2015 Federal Outlook

By Dustin McDonald

The 2014 midterm elections changed the political landscape for the final two years of the Obama presidency. Republicans secured Democratic-held Senate seats in Arkansas, Colorado, Montana, North Carolina, South Dakota, West Virginia, Iowa, and Louisiana, picking up a total of nine seats and arming Senate Republicans with a 54 to 46 majority in 2015. Republicans also expanded their House majority, securing 12 additional seats to raise their total voting advantage to 244 votes, to the Democrats' 186. As Republicans return to Washington for the start of 114th session of Congress, they are quickly pivoting to develop a bicameral agenda that distinguishes them from the president and appeals to voters in anticipation of the 2016 presidential election.

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GFOA priority items on this agenda that affect state and local governments will include efforts to repeal or significantly reform the *Patient Protection and Affordable Care Act* (ACA), overhaul the federal tax code through comprehensive tax reform, revise the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and consider legislation dealing with taxation of Internet access and state and local collection of taxes on remote sales. Below is an overview of expected activity in these areas, and the GFOA's priorities within them.

TAX REFORM

House and Senate leaders, as well as the White House, began the year expressing a desire to find common ground on principles to overhaul the federal tax code. However, federal elected leaders will need to make progress quickly in developing a tax reform framework, as attention will quickly turn away from legislating and toward the 2016 presidential election as the calendar flips toward the fall. Reaching agreement on the broad outlines of what to include in a tax reform package will present challenges for lawmakers. While the White House would prefer to reform only the corporate tax side of the code and use any proceeds from the reform effort to backfill federal investment in national infrastructure, the incoming chairmen of the House and Senate tax authorizing committees have a different vision. For example, incoming Senate Finance Committee Chairman Orrin Hatch (R-Utah) has pledged to ensure that any tax reform effort is revenue-neutral rather than using the exercise to generate funding for infrastructure development. Meanwhile, incoming House Ways and Means Committee Chairman Paul Ryan (R-Wisconsin) has tacitly supported advancing tax reform in two phases, the first focused on corporate reform that potentially creates infrastructure revenue, and the second focused on the individual side of the tax code.

The fate of small businesses in this process remains a large and outstanding issue, and it is unclear how and where within the process tax reformers will address it. While broad support exists among congressional leaders and the White House to at least begin the tax reform effort with a discussion on corporate tax reform, many small businesses file taxes through the individual side of the code, making it not only a priority that must be addressed, but also one that does not fit neatly into the corporate and individual discussions. As lawmakers determine how to address this issue, they risk increasing the size of their reform package and decreasing the support necessary to pass it. Tax reform, whether piecemeal or more comprehensive, has numerous implications for state and local governments. As in the past, the GFOA will work cooperatively with others in the state and local advocacy community to protect the best interests of state and local governments in the areas listed below.

Changes to Municipal Securities. Congress and the administration continue to present tax proposals that would limit or eliminate the federal tax exemption on municipal bond interest. Both of these suggested reforms would negatively affect state and local governments by increasing their bond issuance costs. For example, a 2013 report issued by a coalition of state and local government associations indicates that the White House's proposal to impose a 28 percent cap on itemized investor deductions (to include tax-exempt interest) would increase issuer interest costs by at least 70 basis points.[1] The report also estimates that eliminating the tax exemption would increase issuer interest costs by at least 200 basis points. The GFOA will oppose any plans to cap the amount of municipal bond interest that taxpayers can exclude from their federal taxes, as well as oppose any proposals to eliminate the federal tax exemption altogether. The GFOA will work with its state and local government association partners to educate Congress and the administration on the importance of tax-exempt bonds and the value of this critical financing tool in meeting our country's infrastructure needs.

Deductibility of State and Local Taxes. The GFOA will work against any proposals to limit or eliminate the federal deduction of state and local taxes. The GFOA continues to support legislation that would permanently allow taxpayers to deduct state and local sales taxes on their federal tax return.

MUNICIPAL BONDS

In addition to the implications that possible tax reform efforts could have on municipal securities, the GFOA will be monitoring many other important bond-related matters throughout the year. These include the following.

Disclosure Standards. In July 2012, the SEC released a report citing the need for greater issuer disclosure standards for governments that issue municipal securities. This year, the SEC will continue its pursuit of recommendations in the report, which include both changes to SEC rules and legislative efforts to set disclosure and financial information standards. The GFOA and its state and local government partners will work to oppose such efforts.

Implementation of the Dodd-Frank Act. The GFOA is also expecting the SEC and the MSRB to continue developing regulations that affect municipal securities issuers and the professionals they hire, related to the Security and Exchange Commission's approval of its final Municipal Advisors Rule in fall 2013. The GFOA plans to comment on the rules in order to protect the interests of state and local governments. These expected rules include a detailed regulatory framework over financial advisors and changes to regulations over broker/dealers.

