County of San Mateo

Inter-Departmental Correspondence

Department: COUNTY MANAGER
File #: 16-766

Board Meeting Date: 11/21/2017

Special Notice / Hearing: None
Vote Required: Majority

To: Honorable Board of Supervisors

From: John L. Maltbie, County Manager
Connie Juarez-Diroll, Legislative Officer

Subject: Federal Income Tax Reform

<u>RECOMMENDATION</u>:
Approve a resolution opposing the proposed repeal of State and Local Tax (SALT) deductions, tax-exempt advance refunding bonds, tax-exempt private activity bonds, and the adoption tax credit.

<u>BACKGROUND</u>:
State and Local Tax (SALT) Deductions-Under current law, taxpayers who itemize (rather than claim the standard deduction) are permitted to deduct certain nonbusiness tax payments to state and local governments from their taxable income. An individual may choose to deduct either state individual income taxes or general sales taxes, but not both, and may also deduct any real or personal property taxes. Most filers elect to deduct their state and local income taxes rather than sales taxes because income tax payments tend to be larger, but those who reside in states which forego an income tax, or who have uncommonly high consumption expenditures in a given year, may opt to deduct sales taxes instead. These deductions (both standard and itemized) ultimately reduce the amount of income that gets taxed by the government. Filers have been able to deduct state and local taxes since federal income tax was conceived in 1913.

Tax-Exempt Advance Refunding Bonds-Under current law, tax-exempt refunding bonds issued more than 90 days prior to the redemption date of the refunded bonds are classified as advance refunding bonds. Advance refunding allows counties to refinance outstanding bonds to take advantage of better terms and rates. Additionally, counties are only able to engage in tax-exempt advance refunding once over the life of the bond.

Tax-Exempt Private Activity Bonds (PABs)-PABs are widely used to attract private investment for projects that have some public benefit. Under current law, the interest earned on PABs is tax exempt. In California, PABs work in concert with the Low-Income Housing Tax Credit (LIHTC) to encourage the development and rehabilitation of affordable rental housing.

Adoption Tax Credit-Existing law allows persons seeking an adoption to claim an adoption credit of as much as $13,570 per eligible child. The credit is phased out after certain income levels.

On November 2, 2017, the Republican leadership of United States House of Representatives introduced H.R. 1, the Tax Cuts and Jobs Act (the "Bill"). The introduction of the bill follows a year of work by House Ways and Means Chairman Kevin Brady (R-Texas) and House Republican leadership to craft a comprehensive tax reform package. The 452-page bill would alter nearly every portion of the tax code by lowering individual and corporate tax rates from 35 percent to 20 percent on a permanent basis and setting a new rate for so-called "pass through businesses," or businesses that file on the individual side of the tax code at a rate of 25 percent. To make up revenue lost by lowering rates and to simplify the code, the package proposes to eliminate or caps dozens of tax deductions and credits-several of which will have an impact on counties. The House Ways and Means Committee approved H.R. 1 on November 9 along party lines, 24-16 moving the proposal to the full House for consideration the week of November 13.

On November 9, the Senate Finance Committee unveiled a description of its version of the Tax Cuts and Jobs Act. Like its House counterpart, the Senate plan includes hundreds of structural changes to the tax code; however, some changes are more significant than others. The Senate bill (not yet in legislative language at the time of the writing of this memo) is slated to be worked out during the Finance Committee deliberations scheduled for the week of November 13, with passage of the bill anticipated after the Thanksgiving holiday.

At the county level, both the House and Senate versions of tax reform propose to eliminate or cap a number of tax deductions and credits of importance to Californians:

Provision	**House Bill**	**Senate Bill**
SALT Deductions (Local Property Tax & Sales and Income)	Caps the local property tax deduction to $10,000 Eliminates deduction for both sales and income tax	Eliminates property tax deduction for individual filers Eliminates the state and local tax deductions
Tax-Exempt Advance Refunding Bonds	Eliminates the exemption	Eliminates the exemption
Tax-Exempt Private Activity (PAB) Bonds	Eliminates the tax exemption on newly issued PABs	Retains PABs
Adoption Tax Credit	Original version of the bill called for a full repeal of the credit; however, the credit was reinstated after it was roundly opposed.	Retains credit

While initial versions in each chamber contain some substantial differences, ultimately both chambers must agree on the same package before taking a final vote. Republicans plan to use the budget reconciliation process to pass the bill, requiring only a simple majority vote in the Senate. However, this process adds additional financial restrictions and rules to the legislation, which could impact the extent to which lawmakers can make desired changes to the tax code. Both chambers of Congress intend to move quickly on the legislation, aiming to send a final bill to the President's desk before Christmas.

