Tax Cut Package Largely Spares Municipal Bonds

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ASSET MANAGEMENT

MARKET COMMENTARY

DECEMBER 2017

THE U.S. SENATE AND HOUSE OF REPRESENTATIVES PASSED the conference committee version of the Tax Cuts and Jobs Act, and President Trump's signature is all but certain. The final package was far kinder to municipal bonds than the original legislation passed by the House. Specifically, the adopted legislation does not change the treatment of Private Activity Bonds (PABs). This is important for the municipal market, meaning that upwards of 30% to 40% of annual supply will remain tax-exempt. Other changes will likely have only limited market effects.

Some changes are permanent while others have scheduled sunsets. At sunset, the legislation reverts to prior tax law, which includes higher individual tax rates and lower income eligibility for those rates. In all cases, changes to the tax treatment of municipal bonds applies only on a going-forward basis; no presently outstanding municipal bonds will see a change in tax treatment resulting from this legislation.

Other provisions that directly and indirectly influence the market will not, in our view, have a significant effect on municipal bonds. The balance of this paper focuses on the various aspects of the tax cut legislation as it relates to the municipal market.

Private Activity Bonds Unchanged

As mentioned above, the adopted legislation does not change the tax treatment of PABs. This is positive for the municipal market, as it is estimated that supply from these issuers accounts for 20% to 30% of the overall market. Whereas the House bill would have raised borrowing costs and reduced infrastructure investments by these issuers (others still would be unlikely to access the taxable bond markets entirely), the final legislation allows them to cost-effectively finance such projects as critical access hospitals, life care and nursing homes, college and university facilities and charter schools. It also preserves the ability of investors to construct portfolios with greater credit diversification than would have been allowed under the House bill.

Corporate Income Tax Rate Cut to 21% from 35%

The Tax Cuts and Jobs Act reduces the corporate tax rate to 21% from 35%, a significant cut and benefit to businesses. The cut will lower the taxable-equivalent yield of municipal bonds for corporations. However, this may only marginally reduce corporate demand for municipal bonds and may have little or no impact on municipal yields in the coming

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years. The 30-year AAA municipal bond yield was 2.68% as of 12/18/17. The taxable-equivalent yield would be 4.12% at the 35% tax rate and 3.39% at the 21% tax rate. Both rates remain well above the 30-year U.S. Treasury yield of 2.74%.

In theory, this makes holding municipal bonds less tax efficient for corporations like commercial banks and property and casualty insurers, and it may marginally reduce their demand. However, the amount of municipal bond interest banks and insurance companies can deduct from their taxable income is limited, and therefore the actual effect on taxable-equivalent yields is less than this basic mathematical approach. The effective impact on taxable equivalent yields is only marginal and demand is likely to be only marginally affected. We do not believe the tax cut will induce mass selling of municipal bonds by corporations, however. Taxable investors enjoy other benefits from holding municipal bonds, such as lower default rates, liquidity and diversification, in addition to any tax benefits.

The municipal-to-Treasury yield ratio currently stands at 97.8%, as municipal bonds yields nearly match U.S. Treasury bond yields. With the ratio so close to 100%, municipal bonds remain attractive to investors regardless of tax rates. This should further mitigate any effect of reduced tax rates on taxable buyers. Non-taxable foreign investors have increased their holdings of municipal bonds by 13.2% over the last year, an increase of $12.1 billion, in recognition of attractive ratios and the other benefits of holding municipal bonds. Further, there are other factors that determine market yields for municipal bonds such as supply, liquidity, credit risk and diverse sources of demand.

Over the last year, property and casualty insurers had already sold $21.4 billion of their municipal bond holdings, leaving them with $342.4 billion of the overall $3.8 trillion market. In contrast, individuals own $1.56 trillion or 41% of all municipal bonds through separately managed accounts and mutual funds. Corporations may have already been partially reducing their municipal bond holdings due to expectations of lower corporate taxes as tax reform became more likely. However, the market has produced positive returns year to date in 2017 and actually shrunk by $29.5 billion as more bonds were called and matured than were newly created.

It's difficult to say how reduced taxable-equivalent yield may affect corporate demand for municipal bonds and, in turn, long-term municipal bond valuations. Many factors contribute to overall municipal bond yield. A reduction in corporate demand might become meaningful in weak market environments where liquidity is more highly valued. However, we believe other factors will more than offset any effects of a marginal reduction in demand from corporations. These include reduced supply due to decreased refunding activity and increased demand from high-tax states due in part to reduced deductibility of state and local taxes (SALT).

Advance Refunding Bonds Are No Longer Tax-Exempt

The legislation eliminates the ability of any municipal market participant from issuing tax-exempt advance refunding bonds. This provision is permanent, as there is no sunset on this prohibition.

