

Experience with the AMT and Private Activity Bonds Shows “Capping” the Tax Value of Municipal Bond Interest Would Increase State and Local Borrowing Costs

Capping the tax value of the exclusion for municipal bonds for upper income earners would increase the interest cost to state and local governments. Although a cap is described as a tax on wealthy individuals, the actual impact will be on state and local taxpayers. The real world example of private activity bonds subject to the Alternative Minimum Tax (AMT) proves this.

- Policymakers are considering imposing a surtax on deductions and exclusions claimed by taxpayers above a certain income level.
 - This surtax is intended to “cap” the tax value of these deductions and exclusions.
- If applied to municipal bonds, such a surtax would reduce demand for municipal bonds;
 - Reduced demand would force municipalities to pay a higher rate of interest on bonds used to finance infrastructure investments.
- The Joint Committee on Taxation (JCT) *theorizes* that such a tax on municipal bonds would not increase state and local interest rates.
 - It defies common sense to think such a tax would have no effect; and
 - The real world example of private activity bonds (PABs) subject to the alternative minimum tax (AMT) proves that common sense is correct, not the JCT theory.
- In the real world, PAB issuers subject to the AMT must pay a higher rate of interest than comparable municipal bonds not subject to the AMT.
- Economists estimate—based on the experience with the AMT—that a “cap” would increase the interest rate paid on a municipal bond by anywhere from 40 to 92 basis points.
 - Considering the size of the municipal bond market—currently \$3 trillion—this would be a massive increase in the cost of financing infrastructure investments.

Background

Some policymakers have proposed capping or limiting the interest exclusion for municipal bond interest. One such proposal would, in effect, limit to 28 percent the tax value of a number of deductions and exclusions, including the exclusion for municipal bond interest. The limit would apply to individuals with income of more than \$200,000 and families with income of \$250,000 or more.

There is no “limit” or “cap” in the current tax code, so draft legislation would enact this policy by imposing a surtax on these deductions and exclusions equal to the sum of the taxpayer’s municipal bond interest (and other exclusions and deductions) times:

- The taxpayer’s adjusted marginal income tax rate [in other words, the tax rate that would apply if

a taxpayer's municipal bond interest—and other exclusions and deductions—were included in federal gross income];

- Minus 28 percent.

For example, an investor in the 39.6 percent tax bracket and subject to the 3.8 percent Medicare surtax receiving \$100 of municipal interest would face a \$15.40 surtax on that income (39.6 percent plus 3.8 percent minus 28 percent equals 15.4 percent; and 15.4 percent of \$100 equals \$15.40).

JCT *theorizes* that interest rates on municipal bonds are set by the ultimate bondholder with the lowest marginal income tax rate and that this hypothetical “market clearing” income tax rate is around 18 percent. Because an 18 percent market clearing rate is lower than a 28 percent “cap,” *theoretically*, this surtax would not reduce market demand for municipal bonds and, so, not increase the interest cost to State and local governments.

There are several flaws with JCT's theory, but the chief flaw is the belief that removing high-marginal-income-tax-rate investors from the market would not require an increase in interest rates to attract more, lower rate investors to purchase the bonds not being bought by wealthier investors. *The real world example of PABs¹ subject to the AMT—which in fact pay a higher interest rate to attract investors—disproves this theory.*

Effect

It is a basic tenet of economics that the “impact of (an) excise tax is to shift the demand curve faced by producers down by the amount of the tax.”² This tenet is reflected in legal thinking, where the U.S. Supreme Court has found that “the power to tax involves the power to destroy.”³ It is also reflected in public policy where, for example, lawmakers impose taxes to limit the use of alcohol and cigarettes, while forestalling taxes on retirement accounts to encourage savings.

As discussed above, JCT theory argues against this basic tenet—i.e., argues that a tax increase on municipal bond interest will not decrease the market demand for municipal bonds. There is a case to be made that this theory is flawed methodologically. More importantly though, the real world example of PABs subject to the AMT clearly demonstrates that a surtax on bond interest targeted at upper-income earners does, in fact, increase the interest cost to state and local governments.

The AMT is calculated by subtracting the amount of *regular income tax* owed from the amount of *AMT tax calculated*—a tax imposed at a maximum rate of 28 percent on regular taxable income plus additional “preference” items. Since 1986, PAB interest has been a preference item under the

¹ “Private activity bond” (or PAB) technically means any municipal bond that exceeds private use limits for bond proceeds, and so under the general rules of the tax code, would be subject to the federal income tax. In general, however, the term is used to refer to a municipal bond that exceeds private use limits, but is still exempt from the federal income tax, because, for example, it is being used to finance a “qualified facility” such as toll-road, port or airport.

² Iowa State University, Econ 101: Principles of Economics – Chapter 7: Taxes, (Fall 2010).

³ McCulloch v. Maryland, 17 US 431 (1819).

AMT.⁴ In other words, for PABs the AMT functions somewhat similarly to the 28 percent cap discussed above—a surtax on municipal bond interest earned by upper-income bondholders.

As a result of this surtax, PABs subject to the AMT have a higher interest rate and are more expensive for state and local governments to issue.⁵ This increased interest cost is driven by several factors:

- Investors subject to the AMT or expecting to be subject to the AMT in the future either do not purchase AMT bonds, or demand a higher rate of return to offset this tax cost;
- Investors at risk of being subject to the AMT in the future either demand a higher rate of return to offset the risk of the additional tax cost if they do become subject to the AMT, or do not purchase AMT bonds; and
- Investors not subject to the AMT, or not likely to be subject to the AMT, still demand a higher rate of return, to offset reduced liquidity of their investments and the risk of a secondary market trade to a purchaser either subject to the AMT or at risk of being subject to the AMT.

