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Rx for high-SALT investors: municipal bonds

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Residents of high-tax states are filing their first tax returns subject to a new cap on state and local tax (SALT) deductions. We expect many to suffer unexpected cases of sudden-onset heartburn due to increased federal tax liability. Before rushing to the medicine cabinet, however, we believe the best prescription may be municipal bonds. The more income an investor can generate from municipal bonds, the less exposure to potentially higher federal taxes resulting from the SALT cap.

MUNICIPAL BONDS PROVIDE "LOW SODIUM" INCOME

The SALT cap limits deductions against federal tax liability for state and local taxes paid up to $10,000 annually. Therefore, those that previously deducted SALT amounts well in excess of the $10,000 cap could see higher federal income tax liability, depending upon factors like changes to their tax bracket, other allowable deductions and other factors specific to each taxpayer's individual financial picture.

The SALT cap was a critical component of the overall tax reform bill, as it is projected to raise more than $650 billion over 10 years to help offset the cost of lower corporate and individual tax rates. Local income and property taxation rates can vary widely from jurisdiction to jurisdiction, so the impact of the SALT cap isn't uniform across the 50 states.

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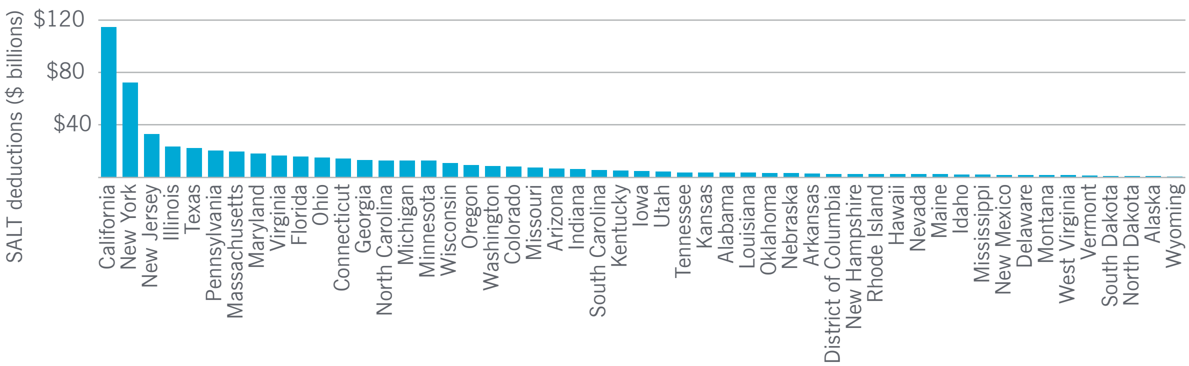
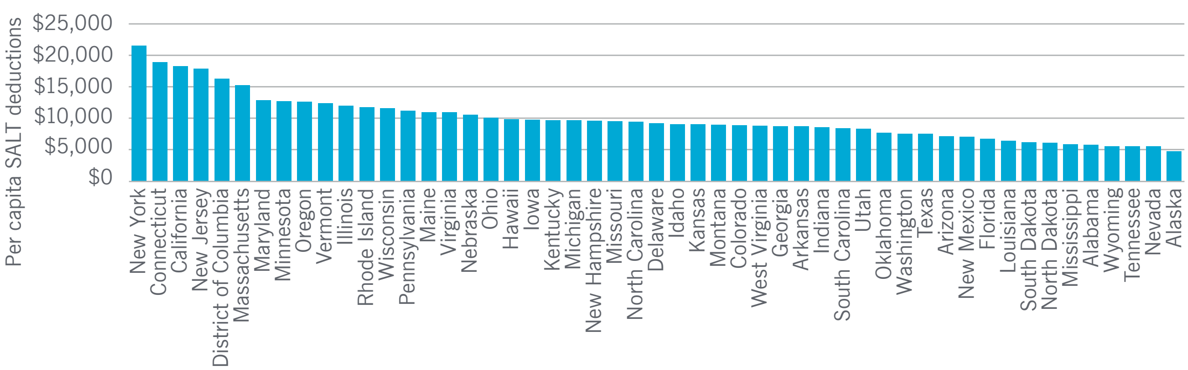
Total SALT deductions vary widely by state



Data source: IRS tax data for 2016 returns.

The most populous states, unsurprisingly, are well represented among the states with the largest aggregate SALT deductions. Per capita calculations of SALT deductions, however, may provide a better barometer of the impact of the SALT cap on individual investors in specific states.

Per capita SALT deductions better illustrate the impact on individual investors



Data source: IRS tax data for 2016 returns.

Per capita SALT deductions reflect the average of only the tax filers in a state that itemized their taxes; it is not an average taken across all filers in a state. This is because those that don't itemize their taxes cannot take deductions for state and local taxes paid. Residents of high-tax states – particularly those that historically took large SALT deductions against their federal tax liability – may want to consider increasing their municipal bond income as a means of reducing their tax burden.

