MEMORANDUM

TO	Senate Finance Committee
FROM	Nuveen Asset Management Franklin Templeton Investments
DATE	April 14, 2015
TOPIC	Tax Credit Bonds
SUBJECT	Individual Income Tax Working Group Community Development & Infrastructure Working Group

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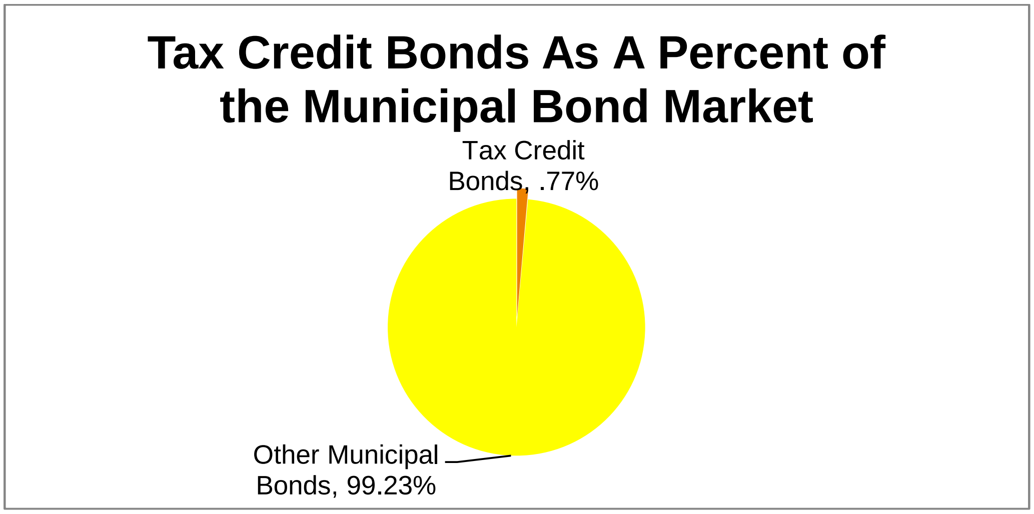
Nuveen Asset Management and Franklin Templeton Investments welcome the opportunity to submit comments to the Senate Finance Committee regarding tax reform. These two companies are two of the world's largest market participants in the municipal bond market. Together, the two companies have approximately $175 billion of municipal assets under management. They also account for a combined 140 years of experience transacting in the municipal market, giving them practical and deep insights into how the municipal market operates. This experience can be useful to the Senate Finance Committee as it considers issues relating to municipal finance in the United States.

In the context of tax reform, the notion has arisen that tax exempt municipal bonds should be replaced with tax credit bonds. However, policymakers should understand that institutional investors actually engaged in the municipal capital markets think this is an extremely ill-advised idea. The current market for tax credit bonds is exceedingly small – less than 1% of the tax exempt municipal bond market. This is for good reason: the capital markets simply will not accept tax credit bonds in any meaningful amounts. They are unmanageably complex, have a small investor pool, and are highly illiquid. There is clear market evidence of this: virtually all tax credit bond issuances fall far short of their authorized amounts. In other words, governments are authorized to offer these bonds, but the markets will not take them. This is an idea that has been tested in the markets - and failed. The idea has risen in Congress many times over the years and consistently been rejected, because tax credit bonds simply cannot provide a meaningful solution to funding America's infrastructure.

Like municipal bonds, tax credit bonds are issued by state and local governments to finance their infrastructure development. With municipal bonds, the interest paid is exempt from federal taxation, permitting state and local government to offer lower interest rates, thereby helping to build state and local infrastructure. With tax credit bonds, in contrast, the federal government offers a tax credit to the investor in the bond. Tax credit bond proponents argue that using a credit means all of the federal support is used to support the bonds. This theory does not stand up to market reality. In fact, tax credit bonds are far more inefficient than tax exempt bonds, and simply cannot be sold in the amounts necessary to finance a meaningful municipal bond program to advance American infrastructure. The reasons are clear:

1. **The tax credit bond market is very small, chiefly because these bonds have been poorly received by investors.** It is important to understand how exceedingly small the tax credit bond market is today. The value of tax credit bonds outstanding is roughly $29 billion**,** compared to other municipal bonds totaling roughly $3.652 trillion. This comparison is shown in the below pie chart:



(Source: The Bond Buyer and the Federal Reserve's Financial Accounts of the United States, http://www.federalreserve.gov/releases/Z1/). This chart raises significant questions whether bonds of this tiny magnitude should suddenly be selected to replace a multi-trillion dollar tax exempt municipal bond market that for 100 years has helped fund over 75% of America's infrastructure.

2. **There is a good reason this market is so small: investors will not buy these bonds in meaningful amounts.** For example, a 2009 joint CBO/JCT study concluded that only about two-thirds of the Qualified Zone Academy Bonds (a type of tax credit bonds) that were authorized had actually been issued. The study continued, "The other limited data that are available appear to confirm that, for other types of tax credit bonds, issuances have been well below authorized amounts." (Source: "A Joint CBO/JCT Study, Subsidizing Infrastructure Investment with Tax-Preferred Bonds", October, 2009 https://www.jct.gov/publications.html?func=startdown&id=3594) In other words, the bonds are available, but investors are simply not willing to buy them. As a result, issuers are not using them, even though the federal government bears most or all of the cost.