DISCUSSION:

State and Local Tax (SALT) Deductions-the SALT deduction has been an integral component of the federal tax code since its creation in 1913 and was one of the six deductions allowed under the original tax code. Eliminating or capping federal deductibility for state and local property, sales and income taxes would represent double taxation and would upset the carefully balanced fiscal federalism that has existed since the permanent creation of the federal income tax over 100 years ago. States and local governments deploy revenues from state and local property, sales and income taxes to help finance long term infrastructure projects, local law enforcement, emergency services, education costs and many other services. By eliminating federal deductibility of these taxes, Congress would be shifting the intergovernmental balance of income taxation and could limit state and local control of our tax systems. Abolishing federal deductibility could also greatly constrain policy options available to states and local governments as these deductions allow local governments the ability to diversity their sources of revenues, so they are not solely dependent on property taxes, which are subject to rapid changes in housing prices.

While County specific tax data is not available, according to the Department of Finance, more than six million Californians take advantage of the state and local tax deduction each year, deducting an average of $18,438 per family. In all, California taxpayers deducted $112.5 billion in state and local taxes in 2015, the most recent year analyzed by the non-partisan Tax Policy Center.

A number of federal lawmakers, including 36 members of the California Congressional Delegation, have publicly opposed GOP efforts to eliminate the SALT deduction. Joining them in their opposition are the following groups: National Governors Association, United States Conference of Mayors, the National Association of Counties, and the National Conference of State Legislatures.

Municipal Bonds-tax-exempt municipal bonds have also been a feature of the United States tax code since 1913. Municipal bonds remain the primary method used by states and local governments to finance public capital improvements and public infrastructure projects. States and local governments own and operate the vast majority of our nation's infrastructure systems and invested $3.8 trillion in infrastructure through municipal bonds from 2007 to 2016. The federal tax exemption reduces the cost of issuing municipal bonds, which is vital to taxpayers across the country who pay the interest and principle on municipal bond debt in exchange for investing in public, community assets.

Bond refundings are most commonly used by state and local governments to achieve savings on interest costs. Refunding bonds can also be issued to remove or revise burdensome bond covenants or to restructure debt service payments.

Tax-Exempt Advance Refunding Bonds-under federal law, governments may engage in a tax-exempt advance refunding only once over the life of the bonds.

The ability to advance refund outstanding bonds provides substantial savings to taxpayers and counties throughout the country. In 2016, the advance refunding of more than $120 billion of municipal securities saved taxpayers at least $3 billion. Best practices advanced by the Government Finance Officers Association (GFOA) recommend minimum savings thresholds on a present value basis of 3 percent to 5 percent when advance refunding municipal securities. The combined impact of all bond proposals in H.R. 1 would be an additional $60 billion in federal revenue at the expense of local governments and infrastructure development.

According to the County's municipal bond advisors, if approved, the House GOP tax plan would limit the County to advance refundings on a taxable basis only. Taxable municipal revenue bonds trade at higher rates-1.50 percent to 2.25 percent-than tax-exempt bonds. Thus, for a $100 million financing, this would mean an annual payment of approximately $7.8 million versus $6.2 million under the lower pre-tax rates-or $1.5 million in annual losses. Over 25 years, this would translate into an estimated $39.7 million increase in gross dollars or $20.3 million in present value dollars. It is expected that many advance refundings would not happen for the first ten years (when bonds have call protection) if they had to occur on a taxable basis only. After the tenth year (i.e., once the bonds are callable), the County could move forward with a tax-exempt refunding assuming interest rates are desirable. This could mean several years of lost savings.

Tax-Exempt Private Activity Bonds (PABs)-are an important tool for state and local governments to help finance major public projects, including transportation and water infrastructure, affordable housing construction, and schools. Eliminating PABs' tax-exempt status would drive up the costs of borrowing for these projects by 25 percent and be a disincentive to spurring private-public sector investment in our community.

Importantly, PABs also work in conjunction with low-income housing tax credits (LIHTC) in the development of affordable housing. Under current rules, housing sponsors and developers can raise project equity through the sale of federal tax benefits to investors who can receive two types of credits: nine percent (9%) and four percent (4%). A taxpayer may deduct the approximate percentage of a project's "qualified basis" from their annual federal tax liability in each of ten years. Furthermore, the 4 percent credit can only be claimed if 50 percent or more of the project is funded using tax-exempt private activity bonds.

