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Trump Victory Threatens Key Muni Tax Break in Hunt for Revenue.

- **Muni bonds pay interest to investors exempt from income taxes**
- **Eliminating the tax break seen as option to pay for tax cuts**

The tax break offered to municipal bond investors is coming under threat as Republicans are closer to taking control of both the White House and Congress.

President-elect Donald Trump has promised to further cut corporate taxes and even eliminating the federal income tax. If he goes through with those plans, lawmakers will need to find additional revenue to offset the cuts' trillion-dollar price tag. The muni tax-exemption — estimated to cost the US government less than $40 billion each year — has long been seen as a possible source of funding.

"The likelihood that the tax exemption is materially altered remains low, but the risk is probably at as high a level as it has been in the recent past given the size of projected deficits," said Adam Stern, co-head of research at Breckinridge Capital Advisors.

With the Tax Cuts and Jobs Act of 2017 set to expire at the end of next year, Republicans will "decide how much they want to spend to extend, expand or make the TCJA permanent," Andrew Silverman, an analyst at Bloomberg Intelligence, wrote in a note.

If they extend the tax cuts for a limited period, they'll have more flexibility on whether to fund it by raising taxes or cutting costs, he added.

Back in 2017, the Trump tax cuts eliminated the exemption on bonds sold for a debt refinancing technique, crimping municipal bond sales in the years after that. And earlier this year, the American Enterprise Institute, a conservative think tank, floated repealing the tax-exemption on muni bonds, calling it an inefficient subsidy for local governments.

The tax exemption of muni bonds, established in 1913, is the defining feature of the US public finance market in which states, cities, towns, school districts, hospitals and other borrowers raise money to finance the bulk of the bridges, roads and tunnels. According to Emily Brock, director of the Government Finance Officers Association's federal liaison center, 75% of infrastructure is built with muni bonds. Investors in such debt generally don't pay taxes on the interest they earn, allowing governments to borrow at lower rates.

State and local governments would need to turn to the taxable-bond market if the exemption is completely eradicated. That could "slow the pace of debt issuance and make the cost of capital more expensive for current tax-exempt borrowers," said S&P Global Ratings analysts in a Nov. 7 report.

Brock said the burden to make up for any shortfall in public financing projects will fall on taxpayers, adding that "we haven't seen evidence that the federal government is capable of meeting local infrastructure needs."

To be sure, there is bipartisan support for the muni tax-break. The House Municipal Finance Caucus includes members of both parties.

“We believe that there’s strong political support and justification for the muni tax exemption,” said Margot Kleinman, director of research for Nuveen’s municipal fixed income team.

As part of the tax overhaul in 2017, Congressional Republicans proposed restricting the sale of tax-exempt muni bonds for private-sector projects. That provision ultimately wasn’t included in the legislation.

Mikhail Foux, a strategist at Barclays Plc, said he’s not “overly concerned” about the repeal of the tax exemption because the cost of the subsidy is relatively low. But he said it’s possible that certain sectors, like education, may see their use of the financing tool curtailed.

“Some parts of the muni market might end up on the chopping block, despite not generating sizable revenues for policymakers,” he wrote in a report Friday.

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