What Proposed Tax Reform May Mean For Municipal Bond Investors

by: The Standish Municipal Bond Team

Since Republicans won control of both houses of Congress and the White House in last fall's elections, investors have been anticipating the first major changes to the nation's tax code in 30 years. The wait has ended with the recent release of the Tax Cuts and Jobs Act by the House Ways and Means Committee which provides a potential roadmap, although changes are likely as it will go through a lengthy and contentious legislative process. For municipal bond investors, the news so far is largely good as the proposed reforms contain some helpful provisions. Meanwhile, bond issuers face the possibility that the repeal of certain types of tax-exempt financings could limit their flexibility and increase borrowing costs.

Preserving the Tax Exemption

A key concern for muni bond investors whenever Washington debates tax policy is whether the deductibility of municipal bond interest income will be reduced or eliminated. The current proposal preserves the tax exemption for municipal bond interest.

Top Marginal Tax Rate Maintained

Another feature of the Republican tax proposal is a cut in the number of income tax brackets for individuals. The proposal keeps the top individual tax rate at its current 39.6% on incomes of more than $1 million while cutting the number of additional brackets in half from six to three. Despite that simplification, we expect the rates for individuals in the top three brackets to remain high enough that they will continue to seek the benefits offered by tax-exempt municipal bonds.

State and Local Tax Deduction (SALT) Partial Repeal

Another change that affects individual taxpayers may also support the tax-exempt muni bond market. The Republican proposal calls for ending deductions for state and local income tax (SALT) payments and capping the deduction for property taxes at $10,000 per year. The proposed elimination of the deduction for SALT payments could face strong opposition from Republican legislators in high-tax states. Faced with the loss of these deductions, residents of high-tax states such as New York, New Jersey and California would likely seek shelter from the increased tax bite by purchasing tax-free municipal bonds issued by the states in which they live.

Corporate Tax Rate Lowered to 20%

Corporations would be some of the biggest winners under the tax proposal as their tax rate would drop from 35% to 20%. Cutting the taxes on property and casualty insurers who hold 9% of the muni bond market and on banks who account for 15% could lessen these companies' demand for tax-exempt bonds but we do not believe it would prompt them to broadly sell off their muni bond holdings which still offer other benefits that these holders find attractive.

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Repeal of the Alternative Minimum Tax (AMT)

While AMT bonds make up a small portion of the market, elimination of the tax would cause spreads on previously issued AMT bonds to tighten.

Elimination of Several Tax Exempt Financing Vehicles

While most of the tax proposal's provisions would bolster ongoing demand for munis, reform could affect supply in the market by curbing the ability of municipalities to issue certain types of tax-exempt bonds. The proposal would eliminate tax exempt private activity bonds (PABs), including those issued by 501c3 private non-profit hospitals and colleges, as well as professional sports stadiums. Also included is the elimination of tax exempt advanced refunding issuance, which will curtail the creation and supply of pre-refunded bonds. So far in 2017, private hospitals and colleges have issued approximately $29 billion and $87 billion worth of bonds, respectively. Taken together, these private activity bonds represent 15% of the market. Pre-refunded bonds account for roughly 8% of the overall municipal bond market with approximately $300 billion outstanding, while stadium bonds account for a small fraction of the overall muni market.

Potential Muni Market Implications

If these proposed changes become law, we would expect the number of tax-exempt bonds available to decline over time while taxable municipal bond issuance would increase. In the near term, we would expect issuers to rush additional tax-exempt bonds to market before the new restrictions on their issuance went into effect.

To be sure, while the proposal represents the most significant attempt to reform the federal tax code in 30 years, it must travel a long road before it becomes law. The Senate will be releasing its own version later this week followed by the reconciliation of the House and Senate versions. We will continue to closely follow its progress and monitor its implications for municipal bond investors.

Tax Cuts and Jobs Act Bill - What it May Mean for Municipal Bond Investors

Key Themes Affecting Munis	Municipal Bond Market Implications	
Tax exemption for muni bonds (no change)	Tax exemption for muni bonds preserved.	
New individual tax rates (12%,25%,35% and 39.6%)	Slight positive for munis as top rate retained at 39.6% for incomes above $1 million; munis may become more attractive amid curtailment of itemized deductions making tax exemption more valuable.	
Lower corporate tax rate to 20%	Lower rate does reduce the incentive for banks and P&Cs to hold munis which could taper demand.	Munis still offer competitive yields, high quality, diversification; widespread selling from banks and P&Cs not expected
State and Local tax (SALT) deduction repeal	Partial repeal of SALT allowing deductibility of property taxes only up to $10,000 annual; should increase demand for bonds in high tax states to lessen the state and local tax burden.	
Eliminate Alternative Minimum Tax (AMT)	Existing AMT bonds should rally as yield differential vs. non-AMT bonds diminishes; AMT bonds represent approximately 3% of the broad market.	
Eliminate Tax-Exemption for Certain Bonds:		
Private Activity Bonds (PABs)	The size of the PAB universe will shrink over time; expect increased PAB taxable issuance within airport, housing, hospital and student loan sectors among others; PABs make up 15% to 20% of muni market.	
Professional Stadium bonds	A small segment of the overall market with deals typically rated low investment grade	
Advanced Refunding Bonds (Pre-res)	Advanced refundings vary widely but three years ago made up half of all new refunding issuance; expect pre-re bond supply to decline which is bullish for existing universe due to scarcity value.	

Source: Standish as of November 6, 2017

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