Tax Tweaks in Play as Cities Thirst For Billions to Spend on Public Works

By Marc Heller | September 24, 2014 07:12PM ET

Public-Private Partnerships

Key Development: Municipalities urge changes in policies on tax-exempt bonds.

What It Means: Tax treatment encourages—or discourages—public-private partnerships on infrastructure.

What's Next: Congress could visit the issue in a tax overhaul, or Treasury could address it.

Sept. 23 (BNA) -- For companies such as American Water Works Co. Inc., investing in U.S. public-works projects sometimes hinges on tax policy, which explains why customers like Keith Snyder are writing to the Internal Revenue Service.

Snyder is the mayor of Lincoln, Ill., one of many cities that use American Water or another company as a water provider. With a few tweaks to the U.S. tax code, communities could take more advantage of public-private partnerships to upgrade and repair ailing water systems and other infrastructure, he told the IRS and Treasury Department in an Aug. 5 letter (170 DTR G-1, 9/3/14).

Snyder told Bloomberg BNA in a Sept. 8 e-mail that American Water, a publicly traded company, asked him to write the letter to the IRS and Treasury.

American Water complains that the tax-exempt municipal bonds cities use to pay for such projects can lose that status when a company or corporation takes ownership or control of a facility. This is among a handful of tax issues that advocates for public-private partnerships say could be changed by administrative action or legislation, to help modernize water systems, highways, ports and other projects that have become harder for governments to finance alone.

Another possible tax change would be easing taxes on foreign pension funds that invest in U.S. projects—an idea floated by the Obama administration and supported by some lawmakers. Protecting the tax exemption for private activity bonds, which House Ways and Means Committee Chairman Dave Camp (R-Mich.) proposed eliminating as part of a tax overhaul draft in February, is another. Camp isn't running for re-election this year.

$500 Billion Needed

The need for more money to upgrade public facilities is obvious, advocates of the public-private arrangements say. The Environmental Protection Agency estimates that $500 billion will have to be invested in water, sewer and fire protection systems during the next 20 years, Snyder said in a letter with similar wording in letters that officials in other communities have written recently to Treasury and the IRS.

“This financial scope is simply too great for either the public or private sector to tackle alone,” Snyder wrote.

“Deteriorating infrastructure is not going to go away,” said Mark Strauss, senior vice president of corporate strategy and business development at American Water.

Strauss told Bloomberg BNA that tax changes could give municipalities more flexibility in making big projects feasible. A reworking of tax rules could be combined with other moves such as eliminating the annual cap on tax-exempt private activity bonds for projects, set at $95 per capita per state or $284.6 million, whichever is greater, Strauss said. Reps. John Duncan Jr. (R-Tenn.) and Bill Pascrell (D-N.J.) have backed legislation (H.R. 4237) to do so (51 DTR G-7, 3/17/14).

About 1.3 percent of exempt facility bonds were issued for water and wastewater projects in 2007, according to the Associated General Contractors of America.

Without the changes, Strauss said, “these kinds of things discourage even early-term thinking.”

Tax Exemption at Stake

When a city leases or sells a project funded with municipal bonds to a water company, Strauss said, the municipality may be forced to pay off the bonds early or defease them—that is, set aside enough cash to retire the debt—or the bonds can lose the tax exemption.

Defeasance is costly when interest rates are low, as they have been, as cities move money into low-interest Treasury securities that could otherwise be directed to valuable public works, Snyder said in his letter. The Treasury Department should lessen the defeasance penalty while the gap between interest rates earned on Treasury securities and municipal bonds remains high, he said in the letter to Mark Mazur, assistant Treasury secretary for tax policy, and William Wilkins, chief counsel at the IRS.

The Treasury Department could act alone to address that issue, Strauss said.

American Water, of Voorhees, N.J., operates in more than 40 states and parts of Canada, as a regulated utility or a market-based provider or both, according to its Web site. Its service areas reach 14 million people, the company said.

Although American Water and other companies have advocated for such changes for several years, Strauss said he has seen more interest in Congress in the past six months, perhaps because of discussions surrounding how to pay for highway and other surface transportation projects in light of an inadequate national Highway Trust Fund.

‘P3' Grows in Congress

The cause of public-private partnerships may be gaining steam with creation of a so-called P3 caucus in the House, as well as a special panel on public-private partnerships in the House Committee on Transportation and Infrastructure.

The panel said in a report Sept. 17 that virtually all major surface transportation projects in the U.S. that use public-private partnerships rely in part on tax-exempt private activity bonds; examples include a $2 billion private activity bond allocation for the Interstate 4 Ultimate Project in Orlando, Fla., and $589 million in private activity bonds for the Capital Beltway high-occupancy lanes in Northern Virginia.

Municipal water projects, in contrast, are typically funded with tax-exempt municipal bonds, which don't allow much use of public-private partnerships, said Rep. Todd Young (R-Ind.), a leading congressional advocate for the partnerships and a member of the House Ways and Means Committee.

Young told Bloomberg BNA Sept. 17 he would also like to expand the use of private activity bonds for public-works projects, including expanding eligibility.

“We just can't rely on government spending alone during this era of limited government resources,” Young said.

Test: Tax Overhaul

A major test for public-private partnerships may come when Congress weighs a broad overhaul of the tax code, possibly in 2015 and 2016. Tax incentives for municipal bonds aren't in much danger, realistically, tax lobbyists say, but Camp did propose in his February overhaul draft to eliminate the tax exemption for private activity bonds.

Rep. Paul Ryan (R-Wis.), poised to take the helm of the Ways and Means Committee after Camp retires at the end of 2014, has defended private activity bonds. He introduced legislation in 2009 with Rep. Richard Neal (D-Mass.) to prevent the interest earned on the bonds from being counted against taxpayers for purposes of the alternative minimum tax.

The treatment of private activity bonds is one area where Young and Camp aren't in lockstep. That funding method needs to be expanded, not pared back, Young said, and the bonds can't work without the tax exemption, which Camp proposed to eliminate.

“It's essential,” Young said.

To contact the reporter on this story: Marc Heller in Washington at mheller@bna.com

To contact the editor responsible for this story: Cheryl Saenz at csaenz@bna.com

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