Desk Commentary

The Tax Cuts and Jobs Act and the Municipal Market

Fixed Income & Currencies Municipal Products

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The tax bill released by the House republican leadership this week represents the next step in a tax reduction/reform process that commenced with the September 2017 release of the GOP tax reform framework. The bill follows the broad concepts set out in the September framework, in that it generally calls for a lowering of both corporate and individual rates and a widening of the base, but it also includes several significant provisions that directly affect the municipal bond market.

Specific Municipal Bond Provisions

- Repeals the authority to issue tax-exempt advance refunding bonds
- Terminates the issuance of private activity bonds (PABs) including all 501(c)(3) bonds
- Repeals the authority to issue new tax credit bonds
- Eliminates the ability to finance professional sports stadiums with tax-exempt bonds

Other Key Elements of the Bill

- Replaces the current seven individual tax brackets to four with rates of 12%, 25%, 35% and 39.6%, and significantly raises the income thresholds associated with each bracket. The top bracket now applies to incomes over $1 million (joint) compared to the current $470,700
- Increases the standard deduction to $24,000 (joint) from the current $12,700 but eliminates the personal exemption
- Repeals the alternative minimum tax (AMT)
- Reduces the mortgage interest deduction cap to $500,000 of mortgage principal from the current $1 million
- Eliminates the deductibility of state and local income taxes and limits the deductibility of state and local property taxes to $10,000
- Retains charitable deduction but repeals all other itemized deductions
- Doubles the federal estate tax exemption to $22.4 million for married couples and repeals the tax in 2023
- Reduces the corporate tax rate to 20% and establishes a pass-through rate of 25% on 30% of pass-through income, but excludes professional services from this provision
- Allows for the immediate expensing of capital investment
- Replaces the current worldwide corporate tax system with a territorial tax system

The Congressional Joint Committee on Taxation has estimated that the bill, as currently constructed, would produce a net revenue loss of $1.41 trillion over ten years. We note that this is consistent with the $1.5 trillion deficit figure that was included in the recently passed FY2018 budget. According to Joint Tax, the bulk of the revenue losses are generated by the reclassification of the individual income tax brackets (-$1.1 trillion), the doubling of the standard deduction (-$921 billion), and the reduction of the corporate tax rate (-$1.5 trillion). Joint Tax estimates that these losses will be principally offset by increased revenue from the repeal of the personal exemption ($1.6 trillion) and the repeal of itemized deductions ($1.3 trillion). We note that the municipal bond provisions are modest revenue raisers, as the PAB termination is estimated to produce $39 billion over the ten-year period, the advance refunding repeal $17 billion, and the tax credit and stadium bond repeals $500 million and $200 million respectively.

Implications for the Municipal Bond Market

Unlike some of the tax reform proposals released during the 2016 presidential campaign, the bill does not cap or repeal the municipal bond interest exemption. Given the loss of most itemized deductions, under the current version of the bill municipal bonds will remain one of the few tax-advantaged vehicles available for taxpayers. However, the higher income thresholds associated with the proposed new tax brackets may potentially reduce the after tax attractiveness of municipals for some investors. More importantly, the reduction of the corporate tax rate to 20% will likely reduce the appetite of bank portfolios and insurance companies for tax-exempt municipals. Many of these investors adjusted their municipal bond return parameters earlier this year in order to compensate for a potential drop in the corporate rate, but the proposed 20% rate may be lower than some of these investors had planned for. While we don't anticipate that these investors will liquidate their current holdings if the 20% rate is enacted, we do expect them to substantially reduce their future purchases.

The proposed tax-exempt issuance limitations enumerated in the bill (advance refunding repeal, etc.) would reduce the supply of new issue municipal debt beginning in 2018. Importantly, we believe that, the very existence of these provisions effectively eliminates any ability to issue these bonds after January 1, 2018, regardless of when or if the bill becomes law. We think that this effective shutdown of advance refunding and private activity issuance (including all 501(c)(3) bonds) will continue to be the case until either the bill is withdrawn or a final enacted tax bill specifies otherwise. On average, the bond types at risk of elimination have accounted for approximately 40% of total issuance in recent years. A reduction of supply of this magnitude would substantively enhance the value of the remaining tax-exempt bonds in the market, assuming the continuation of historical issuance patterns. We note that it is conceivable that some issuers may try to accelerate issuance of planned 2018 advance refunding and private activity bonds into the last two months of 2017. While this could cause a temporary spike in supply and a corresponding increase in yields, we believe that any dislocation of this type would be very short-lived. Further, if the advance refunding language survives through the enactment of the final bill, issuers may begin to look for other ways to regain their lost refunding optionality, such as issuing private placement debt or shortening the call provisions on publicly issued debt. Finally, the elimination of the AMT should increase the value of those bonds currently subject to this provision and would eliminate the AMT premium that issuers typically assume to sell these bonds. We note however, that since the September release of the GOP tax reform framework, this AMT spread has diminished significantly.

The repeal/limitation of the deductibility of state and local taxes will likely increase the attractiveness of tax-exempt debt over the near term, especially those municipal bonds issued in high tax states. However, over the longer term, we believe this provision will have a deleterious effect on the credit quality of state and local governments in high tax states as political considerations may force these entities to limit or reduce tax rates, thus pressuring budgets and fiscal operations.

We remain in the early stages of a very complex process. The release of the House bill represents only the first step and it is likely that the various individual and corporate tax provisions will be altered numerous times before a final unified package arrives on the President's desk. In that regard, we are concerned that the tax-exempt issuance limitations in the current House bill may have created an opportunity for other, more onerous municipal bond provisions to be included in future versions of the legislation. Accordingly, we again urge all municipal market participants to closely monitor the progress of this legislation in the coming weeks and months.