Bond Case Briefs

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Taxation Of Municipal Bonds?

Is there a threat to the municipal bond interest deduction?

The new administration's focus on tax reform, especially as many of us pay our federal and state taxes this week, draws our attention to the taxation of interest on municipal bonds. I recently heard a presentation by Steve Benjamin, mayor of Columbia South Carolina and executive director of the board of Municipal Bonds for America (MBFA), a group that comprises state and local government officials, municipal industry groups such as the American Public Power Association, and Bond Dealers of America. The mission of the MBFA is to educate members of Congress about the benefits of municipal bonds. The organization, along with the National Association of Counties (NACo) and many others, have sent letters to Congress extolling the virtues of municipal bonds and urging Congress not to tax municipal bond interest or eliminate the federal deduction for state and local taxes. Individuals and organizations can learn more about the MBFA and even sign the letter to Congress at municipalbondsforamerica.org.

The letters specifically remind current members that Congress officially recognized the importance of the federal/state partnership on October 3, 1913, when the tax system was codified. The exemption of interest on municipal bonds was one of 12 personal deductions and exclusions considered essential to the functioning of the nation. The principle of reciprocal immunity, by which the federal government does not tax states and local governments and vice versa, was considered imperative. A description of the original tax code is on the MBFA website; and the NACo site has a copy of the 1862 Emergency Federal Income Tax (a tax that incidentally was later determined to be unconstitutional), which included deductions for state and local taxes.

Tax-exempt municipal bonds play an important role in our building of infrastructure – we see the results every day in roads and bridges, airports, mass transit systems and affordable housing, hospitals and universities. Tax exemption results in lower interest expense for issuers, thus reducing property or other taxes and fees for residents. Private activity bonds (not to be confused with the internationally utilized public–private partnership model) are a type of municipal bond that helps fund infrastructure. Some of the revenue for bond repayment derives from the activities of private entities (such as an airport's collecting gate fees from airlines) or accrues when a private developer builds a project, for example a city hall, and leases it back to the municipality. Private activity bonds (PABs) are currently subject to the alternative minimum tax (AMT). If the AMT were abolished, it would result in lower costs and wider market access for PAB funded projects as well. Federal taxation of interest on municipal bonds would drive up funding costs and make projects more expensive.

To provide offsets to the proposed reduction in personal and corporate tax rates, some lobbyists have suggested that everything is on the table, including taxation of municipal bonds. In Citibank's March 6 2017 Municipal Weekly, the bank concludes that the potential revenue over 10 years from the taxation of municipal bonds would not be significant and that the political fallout from such a drastic step could be extremely negative for incumbent members of Congress. A retroactive tax on outstanding municipals could cause wealth reduction of $450–$500 billion, as the value of the municipal bonds would erode. This tax option is considered unlikely because it would be a breach of trust since the buyer was sold the bond with tax-exemption and with clean legal opinions issued under then current law. The option would generate $272 billion over 10 years, while the option of taxing only new bonds would yield $196 billion over 10 years. By comparison, the House GOP tax plan estimates a revenue loss of $2.2 trillion over 10 years from the reduction in individual income and payroll taxes.

Tax exemption of municipal bond interest is often seen as a boon to the wealthy, and according to 2014 tax data, roughly 40% of municipal interest is received by individuals with adjusted gross incomes above $200,000, while another 15% goes to those with AGI between $100,000 and $200,000. However, Citi (NYSE:C) also points out that 62% of municipal interest is received by those over 65, while another 23% is received by those aged 55 to 65.

Some say municipal bonds are inefficient and have prevented the development of a healthy private system for funding our infrastructure. We pause for a moment here to recognize that many P3 (PPP: public–private partnerships) deals in Europe involve the government's guaranteeing the private operator a return on investment, e.g., a minimum level of toll revenue for a toll-road project. With the P3 model there can be efficiencies gained due to experience and reduced bureaucracy, and certain risks become the responsibility of the operator. Our infrastructure needs are so great that there is room for many financing schemes. Municipal bonds have financed over $1.65 trillion of infrastructure in the last 10 years; however, the 2017 Report Card by the American Society of Civil Engineers once again assigned our overall infrastructure a grade of D+, the same as it did in 2013, the last time the infrastructure survey was conducted. There was modest improvement in seven infrastructure sectors, including schools, rail, inland waterways, wastewater, hazardous waste, ports, and levees, while there were lower grades in parks and recreation, solid waste, and transit.

Simplification of our tax code and reductions in tax rates was widely anticipated by the market and had contributed to expectations of improved economic conditions. Now, however, the market assumes a slower realization of gains due to delays in the implementation of tax reform. The fear that municipal bond interest will be taxed has been one factor contributing to the muni–Treasury ratio's being higher than average. Additionally, Treasury bonds may have lower yields than usual due to their attractiveness in a world of low-to-negative interest rates. They may also be benefiting from a flight to quality.

The muni–Treasury ratio historical average is 76%, in line with taxable equivalent yield. Since the end of the 2008 financial crisis, the muni-Treasury ratio has remained above its historical average, and has at times spiked such as in 2011 when Meredith Whitney issued comments regarding municipal credit quality, during the taper tantrum in 2013 and again as municipal prices were hurt post-the election of President Trump.

At Cumberland we have taken advantage of this disruption in the markets to buy bonds when municipal bond yields exceed their normal relationship to Treasuries, a strategy that has resulted in out-performance when the ratios return to more normal levels. For example, as the reality of the difficulty of implementing President Trump's proposed changes to healthcare and taxation has become clear, the muni-Treasury ratio has shifted back to a more normal level.

We do not think municipal bonds will lose their tax-exempt status. Further, if the maximum tax rate is lowered to 33%, municipal bonds will still be attractive, since the average tax rate for municipal buyers is 25%. If certain deductions are not allowed at the personal and corporate levels, municipal bonds will be one of the few tax breaks that remain. However, it is clear that the exemption is in play and that there are folks fighting hard for its continuation.

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