In recognition of the extremely high cost of developing housing in California, the state legislature authorized a state low income housing tax credit program to augment the federal tax credit program. The state credit is only available to a project which has previously received, or is concurrently receiving, an allocation of federal credits. Thus, the federal program works in concert with the state's program. Nationally, LIHTCs are allocated to each state according to its population. State housing agencies then allocate credits to developers of rental housing according to federally required, but state created, allocation plans.

The House tax reform bill proposes eliminating PABs, so while LIHTCs are explicitly retained in the bill, the elimination of the bonds would eliminate the 4 percent credit and likely lead to a precipitous drop in construction of low-income housing units produced by the program. With much of the private market focused on catering to high-end renters since the housing collapse 10 years ago, the LIHTC program accounts for practically all of the new affordable housing options for low-income Americans. California is the largest beneficiary of the 4% LIHTC and PABs in the country. In fact, the state received $2.2 billion worth of 4% LIHTCs and deployed more than $6 billion in PAB authority for multifamily and single-housing-accounting for approximately two-thirds of all affordable housing built in the state. Collectively, these two funding sources created or preserved more than 20,000 affordable homes in 2016, of which 19,275 units were for households earning 60 percent or less of Area Median Income.

According to County's Housing Department, the 4% LIHTC is the primary program used for the development of affordable housing in the County. In 2013, for example, the County was awarded approximately. $133.8 million in 4% LIHTC bond awards for the development of 920 units of affordable housing for seniors and families from Daly City to East Palo Alto. If not for the tax credit, these units would not have been built, or would have been built, but at exorbitantly high levels of County contribution. Because PABs are key in the 4% LIHTC segment, it is important that they remain; otherwise, the 4% LIHTC would not be very useful to non-profit housing developers. Should PABs be eliminated, it is expected that the County would need to contribute more local funding for the construction of future affordable housing units.

In California, where the housing shortage stands at 1.5 million units statewide and is growing by a staggering 60,000 units per year, losing the program would effectively eviscerate a program that has put a roof over the heads of thousands of homeless or near-homeless low-income families and seniors.

Adoption Tax Credit-the adoption tax credit advances the important goal of enabling domestic and intercountry adoptions, especially for children with special needs who otherwise might linger in costly foster care without the benefits and security of permanent families. Nationally, over 53,000 children were adopted from foster care in fiscal year 2015 alone. The adoption tax credit benefits middle class working families seeking to adopt. By offsetting some of the costs of adoption or of caring for a child with special needs, the tax credit makes adoption a more viable option for many children and families. For year 2017, the tax credit for adopting a foster child with special needs is set at $13,570.

The House GOP tax proposal initially eliminated the credit, although it was later restored just before the Ways and Means Committee approved the plan. The Senate plan preserves the credit; however, adoption advocates remain concerned that an attempt to remove the adoption credit could resurface.

The San Mateo County Human Services Agency is a full service adoption agency committed to providing stable and supportive homes for children who have been removed from their parents and with the goal of family reunification. In the event that reunification is not possible, the County connects resource families with foster placements and adoptions. Last fiscal year, the County successfully finalized 35 adoptions, an increase of 17 from the previous fiscal year as HSA is focused on placing youth in permanent family settings. Proposals to eliminate the Adoption Tax Credit would negatively impact these efforts.

The resolution has been reviewed and approved by County Counsel as to form.

Approval of this resolution contributes to the Shared Vision 2025 of a Collaborative Community by promoting federal policies that support services and program that benefit the residents of San Mateo County.

FISCAL IMPACT:
Adoption of this resolution has no fiscal impact. If enacted, the following components of the Republican tax plan would have the following fiscal and programmatic impacts to the County:1) SALT deduction repeal-would lead to the double taxation of County residents and limit the ability of the County to control our local tax system; 2) tax-exempt advance refunding bonds repeal-would limit the County to refunding bonds on a taxable basis potentially costing the County millions of dollars in additional funding costs; 3) private activity bonds repeal-would lead to a huge drop in the construction

of affordable housing units and create a great demand for local funding (i.e. Measure K) to build new units; and 4) adoption tax credit repeal-would make adoption more costly for families in the County potentially leading fewer families to seek adoptions.