Bank Qualified Debt Limit. The GFOA will work with its state and local government and industry partners to increase the bank qualified debt limit from $10 million to $30 million. The $10 million amount was set in 1986. Congress temporarily increased that limit to $30 million in 2009 and 2010, but the limit reverted back to $10 million in 2011. The GFOA will continue to support legislation that would permanently increase the annual bank qualified debt limit to $30 million and have it indexed to inflation thereafter.

PENSIONS AND RETIREMENT

Continued scrutiny of state and local government retirement plans is also expected this year. To that end, the GFOA, along with other Public Pension Network members representing both state and local governments and retirement systems, will continue educating members of Congress regarding the true fiscal condition of public pension systems. We will also continue to consider whether proposed initiatives support flexibility at the state and local level to provide retirement security to public-sector employees, and to oppose Congressional proposals to undermine the authority of state and local governments to effectively govern and finance their pension plans.

New Senate Finance Committee Chairman Orrin Hatch has suggested that retirement security issues will be a priority for his committee. In fact, at a Senate hearing on retirement savings in September 2014, the senator said that he wished to have his legislation, the *Secure Annuities for Employees* (SAFE) *Act*, be the next retirement bill to come out of the committee, and he urged bipartisan work on the measure. The bill, which was first introduced in July 2013, would allow state and local governments to offer a new type of defined benefit plan consisting of individual deferred fixed income annuity contracts. These contracts would be purchased by state and local government employers on behalf of their employees from annuity providers whose contracts would be fully guaranteed by a state guaranty association. State and local governments would be able to provide a traditional defined benefit pension plan as well as a deferred fixed income annuity contract, although an individual employee could not participate in both.

The GFOA is still gathering information about Senator Hatch's *SAFE Act*, which does not mandate that state or local government employers provide annuities to their employees, but would allow them to offer this plan as another "tool" for providing retirement benefits. Despite the bill's voluntary nature, some concerns have been expressed, including its failure to address existing unfunded liabilities and to provide survivor and disability coverage for employees and their families. Senator Hatch's staff has said that his office was looking at all possible vehicles for moving the bill forward, including making it part of comprehensive tax reform.

Another pension proposal that is being reintroduced in 2015 is *The Public Employee Pension Transparency Act* (PEPTA), sponsored in the past by Representative Devin Nunes (R-California) and Senator Richard Burr (R-North Carolina). The bill would require states and local governments to report their financial data to the Treasury Department as though they were invested only in U.S. Treasuries, rather than the diversified portfolios actually in use. This would create a false picture of the true condition of public pensions. State and local government plan sponsors that do not comply with the legislation's reporting requirement risk losing their ability to issue tax-exempt bonds and to receive direct subsidies under the Build America Bonds program and other direct subsidy bond programs. For these reasons, the GFOA, along with many other associations representing states and local governments and retirement systems, will continue to express our strong opposition to the PEPTA legislation.

In addition to the continued conversations about the need for PEPTA, ideas related to other types of federal intervention continue to garner attention. Some pension pundits have raised the question of PERISA — that is, essentially extending some or all of the Employee Retirement Income Security Act of 1974 (ERISA), which covers private-sector retirement plans, to the public sector, as a way of mandating reporting, disclosure, fiduciary standards, and possibly even funding requirements on state and local governments. In addition, the idea that all newly hired state and local public employees should be covered by Social Security has reemerged, particularly after Washington's efforts to find all available dollars to put toward deficit reduction. President Obama's National Commission on Fiscal Responsibility and Reform endorsed this proposal in its report issued in December 2010. While no member of Congress has introduced legislation specifically advancing any of these objectives, the GFOA and its state and local government partners will continue to closely monitor any PERISA and Social Security reform debate and advocate against any proposals to mandate standards that affect the fiscal sovereignty of states and local governments.

Finally, the governmental plans community continues to await 2015 proposed regulations from the Internal Revenue Service and the Department of Treasury that seek to clarify both the definition of normal retirement age and governmental plan.

HEALTH CARE

Soon after their sweeping victory in the House and the Senate, Republican leaders once again made clear that a priority issue for this year would be to significantly amend the ACA. It is not yet clear how far Republican leaders intend to go, as some provisions of the law, such as no preexisting condition exclusions and coverage for children until age 26, remain very popular among constituents. According to House Speaker John Boehner (R-Ohio) and Senate Majority Leader Mitch McConnell (R-Kentucky), priority issues for reform include doing away with the requirement that most individuals maintain health coverage or pay a penalty, eliminating the excise tax on medical devices, and amending the definition of a full-time employee who is eligible to receive employer-provided health insurance from an individual who works 30 hours per week to one who works 40 hours.

