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Tax Tradeoffs Would Leave Muni Market Unrecognizable.

The municipal industry will be forever changed if the tax reform package proposed in the House is adopted unaltered. Of course, the probability of no alterations to Tax Cuts and Jobs Act H.R. 1 is quite remote. But the allotted compressed timeframe considered for adoption means that the tradeoffs will need to be determined quite swiftly, with less contemplation and reflection.

Administration officials had said the bill would preserve the municipal tax exemption, and thus leave the muni market untouched. I do not call eliminating the tax exemption for Private Activity Bonds (PABs) leaving the market untouched. When bonds representing about 20% of the existing market are no longer eligible for tax exemption by proposed legislation it is quite noticeable. We continue to refine the percentage but it is not available in a discrete category in the existing classifications for debt outstanding. The other complicating factor is that the description cuts across sectors. Housing, healthcare, and bonds across other sectors will be forever transformed.

If it were not for the federal government's need to offset the effect of the tax cuts with other revenues and expenditure reductions, why would anyone want to curtail advance refundings? Advance refundings have saved mainstream municipal issuers billions in this cycle. Although current refundings will remain an option, the greatest amount of savings has been obtained with advance refundings. The category in a "normal" market typically represents about 25% to 35% of our total annual volume, not taking into account some of the recent peaks in refunding activity. One of the primary rationales over the years for an investment banker to visit an issuer has been the premise of discussing a refunding of higher coupon debt for real savings in interest costs. You will recall that refundings used to be unlimited and then were permitted only once. The inexorable progression to zero has arrived. It would make sense for bonds outstanding to have their one chance preserved.

I have not met many professionals in our business who are enamored of tax credit bonds. Having said this bluntly, tax credit bonds have encouraged issuance in segments where needs are great, including schools and energy efficiency just to name a couple. Some interested parties have even been discussing bringing back some form of Build America Bonds. The existing subsidy had become troublesome due to sequestration, but most consider the BABs program a resounding success even long after the program ceased. Taxable buyers had a real opportunity to get much more familiar with the widespread stability that municipals offer for the most part. Many in the buyer base consider that stability only second to the Treasury market.

Removing the tax exemption for stadium bonds has been in view for a very long time. Senator Moynihan was the first to raise the issue many years ago when he maintained that new stadiums were being constructed with taxpayer subsidies while schools were crumbling. Although many sports fans will lament the more mixed prospects for new stadiums, somehow, we believe the industry will find a way.

Many other provisions in the bill will affect the municipal industry in myriad ways. The deduction for state and local taxes, or SALT, has been under assault. Limiting the property tax deduction to $10,000 per year will directly affect many homeowners on both coasts. One does not consider the purchase of a home just based on the amount of property taxes due on that property. On the other

hand, many consider the purchase of a home based on the quality of the local school district. Local schools are primarily supported by state aid and the property tax. Given that the real estate tax deductibility would be trimmed, it may not be as easy to pass a school tax increase in the future. There is the tax consideration for operations but also for capital improvements a.k.a. debt service. The limitation on the deductibility may have an effect on the outcome of ballots for school bonds in the future. It stands to reason that the increase in taxes necessary for the improvements being contemplated may not be as forthcoming in the future.

Deductibility for other state and local taxes, primarily income taxes, would not be preserved over the $400,000 limit. The bulk of the taxes that are collected are skewed to these higher income levels. High wealth and income states would be particularly vulnerable to this provision. Of course, there is also the weighty matter of how the states that have income taxes would "harmonize" with a vastly changed federal system of taxation.

Capping the mortgage interest deduction at $500,000, down from $1,000,000, will also pose challenges, although existing property holdings before Nov. 2 are grandfathered. The "move up" market will be greatly affected. Assessed valuation (AV) growth is linked to new growth and the appreciation that has been accumulated on existing properties. One has to come to the conclusion that AV growth will probably slow appreciably. Once again, this tendency will serve to slow the growth in property tax revenues or the fundamental revenue source for local governments. One other provision that will serve to suppress housing turnover is the lengthening of the holding period for the break from taxes on a housing capital gain to five years from two years. AV growth also climbs considerably at times based on housing turnover activity.

The four proposed tax brackets on the personal side and the corporate tax bracket change to 20% will lead to greater savings for taxpayers of all kinds. Adjusting the threshold to $1 million for the 39.6% top bracket will serve to dissuade some from investing in municipals. Municipal issuers will have to adapt simply by offering higher returns to investors. At the same time, if PABs are no longer allowed, the market will be smaller by definition.

How to adapt in the new environment? Consider buying revenue bonds in "safe" sectors. Revenue bonds already represent approximately 65% of issuance. General obligation bonds will be more affected going forward and it may take some time to determine to what degree.

Also, taxing large endowments at colleges and universities is a new one. I thought we cared about college affordability! Many other provisions will also affect higher education if adopted.

We know that the final bill will inevitably be transformed before adoption. But many of the base case provisions will be preserved through the process. Some doubt whether there will be any bill, but the momentum is there along with the concern over the mid-term elections. Municipals are clearly being asked to forgo a lot of consideration for the greater good.

Repealing AMT will be a boon to outstanding holders of AMT bonds and will be a positive for many middle class taxpayers that have had to pay the AMT and who were not the original targets for same.

The time to voice opposition is now!

The Bond Buyer

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