BDA Bond Dealers of America

April 15, 2015

Senator Dean Heller
Senator Michael Bennet
Community Development & Infrastructure Tax Reform Working Group
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairmen Heller and Bennet:

On behalf of the Bond Dealers of America (BDA), I appreciate the opportunity to submit the following recommendations for your working group to consider as you weigh policy options to reform the nation's tax code. BDA is the only DC-based association representing the interests of middle-market securities dealers and banks focused on the United States fixed-income markets. Our comments focus on the importance of tax-exempt municipal bonds to finance critical community development and infrastructure projects across the country, as well as the benefits to smaller governmental entities of tax-exempt "bank-qualified" bonds.

Municipal Bonds

State and local governments have relied on tax-exempt municipal bonds for more than 100 years to finance critical infrastructure and community improvement projects including schools, hospitals, roads, highways, bridges, subways, seaports and marine terminals, water and wastewater facilities, multi-family housing, libraries and town halls, electric power and natural gas equipment for city-owned utilities, and other public projects.

Limiting or eliminating the tax-exemption of municipal bonds would significantly increase costs to state and local governments, which would cause decreased investment in critical infrastructure projects and increased taxes for residents. For example, in the last decade, municipal bond-financed projects cost $495 billion less than if they had been financed with taxable debt. In addition, capping the value of certain deductions and exclusions, including interest on outstanding municipal bonds, at 28 percent, as has been proposed in the past, will increase tax-exempt rates for new issues – borrowing costs borne by state and local governments - by up to 70 basis points. This translates to increased infrastructure costs of 15-20 percent for state and local governments.[1] These increased costs would either force issuers to raise taxes, utility rates, and user fees in

[1] National Association of Counties, National League of Cities, United States Conference of Mayors, *Protecting Bonds to Save Infrastructure and Jobs*, March 2013.

order to maintain budget sustainability or would result in less capital being directed into public infrastructure. Taxing a previously untaxed security would also destroy investor confidence, creating volatility and uncertainty in a historically stable market. In turn, investors would either perceive more risk in municipal bonds and require higher yields or seek alternative investments with less perceived risk, pulling the capital and liquidity that local governments need out of the municipal market. Additionally, a 28 percent cap would reduce the value of municipal bonds by roughly $200 billion with a substantial portion of that market erosion falling on middle-income investors.[2]

Contrary to the argument that tax-exempt bonds serve as a tax break for the wealthy, roughly one-half of municipal bond interest is paid to households with income of less than $250,000. Three-fifths of municipal bonds are owned by individuals over the age of 65. These investors purchase municipal bonds because of the tax-exemption of the interest and because of the stability of the municipal bond market and the safety of the investment. The 40-year default rate for municipal bonds is 0.13 percent, compared to 11 percent for corporate bonds.

Moreover, alternative financing mechanisms like direct-pay bonds and tax-credit bonds should supplement the current system, rather than replace tax-exempt bonds as has been proposed in the past. Direct-pay bonds and tax-credit bonds can be important vehicles to provide an additional subsidy for projects when implemented correctly. For example, the temporary Build America Bonds (BABs) program was successful in financing more than $180 billion in new projects across the country. However, while selling these bonds, BDA member firms sometimes encountered skepticism from issuers and investors about the government honoring long-term subsidies in the face of growing budget pressure. As dealers, our members know that being able to deliver as promised is key to the future desirability and marketability of direct-pay bonds, tax credit bonds or any other bonds requiring a federal payment.

We encourage you to maintain the current law tax exemption for municipal bonds based on their importance to the nation's infrastructure and their value for middle-income earners.

Bank-Qualified Bonds

Bank-qualified bonds were established in the 1986 Tax Reform Act to give small municipal issuers of no more than $10 million in bonds in a calendar year more affordable access to capital by helping them to sell tax-exempt bonds directly to local, community banks. Local banks understand the infrastructure needs of local issuers and are willing to purchase their bonds. However, the tax code presents a barrier because typically, if a bank borrows money to purchase tax-exempt debt from a municipal issuer, it cannot deduct the interest it pays to borrow that money. Banks, therefore, have a

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[2] Michael Kaske, *Tax Cap Threatens $200 billion Muni Loss, Citigroup Says,* Bloomberg, December 7, 2012; Brian Chappatta, *Tax-Status Threat Fuels Worse Losses Since Whitney: Muni Credit*, Bloomberg, December 21, 2012.

disincentive to buy tax-exempt debt but for the bank-qualified provision, which permits banks to deduct the interest for these small issues.

The original $10 million limit, however, was enacted nearly 30 years ago and was never indexed for inflation. In 2009 under the American Reinvestment and Recovery Act, Congress increased the annual limit for bank-qualified bonds to $30 million. Congress also made 501(c)(3) organizations such as hospitals and small colleges eligible for the provision. Furthermore, in order to facilitate pooled borrowings (where for efficiency, the borrowings of several different issuers are combined), the limitation was applied at the borrower level, rather than the total size of the aggregate issue. These provisions expired on December 31, 2010.

We encourage you to re-instate the $30 million annual limit, permanently index the limit for inflation, and reinstate the additional improvements made under ARRA. These improvements will allow for increased bank participation in the market, driving down the cost of capital for smaller issuers and reducing costs for taxpayers.

Sincerely,

Michael Nicholas
Chief Executive Officer
Bond Dealers of America

CC: Senator Dan Coats
Senator Maria Cantwell
Senator Tim Scott
Senator Bill Nelson