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Global tax rate may hurt muni demand, Biden floats vague fix

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Municipal bond advocates are warning that a new global minimum tax could diminish demand for tax-exempt debt.

And while the details remain unclear, President Joe Biden's new budget may feature a fix, one that could require Congressional action on tax-exempt interest.

At issue is a new minimum global corporate tax rate of 15%, a deal signed last October by 136 countries aimed at making it more difficult for major multinational companies to pay low tax rates. The tax is set to take effect in 2023. As an enforcement mechanism, the so-called Pillar Two agreement creates a "top-up tax" that allows other countries to bring a company's tax rate up to 15% if the rate falls below that in any of its jurisdictions.

An aerial view of Washington, D.C., focusing on the U.S. Treasury Building. **Carol M. Highsmith: Photographer**

The new provision would generate $150 billion in new money annually, according to the Organisation for Economic Cooperation and Development.

By creating a 15% floor, the top-up tax would diminish the value of investing in tax-exempt debt or tax credits for affordable housing or research and development, which many U.S. corporations use to lower their U.S. tax liability.

“How do you fall below 15% in the U.S.? Because you make a lot of investments in municipal bonds or you make investments in low-income housing projects, or you’re a very tech heavy company and you do a lot of research,” said Pat Brown, PWC's Washington national tax services co-leader.

The Pillar 2 rules, which the OECD released in December, also feature a number of quirks that make it “quite easy” for U.S. companies to fall below 15%, Brown said.

U.S. companies that would be affected by the new rule claim about 70% of the incentive tax credits and 80% of the tax-exempt interest reported by all companies, said a group of nonprofit and business organizations, including the Securities Industry and Financial Markets Association, that sent a March 28 letter to Treasury Secretary Janet Yellen urging her to modify the rules.

“We’re looking at the Pillar 2 provisions and trying to determine whether it would have the effect of discouraging corporate purchases of tax-exempt bonds, especially by banks and property and casualty companies,” said Michael Decker, senior vice president of federal policy and research at Bond Dealers of America. “And it looks like theoretically it could have that effect. We don't like anything that discourages demand for tax-exempt bonds.”

The new rule runs smack up against legislation like the Infrastructure Investment and Jobs Act and other laws Congress designed to encourage investment in domestic infrastructure, affordable housing and other areas, said Katie Kramer, vice president at the Council of Development Finance Agencies.

“We are talking with Congressional leaders to help them understand the importance of this particular tax policy and how it could potentially affect things that are important policy acts like IIJA,” Kramer said. “It doesn’t have to be a series of unintended consequences.”

The CDFA is organizing a coalition of groups, including the Affordable Housing Tax Credit Coalition, and plans to send a letter to Treasury this week expressing concerns about the global tax.

“There’s already a pretty large coalition on the business side, but what’s missing is the state and local governments and the community finance piece to help balance out the policy effects on the ground,” Kramer said.

The GFOA is also tracking the issue, said lobbyist Emily Brock.

In a surprise move earlier this week, a potential fix emerged in Biden's FY23 budget.

The spending plan proposes a domestic top-up tax that would capture the difference if U.S. company’s rate falls below 15%, a move that would keep the additional revenue in the U.S.

And the Treasury's Green Book includes a vaguely worded paragraph that appeared to be aimed at addressing market concerns:

“Separately, the proposal would provide a mechanism to ensure U.S. taxpayers would continue to benefit from U.S. tax credits and other tax incentives that promote U.S. jobs and investment.”

Industry advocates said they're trying to figure out what the paragraph means.

“We don’t know what the mechanism is but we’re certainly going to be continuing conversations with the administration and other policy makers to ensure the mechanism will indeed protect these credits,” said Emily Cadik, the executive director of the Affordable Housing Tax Credit Coalition. “Without an exception for credits like the housing credit, we expect a major share of investment will be at risk.”

One possibility is a mechanism that makes tax credit bonds refundable. But that would likely not work for tax-exempt interest, said Brown.

“Reformulating how tax-exempt bonds work or making tax credits refundable, all of this would require action on the part of Congress,” Brown said. “The only thing Treasury can do is go back to the OECD and say we need to fix the rules.”