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New year brings new challenges and opportunities for tax policy

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The changing year will ring in the 118th U.S. Congress while also bringing policy changes and legal challenges to the muni market.

Despite the uncertainty, there are strains of optimism emerging among some industry leaders. Hope is still alive for the eventual return of advance refundings, even if it may be a longshot. Other priorities have virtually no chance of gaining traction in a legislature where power is split between the two major parties. The reinstatement of tax-exempt advance refunding has been the top priority of municipal market lobbyists ever since it was stripped away in the 2017 Tax Cuts and Jobs Act.

"This remains the outstanding muni priority I feel with the best chance of advancement," said Brett Bolton, vice president of federal legislative and regulatory policy at Bond Dealers of America. "I say this because of longstanding bipartisan support and continued growth of support of sitting Ways and Means members on both sides of the aisle. It should be noted that many Republicans remain unwilling to overturn anything that was passed in the 2017 Tax Cuts and Jobs Act."

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Even if the refundings were to make a comeback, interest rates would need to drop to make them effective. "I think there's an opportunity potentially, to reinstate advance refunding, although it's not heavily used in a rising interest rate environment," said Leslie Norwood a managing director, associate general counsel, and head of munis, at the Securities Industry and Financial Markets Association. "The typical advance refunding is high to low."

The combination of bipartisan support for reinstatement, unclear scoring on its cost, and questionable rationale for why refundings were cut in the first place may keep it in play.

"We did not lose advance refundings with tax exempts to deficit reduction, we lost it for a tax cut," said Tom Kozlik, director, head of municipal strategy and credit, Hilltop Securities Inc. "That shocked me. This policy outcome is a fact hardly anyone recognizes, much less understands."

The new year will also raise the curtain on the corporate minimum tax which was ushered into existence by the Inflation Reduction Act of 2022.

The legislation only applies to corporations with three-year average incomes of more than $1 billion. It requires them to compare a 21% tax rate on their corporate income versus a 15% tax rate on their book rate and pay the higher of the two. Book rate is the earnings the firms report to shareholders on their financial statements.

Tax-exempt munis may not be exempt from book income which could force large-sized buyers of munis to the sidelines. "We need to make sure that we are vigilant about any potential threats to chipping away at the tax exemption. And that's actually what this is," said Government Finance Officers Association federal liaison Emily Brock.

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Viewpoints differ in how much influence the large corporate buyers exert on the muni market and what effect, if any the legislation will have.

"From our perspective, the impact of the corporate minimum tax on the demand for municipal tax-exempt municipal securities was really de minimis," said Norwood. "Our view was that in this environment, the impact of the CMT was on few bonds. And not many that participate in the tax-exempt municipal securities market. Our concern was more so if there was a market dislocation, because that's typically when these market participants step in and support the market. Luckily, we have not had one."

Brock's concerns are not allayed. "Our biggest buyers are property and casualty life insurance and banks," she said. "Those are the two biggies that are up top." There is also confusion about how the Internal Revenue Service will interpret and enforce the new rules. Brock's organization is aware of ongoing listening sessions held by the Treasury to gather stakeholder input.

If the big muni-buying fish are driven of out their tax-exempt harbors there are a few other places to hide. "Given how many corporations use munis, the alternatives for most are products like Treasury bills, commercial paper, taxable institutional money market funds, and the like," said Bolton.

As Republicans take hold of the purse strings by assuming a majority in the House, the future of the IRS's budgetary windfall also allocated in the IRA is being called into question. "Based on reports since the funding was announced, they will absolutely fight this tooth and nail," said Bolton.

Others are already seeing changes in the form of boots on the ground.

"The IRS enforcement people have told us that they were planning to hire more people even without the additional funding, but this will likely accelerate and broaden that trend, which likely will increase the number of bond audits that we see," said Johnny Hutchinson, partner, Nixon Peabody LLP.

"I think a lot of people will be questioning the administration's desire to want to hire significant number of new enforcement agents at the IRS, though real geeks would tell you that they've been low on enforcement agents for a very long time," said SIFMA's managing director tax, Justin Sok.

With the Democrats losing leverage the possibility of lifting the cap on the state and local tax deduction is fading into the rear-view mirror.

"If a fully democratic Senate, House and White House with vocal members from blue states couldn't get it lifted, I doubt it gets lifted in a Republican Congress," said Sok.

The coming year seems to promise more audits, more clarifications from the IRS, and more taxes on corporations that invest in bonds. There is hope for refundings but none for caps on SALT. Politics feel tamer for the moment, but things may change when the opening gavel falls. Many are also looking forward to a certain amount of legislative gridlock.

"My general thought is that, while municipal bonds enjoy bipartisan support and are useful tools both in red and blue jurisdictions, the likelihood of meaningful tax legislation passing through a split Congress is remote," said Richard Moore, a tax partner at Orrick, Herrington & Sutcliffe.

"Perhaps something modest can be done, such as reducing the 50% low-income housing tax credit test to 25%, which would have the practical impact of increasing the amount of available volume cap. Bigger goals, such as reinstating advance refunding or a sequestration proof direct pay bond, are going to have to wait."