

Tax Reform: Repercussions for Municipal Bonds

December 2017



Investors are understandably concerned about the possible effects of tax reform on their municipal bond portfolios. Both the House and the Senate's versions of tax reform (Tax Cuts and Jobs Act H.R. 1) contain changes that will touch many sectors of the economy, including changes to individual and corporate tax rates. Below is a summary comparison of the House, Senate and existing tax rules for the proposed changes that would most directly affect the municipal bond market.

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COMPARISON OF BILLS

FEATURE	HOUSE	SENATE	EXISTING TAX RULE
MUNICIPAL BONDS			
Private Activity Bonds	Repeal tax exemption	Tax exempt	Tax exempt
Advanced Refundings	Repeal tax exemption	Repeal tax exemption	Tax exempt
Tax Credit Bonds	Repeal tax exemption	Tax exempt	Tax exempt
Stadium Construction	Repeal tax exemption	Tax exempt	Tax exempt
STATE AND LOCAL			
State and Local Tax (SALT) Property Tax	Property tax deductions only up to \$10,000 for individuals, not businesses	Property tax deductions only up to \$10,000 for individuals, not businesses	State and local property taxes are deductible
Income and Sales Tax	Repeal deductibility	Repeal deductibility	Currently deductible
Mortgage Interest Deduction	Interest on mortgages up to \$500,000	No change to existing rule	Interest on mortgages up to \$1 million
HIGHER EDUCATION			
Endowment Excise Tax	1.4% excise tax on net investment income of private university endowments where endowment per student is at least \$250,000	1.4% excise tax on net investment income of private university endowments where endowment per student is at least \$500,000	None
Graduate research and teaching assistant tuition waiver	Exemption for tuition waiver eliminated	Exempt from income tax	Exempt from income tax
TAXES			
Corporate Tax Rate	Cut to 20%	Cut to 20%	Currently 35%
Individual Income Tax	Four brackets, max rate of 39.6%	Seven brackets, max rate of 38.5%	Currently 39.6%
Alternative Minimum Tax (AMT)	Repeal Tax	Reinstate AMT with increased exemption amounts and phase out thresholds Reinstate corporate AMT	Applicable to certain earners

POTENTIAL IMPACT ON MUNICIPAL BONDS

Repeal of the AMT and Tax Exemption of Private Activity Bonds

The repeal of AMT and inability to issue private activity bonds in the House version should make existing private activity bonds more valuable in the short run. For current AMT private activity bonds, they will then have the same tax treatment as all other municipal bonds. A reduction in overall private activity bonds, including those issued for not for profit hospitals and education institutions, would also be positive for current holders. In the longer term, these issuers are likely to pay higher borrowing costs, which could be a credit negative. However, in the Senate version some AMT is added back in creating additional uncertainty, so this will be one of the key points to be reconciled.

Advanced Refunding

If issuers are no longer able to advance refund their debt, it will likely lead to a significant reduction in municipal bond issuance as it has been estimated that 15-25% of issuance is advanced refunding driven¹. Without this issuance there would be a reduction of outstanding bonds which could be a positive for the prices of all municipals. This potential change is having an impact on supply right now as many issuers are rushing refunding deals to market out of concern that the window will close on December 31, 2017. However, taking away the advanced refunding option would eliminate a tool that issuers have used for decades to reduce their borrowing costs or create flexibility, so this could also be credit negative. Issuers may adopt different call structures but could face higher borrowings cost as investors may demand greater compensation for shorter calls.

State and Local Tax Deduction

In the short run, if the deductibility of state and local taxes is eliminated or severely curtailed, it is likely to be a positive for current investors in specialty municipal bonds from high tax states. Longer term though this could be a credit negative for higher tax states, should higher effective taxes lead to population movements from higher tax states to lower tax states. And, there is no certainty that the states which experience in-migration will be able to maintain their credit quality with an increased population. To a lesser degree, limitations on the **Mortgage Interest Deduction** could also hurt credit quality should these changes negatively impact real estate values which could eventually reduce property tax receipts.

Endowment Excise Tax

This Senate proposed an excise tax on higher education institutions with an endowment per student of \$500,000 or more while the House version is \$250,000 or more. The Senate version affects no more than a few dozen institutions with significant endowments while the House version would affect more schools. However, Given these institutions' financial flexibility, we don't believe it will have much of an impact on their credit quality.

Corporate Tax Rate

Most corporations don't buy many municipal bonds, so the reduction of the corporate tax rate to 20% should not impact the investments of many of them. The notable exception to this is property and casualty insurers who generally buy longer bonds to match up with their liabilities. This lower tax rate will likely make municipal bonds less attractive to these companies which could reduce demand for bonds longer than 15 years. If other factors such as less refunding issuance don't offset such a drop in demand, this could be a negative factor for this maturity range.

Individual Tax Rates

The Senate plan reduces the top marginal tax rate to 38.5%, while the House proposal aims to retain the current 39.6%. The House also plans to reduce the number of tax brackets. While these tax rate changes are notable, there has been a relatively weak historical relationship between marginal tax rates and municipal/Treasury ratios.

Conclusion

The reconciliation process will determine the final provisions so these conclusions may change and there is always the possibility that no bill gets passed. Fiera Capital is analyzing these risks carefully as large rewrites of the tax codes may lead to unintended consequences. Please let us know if you have any further questions.

ENDNOTES - SOURCES

1. Citi Research

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