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# MEMORANDUM

**To:** City of San Jose
**From:** Patton Boggs LLP
**Date:** November 28, 2005
**Subject:** President's Advisory Panel on Federal Tax Reform Proposal – Notable Issues for Local Government

The bipartisan President's Advisory Panel on Federal Tax Reform recently released its final report with a series of recommendations on changes to simplify and streamline the tax code, with the constraint that the aggregate package of changes must be revenue-neutral.

This memorandum preliminarily identifies and reviews recommendations of significance to local governments, including repeal of the Alternative Minimum Tax (AMT), State and local tax deductions, and the Low Income Housing Tax Credit (LIHTC); and changes in the mortgage interest and tax-exempt bond deductions. It also notes proposals of interest related to defined contribution retirement plans, personal retirement plans, and college savings plans.

**Prospects for Tax Reform Advancement**

We do not anticipate any serious legislative action on Advisory Panel proposals next year, although the President may mention a future tax code overhaul in his State of the Union speech.

Given the current difficulties in passing tax reconciliation and the upcoming congressional elections, the Administration will be focused more on extending the tax cuts approved in 2001 and 2003. In addition, in order to achieve revenue neutrality, the reform package cannot be picked apart and passed piecemeal; the various proposal elements are interconnected. Finally, various Members of Congress (including the Chairman of the Senate Finance Committee), State and local elected officials, and influential industry associations have expressed serious reservations / opposition to key provisions.

The complexity of the issue and the potent organized opposition from external interests suggest no real prospect for advancing a tax reform bill until at least 2007, if Administration interest remains.

**Issue Identification and Assessment**

**(1) Alternative Minimum Tax (AMT) Elimination - Individual and Corporate.**

Because the current AMT income criteria captures more taxpayers each year and must be adjusted annually, a complete elimination of the AMT is popular as a stand-alone proposition. From the local government perspective, eliminating the AMT primarily is helpful to issuers of private activity bonds, especially airport bonds. If the deductibility of state and local taxes were not also proposed (see below), individuals who had been captured under the AMT, and therefore not able to deduct state and local taxes, would have benefited. However, the elimination of those deductions in combination with the repeal of the AMT means no net change for those individuals.

**(2) State and Local Tax Deduction Elimination.**

Eliminating the federal deduction for State and local income taxes will have a substantial impact on State and local political decisions with regard to taxation policy, and potentially force budget cuts.

The change yields a federally-mandated double taxation because it requires taxpayers to pay taxes twice on their income, property, and purchased goods. However, this argument only works in one direction, because you cannot deduct federal taxes from State and local assessments. This shifting of burden likely will create economic and political pressure to reduce State and local taxes. In particular, it would constrain State and local flexibility around income tax levels, especially during trying times

Unlike other deductions in the federal income tax system, citizens have no choice but to pay state and local income, sales, and property taxes each year. Taking away the deduction would increase a citizen's overall effective tax rate, particularly with annual fixes to limit application of the AMT. The elimination is proposed as an offset to AMT repeal, but that tax already forbids State and local deduction, so the net impact of the proposal on affected individuals.

The federal government has imposed unfunded mandates forcing State and local governments to accept a growing share of fiscal responsibility for essential systems. Further deterioration of available options for State and local governments to raise revenues to fund theses mandates would jeopardize many of the services and infrastructure that citizens demand from their local and state governments. A comparable debate in the early 1980s focused on State and local governments giving up deductibility in exchange for increased revenue sharing; such compensatory measures are not now being discussed.

In addition, the proposal would have a negative impact on small, independent business owners who are taxed as individuals, not as businesses.

Opposed: National Federation of Independent Businesses; National League of Cities; U.S. Conference of Mayors; School boards and teachers' groups.