Stated differently, if all of the investors in tax-exempt bonds with marginal income tax rates above the “cap” rate leave the market or are demanding a higher rate of return, it defies logic to think that issuers of municipal bonds would not have to increase interest rates to attract additional lower marginal rate investors. [Although there are often more investors seeking to purchase a bond issue than there are bonds in that issue, that does not mean that this is usually the case or that there is sufficient demand from lower marginal rate investors to make higher marginal rate investors irrelevant to the sale of the bonds.] At the other extreme, if higher marginal rate investors are needed in order to continue to sell tax-exempt bonds, those investors are going to demand higher interest rates to compensate them for the partial tax on that interest.

A real world example is the Dallas/Fort Worth International Airport, which has been undergoing a massive Terminal Improvement Program, \$3.1 billion of which is being financed with PABs subject to the AMT at an estimated additional interest cost of \$268 million when compared to the cost of financing such improvements with tax-exempt bonds, which are not subject to the AMT.

The same factors increasing the interest cost of PABs subject to the AMT would increase the interest cost of all municipal bonds if a 28 percent cap on the tax value of the exclusion of municipal bond interest were imposed.⁶ Specifically:

⁴ Exceptions to this general rule include exceptions for qualified facility private activity bonds issued to finance housing projects, which are exempt from the regular income tax and the AMT.

⁵ Piper Jaffray, “The ABCs of AMT Bonds,” (2004) (“the current spread differential between AMT and non-AMT [general obligation bonds] is between 30 and 48 basis points”); MoringStar.com, “Course 309: Muni-Fund Considerations” (“bonds subject to the AMT ... tend to yield more than non-AMT bonds”); T. Rowe Price, “Investing in High-Yield Municipal Bonds,” (2009) (“bonds whose interest is subject to the AMT frequently offer higher yields than otherwise similar non-AMT bonds”); Michael Johnston, MunicipalBonds.com, “Are Municipal Bonds Exempt from the AMT?” (Feb. 19, 2013) (“AMT bonds pay about 15 to 20 basis points over comparable non-AMT bonds”); and Brown Brothers Harriman, “Strategy Insight: The AMT – Dreaded Tax or Income Opportunity,” (March 2014) (“AMT bonds still offer an additional 40bps of spread over comparable non-AMT debt”).

- Investors subject to the 28 percent cap will not purchase municipal bonds, or will demand a higher rate of return to offset the tax cost of owning municipal bonds;
- Investors at risk of being subject to the 28 percent cap in the future will demand a higher rate of return to offset the risk of the additional tax cost if they do become subject to the 28 percent cap or will not purchase municipal bonds; and
- Investors not subject to the 28 percent cap, or not likely to be subject to the 28 percent cap, will still demand a higher rate of return, i.e., a lower price, to offset the reduced liquidity of their investments and risk of a secondary market trade to a purchaser subject to the 28 percent cap or at risk of being subject to the 28 percent cap.

Additionally, there is every reason to believe the impact of these effects would be magnified by the scope of the proposal. Just three percent of municipal bonds are PABs subject to the AMT, but every municipal bond could be subject to the 28 percent cap.

Additionally, while investors have long since adjusted to the application of the AMT to PABs, the surtax imposed by a 28 percent cap would apply to all current bondholders with no warning. This would hugely reduce the current value of bond holdings.⁷ As a violation of more than 100 years of precedent, it would also drive up the interest rates on future bond issuances as future investors are forced to try to guess whether further changes—a higher surtax, a lower threshold—might come.

As a result, the interest cost to state and local governments issuing municipal bonds subject to a 28 percent cap, would likely increase substantially. Three separate studies found that a 28 percent cap would increase the interest rate required, with estimates ranging from 40 basis point to 92 basis points.⁸ Considering the size of the municipal bond market—currently \$3 trillion—this would be a massive increase in the cost of financing infrastructure investments.

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⁶ Other deductions and exclusions may not be affected to a similar degree by a “cap,” i.e., the elasticity of demand for, example, housing and health care is likely lower than the elasticity of demand for tax-exempt bonds.

⁷ Michael Kaske, Bloomberg, “Tax Cap Threatens \$200 billion Muni Loss, Citigroup Says” (Dec. 7, 2012)(reporting analysis that limiting the tax value of the exclusion for municipal bond interest will reduce the value of existing bonds in the secondary market); Brian Chappatta, Bloomberg, “Tax-Status Threat Fuels Worst Losses Since Whitney: Muni Credit” (Dec. 21, 2012).

⁸ BLX Group LLC, “Tax Reform Proposal Analysis: Impact on Tax-Exempt Bond Financing,” prepared for American Public Power Association 6 (Jan. 28, 2013) (estimating a 77 basis point increase in all-inclusive borrowing costs for large issuers and a 92 basis point increase in all-inclusive borrowing cost for smaller issuers); George Friedlander, Citi “Muni Issuers and the Current Market Environment: Threats, Challenges and Opportunities” 10 (Mar. 30, 2012)(estimating a yield increase of as much as 75 basis points); and John Hallacy & Tian Xia, Bank of America Merrill Lynch, “Munis & Derivatives Data” 1 (Feb. 13, 2012)(estimating a 40 basis point increase on issuer costs).