A New Year, A New Tax Code

The Knowns and Unknowns of Impact to State and Local Governments

By Emily S. Brock

State and local governments are now operating under a federal tax code that is different from the last reform effort in 1986.

The start of every new year generally brings a sense of opportunity and eagerness to begin anew. But for state and local governments, ringing in 2018 marks the beginning of an era of potential uncertainty, the result of a revised tax code rushed through Congress at the end of 2017.

Governments will need to take a hard look at their budgets and finance strategies through the lens of the new federal tax regimen. This article will recap some of the more notable changes signed into law in the final days of 2017.

NEW TAX BRACKETS

While differences existed between the House and Senate drafts of the bill released in November 2017, the disagreements were resolved largely within the final weeks of December, delivering a significant legislative win for the president. As expected, the law generally reduces tax rates, but it does not reduce the overall number of tax brackets, as House leaders initially hoped. The seven brackets are:

- 10 percent on taxable income up to $9,525 (individuals)/$19,050 (households)
- 12 percent between $9,525/$19,050 to $38,700/$77,400
- 22 percent between $38,700/$77,400 to $82,000/$165,000
- 24 percent between $82,500/$165,000 to $157,500/$315,000
- 32 percent between $157,500/$315,000 to $200,000/$400,000
- 35 percent between $200,000/$400,000 to $500,000/$600,000
- A top bracket of 37 percent on taxable income of more than $500,000/$600,000

The standard deduction was doubled to $12,000 for individuals and $24,000 for households. Personal exemptions were repealed, but the child tax credit was increased to $2,000 per child, $1,400 of which is refundable. All of the rates expire after December 31, 2025.

THE SALT DEDUCTION

GFOA has been actively opposing attempts to repeal the state and local tax (SALT) deduction. Over the course of 2017, GFOA issued a number of reports and engaged in extensive efforts to educate members of Congress about the importance of the deduction and how eliminating it would affect state and local government budgets. While SALT initially faced complete elimination under the Senate proposal, the deduction was partially preserved in the final version. For individuals, the SALT deduction is capped at $10,000 for property, plus income or sales taxes. GFOA encourages its members to share information on any modifications in state and local tax laws as a result of the federal change.

FINANCE CHANGES

Unfortunately, the change in the SALT deduction is not the only new reality

that state and local governments face under the tax law. The additional changes in the realm of public finance could have a lasting impact and may increase pressure at the state and local levels as federal policymakers look to turn their attention to infrastructure investment. While the tax exemption for municipal bonds was largely preserved, several finance changes could have a significant impact on public issuers.

The first notable finance change is that advance refunding — when issuers refinance outstanding bonds before the original bonds mature or are callable — has been eliminated. Previously, governmental bonds and 501(c)(3) bonds were permitted one advance refunding, mostly so issuers could take advantage of a favorable interest rate environment. This ultimately reduced borrowing costs, providing resources for new projects. GFOA and other organizations representing public issuers conducted extensive outreach to congressional offices upon learning that this provision was included in the initial House draft released in early November. Data shared with congressional staff members showed that issuers in every state had experienced substantial debt service savings within the last four years as a result of advance refundings. Unfortunately, the provision remained and the final version did not include any sort of transition relief. As a result, issuers with any plans to advance refund bonds had only a matter of weeks to complete the process by December 31, 2017.

The second notable change is a repeal of the authority to issue tax credit bonds. These bonds were another important finance mechanism used by various public issuers and included instruments such as qualified school construction bonds (QSCBs), qualified zone academy bonds (QZABs), and clean renewable energy bonds (CREBs). However, any tax credit bonds issued as direct-pay bonds before January 1, 2018, will be eligible to receive interest subsidy payments.

On a more positive note, private activity bonds (PABs) were left unchanged when the final tax reform bill was signed. The initial House version eliminated the tax exemption for PABs, a move — as with the other finance changes — that took many in the public issuer community by surprise, especially since PABs are used for projects that provide critical needs like affordable housing or airport improvements.

But even with the preservation of PABs, how the tax law changes in total will affect the ability to finance infrastructure investments at the state and local levels remains somewhat uncertain. At the time of this writing, the White House was still several weeks away from releasing its highly touted infrastructure plan. Preliminary details of the proposal suggest one component being at least $200 billion in federal spending that will be provided over the next 10 years. This funding however, will be used to attract and encourage at least an additional $800 billion (estimated) in financing from state and local governments along with private partnerships. The other proposal components are expected to focus on deregulation and streamlining of the federal permit process, both of which are regarded as hindrances to major infrastructure projects.

PUBLIC PENSIONS

It was initially feared that the final package would contain changes to the tax treatment of employee pension contributions. The House draft included a "clarification" that raised concern among public pension plans. It was a provision on the unrelated business income tax (UBIT) treatment of entities treated as exempt from taxation under section 501(a). The language sought to clarify that all entities exempt from tax under section 501(a), notwithstanding the entity's exemption under any other provision of the code, would be subject to UBIT rules. But after pushback from a number of public pension plans, the provision was ultimately removed.

On the corporate side, the current corporate maximum rate of 35 percent has been dropped to a flat 21 percent. Governmental issuers that have private placement or bank loan debt are urged to check their loan documents. Many issuers may have clauses (formulas) in their bank loan documents that result in a lower corporate tax rate, simultaneously increasing the interest rate on the bank loan or private placement of the issuer. This clause could result in higher debt service or other payments, possibly effective as soon as January 1, 2018, when the tax reform legislation was fully implemented.

CONCLUSIONS

The Federal Liaison Center kept GFOA members informed during the development of HR 1, and we look forward to doing the same regarding both expected and unexpected outcomes of the bill's passage. In addition, a comprehensive review of GFOA public policies is underway — please stay tuned as we advance through this new year and new tax code together.

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