INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

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U.S. House of Representatives Committee on Ways and Means
Tax Reform Working Group on Financial Services
Comments of the Investment Company Institute on the Tax Treatment of Municipal Bonds

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Municipal Bonds are a Mainstay of Public Finance That Must Be Preserved

Municipal Bonds and the Fund Industry

The Investment Company Institute (ICI)[1] is pleased to provide these comments on the tax treatment of municipal bonds to the Committee on Ways and Means Tax Reform Working Group on Financial Services.

Investment funds provide average retail investors with professionally-managed, diversified portfolios that individuals cannot replicate on their own. The funds represented by ICI provide an efficient and cost-effective means for individual investors to obtain municipal bonds and are a critical part of the municipal bond market.

At the end of 2012, investors held, in the aggregate, $1 trillion of municipal bonds through hundreds of registered investment companies, including municipal bond funds and tax-exempt money market funds. Individual investors held another $1.7 trillion of municipal bonds directly.[2]

Municipalities Benefit From the Tax Exemption

State and local governments accrue the benefits of the tax-exemption upon issuing municipal bonds. State and local governments pay municipal bond holders lower interest rates on their investments, since municipal bonds produce interest payments that are exempt from tax. Investors accept the lower interest rates because the after-tax return is comparable to a taxable bond.

Retroactive Taxation is Unjust

Investors in municipal bonds paid an implicit tax on their securities by accepting a lower interest rate. Imposing a retroactive tax on their existing investments' interest payments imposes a tax burden for a benefit they did not receive. It is unfair to impose retroactive taxation on investors, many of whom are seniors, on the basis of an economic benefit that flowed to the states and localities that issued the bonds.

Seniors and individuals with AGI under $250,000 hold a substantial amount of all outstanding municipal bonds. Almost 60 percent of income from municipal bonds is earned by taxpayers over the age of 65.[3] And contrary to

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $14.7 trillion and serve more than 90 million shareholders.

[2] ICI data shows that, at the end of 2012, individual investors held 28 percent of the municipal bond market through funds and Federal Reserve data shows that 45 percent was held by individual investors directly.

[3] IRS Statistics of Income Division, 2010.

some claims, most of municipal bonds' tax exemption does not accrue to higher income investors. Fifty-two percent of tax-exempt interest is earned by taxpayers with AGI under $250,000.[4] Targeting these investors with a punitive retroactive tax on a benefit that they did not receive is inappropriate.

Retroactive Taxation Imposes Tremendous Losses on Investors

The losses imposed on existing investors would be significant, as repealing the tax exemption would cause an immediate decline in the value of municipal bonds. Experts estimate that a 28 percent cap would destroy over $200 billion of existing tax-exempt bonds' market value.[5] Seniors would bear almost $120 billion of these losses.

Moreover, retroactive taxation could trigger mandatory redemption provisions in $150 billion of existing municipal bonds. Many municipal bond indentures were written with provisions that force municipalities to immediately redeem any bonds whose tax-exempt interest becomes taxable by operation of a change in the tax laws. Mandatory redemptions of existing bonds will require municipalities to immediately refinance outstanding debt at higher rates.

History of the Municipal Bond Tax Exemption

The Institute urges Congress to preserve the current tax exemption for municipal bond interest. State and local government bonds have been tax-exempt since the codification of the federal tax code in 1913. Through this vital tax-exemption, the federal government provides crucial support for the development and maintenance of essential facilities and services.

Recognizing the vital role that municipal bonds play in the economic growth of U.S. communities, Congressmen Lee Terry (R-NE) and Richard Neal (D-MA) recently introduced a bipartisan resolution, H. Res. 112. The resolution, strongly supported by the Institute and other organizations, celebrates the use of tax-exempt municipal bonds as a bedrock tool to finance public infrastructure over the past century.

Necessity of the Municipal Bond Tax Exemption

The $3.7 trillion municipal bond market is the primary financing tool used by states and counties to finance three-quarters of the total U.S. investment in infrastructure, including in schools, roads, bridges, hospitals, sewer and water systems, and other projects that provide essential services. Without the tax-exemption, state and local governments either would pay far more to raise capital—a cost that ultimately would be borne by taxpayers, through higher taxes—or be forced to reduce infrastructure spending.

A recent study released by four of the major trade organizations that represent states and municipalities reveals the potential impact of limiting or repealing the tax exemption for municipal bond interest. The study found that if the tax exemption was not in place over the last 10 years, states and municipalities would have paid nearly $500 billion more in financing costs. If the Administration's proposed 28 percent cap had been imposed over this same period, state and local communities would have paid added interest charges of $173 billion.[6]

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[4] IRS Statistics of Income Division, 2010.

[5] George Friedlander, Mikhail Foux, and Vikram Rai, *US Municipal Strategy Special Focus: The Case for the Tax Exemption Remains Strong, Even As Threats Grow*, Citi Research (October 2012).

[6] The Government Finance Officers Association, *Protecting Tax-Exempt Bonds for Infrastructure and Jobs*, February 2013.