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The House GOP Tax Bill is Bad For the Muni Market, But the Byrd Rule Could Make Matters Worse.

WASHINGTON – If the Senate Republican tax bill looks similar to the one their House counterparts proposed, things could go from bad to worse for the municipal bond market, according to tax experts and economists.

Senate Finance Committee chair Orrin Hatch, R-Utah, said on Friday that Senate Republicans may release their tax bill by Nov. 10. If the Senate Republicans want to include in their bill most of the concepts in the House GOP plan it may have to find even more revenue raisers to meet the so-called Byrd Rule and allow it to pass a tax bill under the reconciliation process with a simple majority vote. In that scenario, muni bonds could again be on the table as potential revenue raisers.

Under the Byrd Rule, any Senate bill going through the reconciliation process can't have revenue losses and an increase in the deficit beyond a 10-year period.

The House Republican bill would increase the deficit by $166.8 billion in 2027, the tenth year, according to the Joint Committee on Taxation, and there's nothing to indicate those losses would lessen the following year.

"There's no question that the bill would not meet the Byrd Rule," said John Buckley, former House Ways and Means Committee Democratic tax counsel.

Alternatively, the Senate could also cut or make temporary some of the spending provisions to get a deficit-neutral tax bill by 2027 and that would lessen the need for revenue raisers and be a positive for the municipal market.

While most muni market participants are focused on the direct impacts to munis from the House Republican bill — the proposed termination of private activity bonds and advance refundings — tax experts said don't discount the harm that would come to the muni market from a 20% corporate tax rate.

Buckley said that rate would be "destructive" and take banks, life insurance companies and property and casualty insurance companies, out of the municipal market. Currently about 25% of tax-exempt bonds are held by banks and these insurance companies according to bond experts.

George Friedlander, managing partner at Court Street Group Research, said, "At a 20% tax rate, muni yields would have to rise sharply before municipals would be competitive with taxable investments for a corporate investor, such as a commercial bank or a property and casualty insurer."

Friedlander said the 20% rate, by itself, could push municipal bond yields up by 50 to 75 basis points, even before the proposed PAB and advance refunding provisions are considered. That would make borrowing more expensive for issuers.

Friedlander said that House Republicans, for all their talk about the U.S. corporations being competitive with their global counterparts, could have proposed a 29.4% corporate rate and still have been at the average global corporate rate (weighted by gross domestic product).

“There are several provisions in this tax bill that are likely to affect the pricing of municipal bonds,” said Richard Chirls, a partner at Orrick Herrington & Sutcliffe.

For example, he said, owners of pass-through entities such as partnerships and Subchapter S Corporations will also be less likely to buy munis, thereby dampening demand for munis and raising muni prices, because they will only be subject to a 25% tax rate rather than a rate that is now as high as 39.6%.

As for defenders of muni bonds, some banks and corporations involved in private activity bond deals may prefer to have their tax rates reduced to 20% rather than quibble about muni bond provisions.

“Wall Street will be just as happy to underwrite taxable bonds as tax-exempt bonds,” said Buckley.

Meanwhile, the municipal bond market may see a huge rush of PAB and advance refunding deals this month and next as issuers to cover their bases in case Congress passes a tax bill before the end of the year that terminates those financings.

“I anticipate that there will be a lot of transactions that will be moved to December to address the risk that the tax law will be changed,” said Chirls.

“We’re warning people, we’re getting inquiries,” said Milt Wakschlag, a partner at Katten Muchin Rosenman in Chicago. “Deals can be done this year by they have to be timely. There is a longstanding tax prohibition on issuing bonds earlier than necessary because that would be considered an over-issuance.”

He and others said that issuers that have had PAB or advance refunding transactions in the pipeline will definitely consider doing them before the end of the year.

It might even be worse to go into next year with pending tax bills that propose to terminate PABs and advance refundings at the end of 2017, than to have an actual tax bill passed that includes those provisions, he said, adding this would cause enormous uncertainly and chaos in 2018.

“But this not going down without a fight,” he said, referring to efforts to try to convince Congress to back away from the attacks on munis.

The Bond Buyer

By Lynn Hume

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