Tax Reform Begins Uncertain Journey

By Michael Belarmino

The first attempt at comprehensive tax reform since 1986 contains some notable provisions, including the repeal of the state and local tax deduction.

It has been more than three decades since the last comprehensive tax reform effort successfully made it to the president's desk. Times have certainly changed, as the process in 1986 was the result of bipartisan efforts. The bill introduced on November 2, 2017, by House Ways and Means Committee Chairman Kevin Brady (R-Texas), is the product of a hyper-partisan atmosphere, and it runs the risk of being in the same unresolved position as attempts to pass health-care reform just a few months ago. This article will address some of the more notable provisions in the proposal — although as of the writing, the bill remains subject to change.

THE EFFORT BEGINS

While frameworks, outlines, and rumors swirled for more than a year, the release of the much-anticipated tax reform bill, *The Tax Cuts and Jobs Act* (H.R. 1), has formally kicked off the tax reform effort. The comprehensive draft proposes substantial changes to the federal tax code governing individuals and corporations. As expected, the House bill proposes collapsing the current seven tax brackets into four: 12 percent, 25 percent, 35 percent, and 39.5 percent. It also doubles the standard deduction to $12,000 for individuals and $24,000 for taxpayers who are married and filing jointly. But the bill repeals the personal exemption and creates a new, temporary family credit of $300 for each person in a taxpayer's family, including the primary taxpayer and non-dependent children. Further, in a somewhat unexpected twist, the bill proposes to cap the mortgage interest deduction on new or refinanced loans up to $500,000. The bill also repeals the deductions for medical expenses, moving expenses, contributions to medical savings accounts, and student loan interest, as well as the alternative minimum tax.

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One of the primary issues, given the bill's broad impact on districts of both parties, is the repeal of the state and local tax (SALT) deduction, which GFOA has been actively engaged with in recent months. On the individual side, the bill proposes to eliminate the deduction for state and local income and sales taxes paid, and it would cap the local property tax deduction at $10,000 per itemizing taxpayer. Corporations would retain

the ability to deduct those taxes. GFOA will continue opposing this change, especially given the significant impact it would have on the ability of state and local governments to set tax policy. GFOA members can find resources on the impact of eliminating the SALT deduction by visiting www.gfoa.org.

MUNICIPAL DEBT

While the bill does not repeal the current exclusion for interest earned on municipal bonds, it makes some changes that would have a significant impact.

The first notable change in the proposal is a provision to eliminate advance refunding (i.e., when issuers refinance outstanding bonds before the original bonds mature or are callable). Under current law, governmental bonds and 501(c)(3) bonds are permitted one advance refunding. In effect, issuers do this to take advantage of a favorable interest rate environment, which ultimately reduces borrowing costs and frees up resources for new projects. H.R. 1 does not change current refunding (when refunding bonds are issued within 90 days of the call date). GFOA best practices recommend minimum savings thresholds on a present-value basis of 3 to 5 percent when advance refunding municipal securities.

The second notable change in the proposal is that it terminates the ability to use private activity bonds (PABs). Simply put, PABs are municipal securities of which the proceeds are used by one or more private entities. The conditions under which municipal securities are considered PABs are found in Section 141 of the Internal Revenue Code. PABs are used for a wide variety of projects like airports, seaports, affordable housing, and non-profit health and education facilities, all of which provide essential public services.

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With respect to public pensions, it was initially feared that the proposal would contain changes to the tax treatment of employee pension contributions. While the changes are not of that magnitude, the bill does include a "clarification" that may be of concern among public pension plans. The clarification is a provision on the unrelated business income tax (UBIT) treatment of entities treated as exempt from taxation under section 501(a). The language seeks 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. One other pension-related change seeks to reduce the minimum age for allowable in-service distributions to 59 and a half for all defined benefit plans and state and local government defined contribution plans.

CORPORATE TAXES

On the corporate and international side, there are a number of changes to note. For one, the current corporate maximum rate of 35 percent would be dropped to a flat 20 percent. Pass-through businesses, where earnings flow through to owners as income, would face new rules, and the owners of such businesses would pay a 25 percent rate on earnings. And finally, the bill proposes a territorial tax system where U.S. companies would pay tax only on active domestic income (but not foreign-derived income).

CONCLUSIONS

As or early November 2017, the House Ways and Means Committee was marking up the bill (i.e., considering potential changes). When the mark-up is complete, the bill is expected to go to the floor for a vote before the full House of Representatives. Although the process developed fairly quickly, it remains uncertain whether the bill will see changes before a floor vote. It is also unclear whether it will pass the House, as Democrats will likely be unified in voting against it, and a number of Republicans have expressed either concern or opposition to the bill as introduced. And that's just in one chamber, as the Senate still awaits its turn in the spotlight on tax reform.

GFOA encourages members to check the GFOA website for regular updates and potential member alerts.

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