**(3) Tax-Exempt Bond Benefit Limits for Business.**

The Advisory Panel recommendations would create debt issuance problems for municipalities by benefiting only individual taxpayers, proposing that businesses no longer be able to take advantage of tax-exempt interest. Business interests currently constitute approximately one-third of bondholders. In addition, the proposals exempt dividends from income tax free and exclude from taxation 75% of capital gains income, which would reduce the attractiveness of tax-exempt bonds against corporate investments.

As a result, demand for municipal bonds would decrease, and to maintain market competitiveness, interest paid must increase, incurring greater borrowing costs to governments.

Opposed: Bond Market Association, School boards and teachers' groups

**(4) Mortgage Deduction Limits.**

The proposal would (i) limit deductions to 15% of mortgage interest paid as a credit, not as a reduction in taxable income at one's overall income tax rate; (ii) limit total deductible amount to average regional price of housing (limits ranging from about $227,000 to $412,000); (iii) apply deductions only to primary residences; and (iv) apply deductions only to the principal purchase, not equity loans, except for cases of "substantial" home improvements.

Currently, homeowners who refinance their mortgage to take advantage of either equity through appreciation or the amount that they have paid down their mortgage can borrow the amount of their original purchase price plus $100,000, on which all of the interest paid is tax deductible. Americans use mortgage refinancing to finance major purchases, higher education, home repair, and expenses such as weddings and vacations. Under the Advisory Panel proposal, the mortgage interest deduction would not apply to refinanced mortgage amounts, except when the funds are used for "substantial" improvement to the home, the definition of which is not given.

Some core concerns with the limitations involve a likely disproportionate impact on expensive housing markets; all homeowners above the 15% tax bracket pay more; removal of a primary incentive for homeownership; and given the heavy use of deductible home equity loan to finance college for children, indirectly raise the costs of education.

However, the argument also is made that this provision would force higher-cost homes to drop in price by shifting demand for housing purchase and production toward less-expensive housing, thereby depressing the market and open it to lower-income potential homebuyers. The tax credit also would be more broadly tapped by those who do not currently itemize their taxes, about 65% of taxpayers. Some proponents of the change to the mortgage interest deduction point to the homeownership rates in Australia, Britain, and Canada, which are comparable to American rates even though these counties do not offer a mortgage interest deduction as proof that even full elimination of the mortgage interest deduction would not necessarily reduce homeownership rates.

Opposed: National Association of Realtors; Mortgage Bankers Association; U.S. Conference of Mayors.

**(5) Low Income Housing Tax Credit (LIHTC) Elimination.**

The proposal to eliminate LIHTC will weaken investment in affordable housing development by removing the aggregating tax incentive for corporations to buy Housing Bonds. Currently, the LIHTC is the major vehicle for financing affordable housing nationwide. The credit is responsible for development of 40% of national rental housing production annually, and virtually all affordable rental housing.

Opposed: National Council of State Housing Agencies

## (6) Other Issues of Potential Interest

- **Defined Contribution Plans:** The proposal would consolidate work-based retirement savings into a single "Save at Work" plan, combining 401(k), SIMPLE 401(k), Thrift, 403(b), governmental 457(b), SARSEP, and SIMPLE IRA alternatives. Potential implications for retirement plans provided by State and local governments are under consideration.

- **Personal Retirement Plans**: The proposal would consolidate retirement savings plans are into a single "Save for Retirement Account" with $10,000 annual limit. It would replace existing IRAs, Roth IRAs, Nondeductible IRAs, deferred executive compensation plans, and tax-free "inside buildup" of the cash value of life insurance and annuities. Contributions would be made with after-tax dollars like current law Roth IRAs, and earnings would grow tax-free. Low-income taxpayers would receive a match for retirement savings contributions through a refundable credit. The savings package also would ensure that income earned outside these savings accounts would be taxed the same as other income by providing for more uniform tax treatment of financial income.

- **529 Education Savings Plan Cap:** The proposal would cap State-sponsored 529 Plans at $10,000, versus current federal standards that do not limit contributions. Primary incentives for college savings would be part of a new federal "Save for Families" Program.