Advance refunding bonds are sold when an issuer has a series of bonds offering interest rates higher than would be paid if the bonds were sold in the current market, yet the outstanding bonds aren't presently callable. To realize the interest savings, the issuer would sell a new series of bonds and use the proceeds to purchase securities – typically U.S. Treasuries and agencies – to make interest payments on the old bonds until the call can be exercised and the bonds retired. Certain limitations have been placed on these bonds historically, as one project can have two sets of bonds outstanding at any one time. This increases the amount of tax-exempt income and reduces federal tax collections.

The loss of tax-exempt advance refunding bonds (issuers could theoretically attempt to advance refund bonds with taxable bonds) shouldn't reduce infrastructure investment, but could have longer-run effects for investors and issuers alike. Over time, investors would see reduced tax-exempt supply and therefore some increase in value to existing tax-exempt municipals. The precise increase in value due to this scarcity effect is difficult to predict, as advance refunding supply varies greatly with interest rate changes.

For issuers, the loss of advance refunding bonds means one less tool is available to manage interest costs and, at the margin, slightly higher overall financing costs over time as they wait for call dates to trigger traditional refunding transactions. Some issuers may also opt for synthetic refundings of higher-cost debt through derivative contracts – to recreate the financial effects of advance refunding – which could result in new credit risks related to counterparty risk, interest rate risk and termination payment risk, among other concerns.

Alternative Minimum Tax (AMT) Remains

The alternative minimum tax remains for individual filers, though with higher exemption amounts ($109,000 for married, joint, filers and $70,300 for single filers). The phase-outs are set at $1 million for married filers and $500,000 for single filers.

The exemption amount is deducted from a taxpayer's alternative minimum taxable income before calculating amounts owed under AMT. Thus, a higher exemption reduces AMT liability. A phaseout, by comparison, reduces the value of the exemption $1 for every $4 of a taxpayer's income above the phaseout level.

The combined effect of the higher exemptions and phaseouts reduces the number of people subject to the AMT while also reducing the amount of taxable income subject to the exemption phaseout.

Earlier versions of the House and Senate bills fully repealed the AMT, but it was later retained as a way of generating revenue to comply with reconciliation requirements. The change in exemptions and phase-outs is not permanent, as it is scheduled to revert back to current law on January 1, 2026.

State and Local Tax (SALT) Deductibility Capped

The conference bill caps the deductibility of state and local taxes at $10,000 for those who itemize. The legislation allows the $10,000 cap to be comprised of any combination of property taxes and income or sales taxes paid to state and local governments. This provision expires on January 1, 2026.

While the legislation could increase the combined federal, state and local tax burden on certain individuals, the most direct implication for state and local governments is that future efforts to raise property and income taxes could become more politically challenging. Previously, any additional income and property taxes paid owing to tax increases were at least partially federally tax deductible for most taxpayers who itemize their taxes. Under the new legislation, these state and local taxes are no longer fully deductible. Future tax increases by certain state and local entities will be fully realized by taxpayers with more than $10,000 of combined state and local taxes paid.

Because future state and local tax increases will be felt more acutely, there could be more organized resistance to proposed tax increases, particularly in high-tax states. Some state and local credit profiles could come under additional pressure over time if these political challenges delay or prevent tax increases for priorities such as pension contributions, capital investment and other governmental needs. The proposed changes to the deductibility of state and local taxes likely increases the demand for tax-exempt municipal bonds, particularly in states with high income and/or property taxes.

Excise Tax on Investment Income of Private, Non-Profit, Universities & Colleges

The tax cut bill imposes a permanent 1.4% excise tax on the net investment income of private, not-for-profit universities and colleges with more than 500 students and investment assets of $500,000 or more per student. This provision doesn't apply to public colleges and universities. This proposal would, in our opinion, have no direct impact on the bonds of these educational institutions themselves.

The credit profile of such colleges and universities could, at the margin, come under pressure if the tax siphons money from financial aid, research and other investments that allow affected institutions to remain competitive with their peers. Still, we expect the universe of impacted educational institutions to be quite small (approximately 150 institutions) and it would likely affect otherwise healthy and competitive entities that should be able to manage this new tax without adversely affecting their finances or credit profiles.

Mortgage Interest Deduction Capped

The legislation caps the deductibility of interest resulting from mortgage debt used to acquire a home at $750,000, down from $1 million under the prior law. It also eliminates the deductibility of home equity line of credit interest. Currently outstanding mortgages (taken out prior to December 15, 2017) can continue to deduct interest costs on indebtedness of up to $1 million, but would lose their grandfathered treatment upon a refinancing. These changes to the deductibility of mortgage interest revert back to prior law on January 1, 2026. There is modest risk in areas of the country with high home values of a slowing of home sales and thus tax base appreciation, but we expect such outcomes to be the exception to the rule.

Tax-Exempt Financing for Professional Sports Stadiums Preserved

There is no change to the tax treatment of municipal bonds issued for the construction or renovation of sports facilities for private, professional sports teams. The House bill called for the abolishment of such tax-exempt financing while the Senate bill was silent on the subject. The conference bill leaves such bonds tax-exempt going forward. ■

For more information, please visit nuveen.com.

SOURCES

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GPE-NTXREF4-1217P 338248-INV-AN-12/18