AMT BONDS CAN SERVE AS SUPPLEMENTS

A doctor may recommend certain lifestyle changes and dietary supplements when prescribing a new medication. Similarly, investors increasing their municipal income in the wake of the SALT cap may also want to consider a supplement: Alternative Minimum Tax (AMT) bonds. In addition to changing deductions, the 2017 tax law also modified the calculation of AMT.

While estimates vary, most major tax analysis organizations predict these tax changes will result in dramatic declines in the number of taxpayers subject to AMT. As individual investors review their tax returns this year, they may want to consider allowing for AMT bonds in their municipal portfolios.

Interest payments on municipal bonds designated as AMT bonds are treated as a preference item for buyers subject to AMT, making it taxable for such buyers. For that reason, AMT bonds typically find fewer buyers and trade at higher yields than municipal bonds that aren't designated as AMT.

In recent years, AMT bonds typically provided an additional 15 to 40 basis points of spread compared to similar non-AMT bonds. The changes to AMT increased both the exemption and phase-out thresholds for AMT to levels such that many tax policy experts are predicting dramatic reductions in the number of individual tax filers subject to the AMT.

2017 tax reform changed AMT exemptions and phase outs

	Prior to tax reform		Post tax reform	
	Single	**Joint**	**Single**	**Joint**
Exemption	$55,400	$86,200	$70,300	$109,400
Phase out	$123,100	$164,100	$500,000	$1,000,000

Source: Tax Cuts and Jobs Act of 2017.

While the portion of income exempted from AMT was raised by nearly 27% for both single and joint filers, the expected reduction in AMT-eligible filers is likely due to very large increases in phase outs. For every four dollars earned by a filer above the phase out amount, one dollar is deducted from the exemption amount. The cumulative effect of the exemption and phase out increases is to both reduce the number of filers subject to the AMT and – for those that remain subject – greatly reduce the number of filers that will see their exemption amount whittled away and/or eliminated.

Given the large reduction in filers subject to the AMT, we expect the demand for AMT bonds to increase. These bonds are private activity bonds that primarily benefit private interests. One such example might be a municipal airport authority that issues bonds to construct a maintenance facility for the exclusive use of a commercial airline. Such bonds would be deemed AMT bonds. Consider a recent bond issue by the Airport Commission of the City and County of San Francisco that contained both AMT and non-AMT bonds.

AMT bonds may offer higher yield

	Airport Commission of the City and County of San Francisco	
	Non-AMT	**AMT**
Official statement date	11 Jan 2019	11 Jan 2019
Bond series	2019B	2019A
Series size	$91.3M	$1.25B
CUSIP	79766DMD8	79766DMB2
Rating (S/M/F)	A+/A1/A+	A+/A1/A+
Maturity	1 May 2049	1 May 2049
Call date	1 May 2029	1 May 2029
Coupon	5.00%	5.00%
Yield	3.38%	3.70%

Source: EMMA, Bloomberg, L.P. Pricing on the day of original bond issuance.

Both CUSIPs have the same maturity, coupon, call structure and credit ratings. Yet the AMT bond offered an additional 32 basis points of yield – ostensibly to compensate for the potential tax consequences of owning the bond. However, the changes to the tax code mean far fewer municipal investors will be subject to such tax, making the AMT bond effectively identical to the non-AMT bond in all material respects to most municipal bond investors.

Investors subject to greater federal income ***tax liability due to the SALT cap*** *may want to consider municipal bonds.*

SUMMING IT UP

Individual investors should consult with their tax planners and/or financial advisors as to the tax implications of these policy changes on their tax liability. Investors that will be subject to greater federal income tax liability due to the SALT cap may want to consider municipal bonds as a way of generating federal, and possibly state, tax-exempt income to help mitigate the impact of the SALT cap. Additionally, investors may also want to consider adding AMT bonds to their portfolios as a means of increasing the yield of their municipal portfolios, possibly without any added tax liability. Though SALT may pose specific challenges for residents of high-tax states, municipal bonds may well provide much needed relief.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Tax Cuts and Jobs Act of 2017

Internal Revenue Service

EMMA

Bloomberg, L.P.

A word on risk

Investing involves risk; principal loss is possible. All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Bond insurance guarantees only the payment of principal and interest on the bond when due, and not the value of the bonds themselves, which will fluctuate with the bond market and the financial success of the issuer and the insurer. No representation is made as to an insurer's ability to meet their commitments.

This information should not replace an investor's consultation with a professional advisor regarding their tax situation. Nuveen Asset Management is not a tax advisor. Investors should contact a tax advisor regarding the suitability of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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