With regard to the definition of full-time employee, expect Senators Susan Collins (R-Maine) and Joe Donnelly (D-Indiana) to reintroduce their 2013 legislation, the *Forty Hours is Full Time Act*, to change the ACA's definition of full-time employee to 40 hours. Rep. Daniel Lipinski (D-Illinois) introduced a companion bill in the House. The 30-hour definition, they wrote, "is inconsistent with the traditional description of a full-time 40-hour work week, and coupled with the proposed rule's application and other responsibilities, has caused significant confusion among employers who are struggling to understand and comply with the new requirements…" This measure, and others like it that would change the definition of "full-time employee," garnered a good amount of bipartisan support last Congress and is one component of health-care reform that is likely to gain bipartisan momentum in 2015. President Obama has vowed to veto any measures amending the definition of a full-time employee, as well as the other possible changes to the ACA discussed above.

For organizations that represent employers, like the GFOA, such legislation merits some consideration. Reports of state and local governments reducing employee hours to avoid the costs associated with providing health insurance to employees who work 30 hours a week have become commonplace. In addition, according to several public-sector health-care consultants and attorneys, ferreting out which employees are full time versus part time under the ACA's definitions remains one of the biggest challenges facing state and local government employers.

While the confusion created by the definition of a full-time employee may be significant, the most daunting health-care issue for state and local governments is the impending "Cadillac tax." Under that tax, adopted as part of the ACA in 2010, health-care plans that cost more than a certain amount in 2018 — $10,200 annually for individual plans and $27,500 for family plans — will be taxed at 40 percent of their costs above that limit (although plan amounts increase for retirees over 55 and those engaged in high-risk professions). State and local governments are expected to be disproportionately represented among those employers that are subject to the tax because they typically offer more expensive plans than those offered in the private sector. Several local governments around the country, including the State of New York; the City of Boston, Massachusetts; and Orange County, California, have warned that if they cannot reduce their health-care costs or Congress does not take measures to repeal or amend the tax, the impacts will be significant. There have been discussions over the years about the potential effects of the Cadillac tax, but it appears that no earnest efforts have been made toward its repeal. The near-certainty that Congress will be examining changes to the ACA throughout 2015 presents an opportunity for the GFOA and other organizations that represent states and local governments to bring their concerns about the tax to the forefront for serious consideration.

Complicating all matters related to the ACA is the U.S. Supreme Court's decision to hear the case of *King v. Burwell* in March 2015. In this case, the court will consider whether subsides for low- and middle-income health insurance purchasers are available under the ACA, if the insurance is purchased on an exchange operated by Washington, D.C. rather than a state exchange. Only 16 states and the District of Columbia have established exchanges. The ACA makes subsidies in the way of tax credits available to those who buy health insurance on exchanges "established by the state." The IRS interpreted that language to include insurance purchased on federal exchanges as well. The implications of a Supreme Court ruling that individuals who purchase health insurance on federal exchanges (those operated by Washington, D.C.) are not eligible for subsidies would be quite significant. In fact, if the tax credit subsidies are not available in a given state, the ACA's individual and employer mandate would effectively cease to apply in that state, undermining the entire underpinning of the ACA. The court's pending decision will surely have an impact on how Congress approaches modifying the ACA in 2015.

MARKETPLACE FAIRNESS AND THE PREEMPTION OF STATE AND LOCAL GOVERNMENT TAXES

For the past few years, state and local governments have witnessed a growing parade of industries actively urging Congress to preempt state and local government taxing authority of their particular industry through enactment of federal legislation. From the wireless industry, to the rental car industry, to online travel companies, these businesses ask Congress for preferential tax treatment at the expense of local communities, individuals, and families. Many of these industry groups are already working with Congress to secure the introduction of this kind of legislation. Some examples of these proposals include the *Wireless Tax Fairness Act*, the *End Discriminatory State Taxes for Automobile Renters Act*, the *Digital Goods and Services Tax Fairness Act*, the *Business Activity Tax Simplification Act*, and the *Internet Tax Freedom Act*. The GFOA and its partners in the state and local government community will continue to strongly oppose any federal preemption of state and local taxing authority. These measures threaten to reduce state and local tax revenues even as states and localities struggle to fund critical services like education, health care, and public safety. Moreover, they permit Congress to choose winners and losers at the expense of other industries, individual taxpayers and families, and state and local communities.

In addition to these measures, Congress will revisit activity this year on the *Marketplace Fairness Act*. The *Marketplace Fairness Act* is legislation that would compel retailers to collect and remit taxes to state and local governments on online purchases.

The current tax structure for online sales creates vast disparities between brick and mortar businesses and online retailers, and costs state and local governments an estimated $23 billion per year in taxes owed on remote sales. All 45 states that impose a sales tax already require consumers to pay a tax on online purchases, but no federal law exists that enables states to compel online stores to require consumers to pay this tax. In the absence of such a law, these taxes are not being paid, and local businesses are being put at a competitive disadvantage of 5-10 percent to remote sellers.

Notes

1. Protecting Bonds to Save Infrastructure and Jobs, National Association of Counties, National League of Cities, and United States Conference of Mayors, February 2013.

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