3. **Tax credit bonds are highly complex, making them unattractive to investors.** Tax credit bonds are sometimes offered with a sufficient tax credit to permit the state/local issuer to pay no interest on the bond (i.e., the tax credit is intended to suffice as the "payment" to the investor). However, state/local governments with a lower credit rating may have to enhance this bond by offering an additional, taxable interest payment. However, there is little overlap between

investors who want both a taxable interest payment and a tax credit. Mutual funds cannot create – and cannot market - a coherent bond fund somehow mixing these different types of bonds (one with an interest component, one without). In contrast, if an issuer of tax-exempt bonds has a lower credit rating, it simply pays a higher interest rate – and all of the interest can be paid to investors in a coherent pool of funds. It is a simpler bond instrument and therefore highly attractive to investors.

4. **There are simply a myriad of other uncertainties and contradictions with tax credit bonds that make them very unattractive investment vehicles.** For example, it is unclear what tax credit the fund actually would generate. How would this credit match an investor's uncertain future tax liability? Tax credit bonds also feature an odd contradiction: the tax credit is itself treated as taxable income, a feature not present with most tax credits. This oddity compounds the difficulty of finding buyers who want to use tax credits to reduce their tax liability.

5. **Tax credit bonds are not attractive to many large investors, like pension funds, which makes it harder to sell these bonds in longer maturities.** Complex securities, like tax credit bonds, are typically more suitable for large investors, such as pension funds and foreign investors, who have the resources to master the complexity. However, these entities do not need tax credits because they pay no federal income tax. These investors also frequently provide much of the appetite for bonds with longer-term maturities. Since these investors do not buy tax credit bonds, it is harder for state and municipalities to issue tax credit bonds in longer maturities, something they frequently want to do to finance large projects. Therefore, the bonds lack a broad investor base and are not attractive in longer-term maturities.

6. **Stripping the tax credit from the bond does not overcome the complexity and liquidity problems associated with tax credit bonds.** Some have suggested that the tax credit could be stripped out of the security, permitting it to be sold to investors who do have a large tax liability. However, it must be remembered that 60% of all municipal bond issuances are relatively small, $10 million or less. This means that the tax credits stripped from these bonds would be very small, producing thousands of tiny tax credit values that would not be of interest to buyers. In addition, the creditworthiness of the stripped credit would depend on the underlying creditworthiness of the issuer. This is because the U.S. Government would not continue to provide the tax credit if the issuer defaulted on the underlying bond. This also would undermine liquidity and result in far higher rates to issuers.

7. **Tax credit bonds would result in significant more government regulation, which further increases the interest rates state and local governments would need to pay.** Tax credit bonds carry numerous costly and unmanageable regulatory requirements that simply make them unworkable. These include:

   - **Tracking Bond Holders:** Municipal issuers will have to send out quarterly 1097-BTC forms to all holders of tax credit bonds on the "credit allowance dates." Municipal issuers do not now keep records on the holders of their bonds, thereby adding an unprecedented recordkeeping requirement. This burden would fall especially heavily on smaller state and local governments, who would have difficulty maintaining the systems necessary to track holders of bonds. The burden would be amplified for all issuers if the tax credits are stripped from the bonds and sold separately; issuers then would need to track holders of tax credits separately from the holders of the bonds. In a bond issue consisting of bonds with different maturities and coupons, the tax credits might be stripped from some maturities, but not others, further exacerbating the complications.

- **<u>Calculating Yields/SEC Reporting</u>:** The net asset values of mutual funds would have to include accrued interest and accrued tax credit as distinct forms of value, and the funds would have to provide quarterly 1097-BTC forms in addition to annual 1099 forms. It appears that only those shareholders who own shares of a fund on a credit allowance date would be able to take the credit. Would the tax credit be included in computing the yield of the fund as mandated by the Securities and Exchange Commission?

- **<u>Confusing Taxpayer Filing Requirements</u>:** Holders of tax credit bonds and shares of funds holding tax credit bonds would need to file 8912 forms with different rules for the different categories of bonds. (Six different acronyms are currently listed on the form). This requirement will not only be highly unpopular, but will discourage the purchase of tax credit bonds in the first place.

8. **<u>All of these factors dovetail to make tax credit bonds highly illiquid and raise costs to state and local governments</u>.** Because pension funds do not desire tax credit bonds, these bonds typically are marketed to retail investors. As mentioned, however, the complexity of these bonds means retail mutual funds have trouble packaging them - and smaller retail investors are not attracted to these complex instruments. That means tax credit bonds are not attractive either to pension funds, large retail mutual funds, or individual investors. This leaves a very small pool of investors, making the bonds highly illiquid. The additional complexities, regulatory burdens and other impediments further make these bonds unattractive, raising costs to issuers.

This is why, to most market participants, it seems foolhardy to think tax credit bonds could substitute for the highly efficient and effective tax exempt municipal bond market. Some have argued tax credit bonds are not attractive only because the market for them is small today. However, the tax credit bond market is not just small - it also would have trouble growing significantly. The proof is in the market. Past issuances of these bonds have typically been below their authorized amounts. If the market will not purchase these bonds up to current authorized levels, how can we expect tax credit bonds to become the cornerstone of infrastructure financing for state and local governments? A shift to tax credit bonds is more likely to devastate state and local financing, with severe repercussions for the hospitals, schools, utilities and housing of America.

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