To:
Senator Roberts
Senator Moran
Representative Lynn Jenkins

Info CC:
Representative Pompeo

From:
Dr. George McDuffee

Date:
15 April 2013

Subject:
Growing abuse of Federal tax exemption for interest income on Muni bonds.

Ref:
http://www.npr.org/2012/12/07/166745290/school-district-owes-1-billion-on-100-million-loan

The abuse of municipal bonds (and the taxpayers), both in the issuance and in the composition has been rapidly increasing, and this is an increasingly serious Federal concern in that under current laws and regulations the interest income from these bonds is largely exempt from Federal taxes, meaning that the taxpayers NOT owning these bonds and receiving interest, both current and future, must make up the shortfall in revenue that results, especially given the soaring national debt and rapidly approaching so-called "financial cliff."

To be sure, at one time Federal tax exemption was a imminently rational and justified policy to stimulate economic activity through productive and beneficial [for the majority] local community investment, however the context and tacit assumptions justifying this policy have drastically changed, REQUIRING A CRITICAL REAPPRAISAL OF THIS POLICY. For one thing, the form of municipal bonds has changed from a simple, easily understood, loan and repayment over time agreement into highly complex and arcane financial arrangements, many of which are only part of convoluted financial packages which includes credit defaults swaps or other esoteric products, which were never intended to be exempted from Federal taxation. For another, the tacit assumptions of frugality, prudence, skepticism, and desire to benefit the majority of their citizens/taxpayers by local governmental officials are increasingly debatable.

Just as the "interest only" and "teaser" sub-prime mortgages inflated a gigantic U.S. residential real estate bubble, which then collapsed at enormous direct and consequential costs to the American taxpayers and investors, similar municipal bond abuses such as "Capital Appreciation Bonds" are highly likely to result in a similar bubble and collapse.

While "throwing the baby out with the bath water" must be avoided, it is clear changes must be made, and made quickly, if increasingly serious Muni bond abuse outcomes are to be avoided. It is suggested the IRS code be amended to provide:

(1) The interest received by investors in Muni bond PACKAGES, i.e. which include tie-in products such as credit default swaps, is not exempt from Federal taxes.

(2) The interest received from Muni bonds is exempt from Federal taxes only if the bonds have a fixed interest rate, and have a level amortization schedule for fixed period of time, not to exceed 20 years, i.e. no Capital Appreciation Bonds, no balloon bonds and no perpetual bonds, and that the total interest and fees paid cannot exceed the amount of money received as a result of the bonds. (Using the face value of the bonds may be misleading, if the bonds are discounted, i.e. if the face value is 1 million dollars but only 900,000 is actually received.)

(3) The interest received from Muni bonds is exempt from Federal taxes only if the bonds have been publicly offered and at least three bids have been received. Muni bonds with "Negotiated" rates and underwriting are specifically prohibited from tax exemption.

(4) It is highly suggested that a provision be included to require the use of a standardized bond contract/agreement between the issuer and underwriter, provided by the IRS, for the interest to be exempt from Federal income tax. This will preclude efforts at evasion of these provisions, provide known and standardized terms and conditions avoiding needless litigation, and avoid the unnecessary expense of writing custom agreements for every bond issue.

(5) The interest of Muni bonds should be exempt from Federal income taxes only if the individuals responsible for approving the bond issue have signed a "Sarbanes-Oxley" type declaration, under the penalties of perjury, that they understand the provisions, terms and conditions of the bond contract, and that they have received nothing of value for for their approval, and the underwriters have signed a similar declaration stating they have offered nothing of value to the individuals approving the agreement.

(6) The Interest received from Muni bonds is exempt from Federal taxes only if the bonds have been issued for specific projects, and the money is to be placed in escrow or an imprest account and used only for the specified project. To be effective, this provision must be backed by criminal law with severe penalties.

(7) While slightly more controversial and subjective, it would appear that the interest from Muni bonds should be tax exempt only if the purposes for which the money is being borrowed do not conflict with the policy goals and objectives of the federal government, and benefit the aggregate community rather than some small sector. This could take the form of a list of activities and projects for which municipal bond interest would NOT be tax exempt. For example: automotive assembly plants (the U.S. already has gross production overcapacity); or professional athletic facilities such as arenas or stadiums. This would avoid "raiding" by the municipalities on the one hand, and the playing off of one municipality against another by the beneficiaries of the bond funds.