31, 1986 were mandated into Medicare. Those state and local government employees hired on or before March 31, 1986, who were not already covered by Medicare, were grandfathered from mandatory participation. This proposal would now force these employees, most nearing the end of their career, as well as their employers, to pay the Medicare payroll tax. **Raises: \$5.4 billion**

Apply 10% Early Withdrawal Penalty Tax to State and Local Government 457 Plans. At present, the 10% early withdrawal penalty tax is not applicable to participants in section 457 governmental deferred compensation plans. This proposal would now impose this penalty on the 457 plans of state and local government employees, rendering distributions made before age 59 ½, as well as for death or disability, generally subject to both income tax and an additional 10% penalty tax. This provision will fall particularly hard on police, firefighters and other public employees with mandatory retirement ages or early retirement incentives who had planned on relying on their 457 savings for a larger portion of their early retirement income. **Raises: \$1.5 billion**

Impose FICA Taxes on all Salary Reduction Amounts. At present, contributions to cafeteria plans in both the public and private sectors are excluded from wages for FICA purposes. This proposal would require all employees and their employers to now pay FICA on these amounts, creating an immediate tax increase, imposing more costs on an already strained benefits system, and eliminating a significant incentive for participating in and maintaining these plans. **Raises: \$164 billion**

Eliminate 403(b) Catch-up Contribution Rules. This proposal would eliminate rules permitting 403(b) participants to make contributions for up to five years after termination of employment and permitting employees who have completed 15 years of service with certain employers to make additional elective deferrals. Employees of educational institutions have historically relied on these special rules to make up contributions they may have missed early in their career. **Raises: \$800 million**

Impose Withholding on Certain Payments Made by Government Entities. Under current law, the IRS requires employers to withhold income and FICA taxes on employee wages, including salaries of employees and elected officials of federal, state and local governments. Many workers who are not classified as employees are not subject to withholding under current law. For example, no tax is generally withheld from payments made to workers that are classified as independent contractors. This proposal would require all branches of the federal government and all units of state and local governments, except local governments with expenditures under \$100 million a year, to withhold 3% on payments they make for goods and services. This proposal would significantly increase administrative burdens imposed on states and local governments. **Raises: \$ 6.4 billion**