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Passage of Senate Tax Bill Leaves Fate of PABs to Reconciliation.

The Senate's passage of its tax bill by a 51-49 vote early Saturday morning sets the stage for a sea change in the municipal market once it's reconciled with the House's version and signed into law.

The fate of private activity bonds, which would be spared in the Senate bill but killed in the House measure, hangs in the balance. With advance refundings eliminated in both bills, that popular cost-saving tool for municipalities is all but dead.

Both bills would reduce the corporate tax rate to 20% from 35%, although the Senate bill would delay the reduction until 2019. Muni market experts have said that will kill any demand for munis by banks, property and casualty and insurance companies and life insurance companies.

President Trump, however, raised the possibility that the final corporate tax rate might be 22% as a result of upcoming House and Senate negotiations.

Speaking to reporters at the White House Saturday morning, Trump said, "It could be 22 when it comes out but it could also be 20. We'll see what ultimately comes out."

The ultimate fate of PABs is uncertain. The Senate bill, while preserving them, amended its bill on Friday to retain both the individual and corporate alternative minimum tax, which is applicable to PABs that are not 501(c)(3) bonds and makes them less attractive. The bill, on the plus side for the muni market, would raise the amounts exempted from the AMT. The earlier version of the Senate bill would have eliminated the AMT.

House Ways and Means Committee Chairman Kevin Brady said Thursday he might agree to preserve PABs but push for limits on their uses. That's raised concerns among muni market participants who now worry that PABs will be restricted in the upcoming negotiations over a final tax bill rather than left alone as in the Senate bill.

"I think over time that's an area that has drifted in its mission from infrastructure projects that have regional or national significance that should be supported by every taxpayer in America into a wide range of issues," Brady, R-Texas, said in response to a question from The Bond Buyer.

The House bill would terminate PABs after the end of the year. Brady echoed some House Republicans who want some PABs preserved for infrastructure.

Brady said House lawmakers have been learning about the various uses of PABs. "Part of the reason for addressing it in the House version was to have this discussion about should they continue, and if so, in what form," he said.

The Senate on Friday also revised its tax bill to adopt the House provision on federal deductions for state and local taxes. Both bills would eliminate the deductions for state and local income and sales taxes but would permit the deduction of up to $10,000 of state and local property taxes.

Republican Rep. Tom Reed of New York, a member of the House Ways and Means Committee, told The Bond Buyer Thursday that California and Illinois Republican House lawmakers are continuing to press for a deduction for state and local income taxes to be added in conference. Among the possibilities, according to Reed, is a ceiling on the deduction for a combination of property taxes and state and local income taxes.

“Stay tuned,” Reed said. “This is all part of the legislative process. There is going to be further expansion of the SALT deduction. That is one issue that has to be resolved.”

The Senate bill would keep the current mortgage interest deduction for loans of up to $1 million. The House would cap mortgage interest on new home loans beginning Jan. 1 at $500,000. Both bills would end the deductibility of home equity loans.

Before passing its bill the Senate raised to 23% from 17.4% the amount of income that can be deducted by filers of pass-through entities.

Meanwhile, 21 House Republicans sent a letter to the House and Senate GOP leaders early last week urging them to preserve PABs and advance refundings.

The number of House Republicans who signed the new letter is significant because it nearly equals the 22-seat majority Republicans hold in the House. No Democrats voted for the House tax reform bill and none are expected to support the final House-Senate legislation.

Republicans hold a 240-194 advantage in the House with one seat vacant pending a March 13, 2018 special election to replace former Rep. Tim Murphy, R-Pa.

“We strongly object to the proposed elimination of tax-exempt private activity and advance refunding bonds in any final tax reform package,” said the letter sent Brady and House Speaker Paul Ryan, R-Wis.

Their proposed termination, the letter said, “undermines President Trump’s infrastructure and economic development agenda for the middle-class.”

Copies also were sent Senate Finance Committee Chairman Orrin Hatch, R-Utah, and Senate Majority Leader Mitch McConnell, R-Ky.

The letter pointed out that the proposed changes “violate a request made by 162 members of the House of Representatives in a March 9, 2017 letter.”

The earlier letter was a bipartisan request led by Reps. Randy Hultgren, R-Ill., and Dutch Ruppersberger, D-Md., co-chairs of the House Municipal Finance Caucus.

Brady acknowledged understanding the message in the letter.

The elimination of advance refundings in both versions of the bill is already spurring a rush to market in the primary as issuers try to take advantage of the ability to refinance debt prior to the call date while they still can.

However, municipal issuers may have to forget about buying state and local government series securities for the escrows of all those advance refundings.

The debt limit is looming and if Congress doesn’t suspend it or increase it by Dec. 8, then the Treasury Department will have to take extraordinary measures and the first action it usually takes is to halt sales of SLGS.

SLGS are specially tailored, non-marketable securities from Treasury that can only be purchased by state and local governments or other muni issuers subject to yield restriction and arbitrage rebate restrictions under the Internal Revenue Code. They are most often bought by issuers for advance refunding escrows, which are subject to yield restriction requirements. Issuers want to make sure their investment yields don't exceed their bond yields. But issuers can also invest in SLGS with bond proceeds to avoid generating arbitrage.

"Because of the pending tax bills, issuers all across the country are rushing to do advance refundings before New Year's," said Sam Gruer, managing director at Blue Rose Capital Advisors. "The market is expecting a significant amount of advance refundings and the SLGS window is going to be shut down in the middle of it."

Gruer said issuers may instead have to buy open market Treasuries for their advance refunding escrows.

"Given the potential for a large amount of transactions, issuers should start planning for this now," he said.

Market sources said they are especially worried that smaller state and local governments with smaller transactions will be unable to advance refund their bonds.

Federal tax rules contain a safe harbor under which tax regulators won't question the yield on an advance refunding escrow if the issuer obtains at least three bids for the securities to be put into the escrow. But what if smaller issuers don't get three bids or any bids at all for escrow securities?

Underwriters and investment advisors may be swamped with advance refundings and not want to spend the holiday season trying to find bids for small deals, some sources said.

The Congressional Budget Office said in a report issued Thursday that if the debt limit is not suspended or raised after Dec. 8, the Treasury will have to take extraordinary measures but that that will keep the federal government from running out of cash until late March or early April.

Currently there is no statutory limit on the issuance of new federal debt because Congress the limit of federal debt through Dec. 8 in the Continuing Appropriations Act, 2018, and the Supplemental Appropriations for Disaster Relief Requirements Act, 2017, enacted in September.

That means that on Dec. 9, absent any action by Congress to extend the suspension or increase the ceiling, the debt limit will be reset to reflect the cumulative borrowing through the period of suspension.

As of Nov. 17, an additional $700 billion was borrowed, bringing the amount of outstanding federal debt subject to the limit up to $20.5 trillion, the CBO report said. On Dec. 9 the new debt limit will be that amount plus whatever is additionally borrowed through Dec. 8, the report said.

"Under current law, on Dec, 9, federal debt will be at the statutory limit and the Treasury will need to use "extraordinary measures" to continue to raise cash," the CBO said. "Those measures would probably be exhausted in late March or early April.

The Bond Buyer

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