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What Happens If Munis Lose Their Tax Exemption? Advisors Weigh In.

Uncle Sam is sitting on a mountain of debt and needs to find revenue wherever it can.

Tax-free municipal bonds have traditionally been the cornerstones of high-net-worth investor portfolios.

So what happens if those tax-free benefits go away?

Wells Fargo & Co.'s head municipal bond strategist Vikram Rai said this week the tax-exempt status of bonds sold by state and local governments could be in jeopardy no matter which candidate wins the Presidential election in November. Rai stated that the potentially drastic measure would be made to combat the national debt which now sits at $34.95 trillion – and climbing.

Municipal bonds, which pay interest to investors that's exempt from income taxes, have been viewed as a vehicle to raise revenue for the Federal government before. The Obama administration, for instance, proposed limiting the interest from municipal bonds that top earners can exclude from their taxable income, but the plan was never put into action.

"The possibility of such proposals being put forward again in the future in light of a worsening fiscal picture cannot be ignored as deficit reduction and/or tax reform moves forward," according to Rai.

Rai added that at present there is currently "no threat whatsoever" to the tax exemption of outstanding bonds. Nevertheless, Christopher Davis, partner at Hudson Value Partners, says it is not inconceivable for such a plan to be enacted considering the country's dire financial outlook.

"Altering the tax status of municipal bonds would be an out of the box way for either party to find revenue and likely be politically palatable as it primarily hits higher earners," said Davis.

Added Davis: "Losing their tax status would make us much more inclined to buy corporate bonds over municipals given their better liquidity and greater transparency in public company financials. Corporate boards see default as the death of the business and not a negotiating tool the way some legislators unfortunately do."

Michael Cordano, investment advisor at Jackson Square Capital, meanwhile, believes the price of current munis with tax-exempt covenants should increase if tax exempt status were rescinded for future municipal bond issuance.

"Government bodies issuing new bonds will have to offer higher yields to compete with the overall taxable bond market," said Cordano.

Eric Lutton, chief investment officer at Sound Income Strategies, highly doubts local governments will lose their tax-exempt status anytime soon. In his view, it would pose too great a risk to ultra-high-net-worth investors and wealth management firms that employ a more traditional defensive fixed income investment strategy that relies heavily upon tax-exempt municipals.

“We focus on more of a non-traditional offensive fixed income strategy for clients in or near retirement, so our investment strategy would not change too much if municipals lost their tax-advantage,” said Lutton, adding that the vast majority of Americans are in lower tax brackets after retirement, so “municipals don’t pack as much of a punch as they do for ultra-high-net-worth portfolios.”

K. Brad Tedrick, director of wealth management at Wright Ford Young & Co. Wealth Management, says alternative considerations should the tax-exempt status of municipal bonds fall into jeopardy include “options that would provide cash flows that include depreciation or principal while always considering the impact of risk management.”

Another idea, according to Tedrick, would be to “pair a portfolio with direct indexing options that can provide other tax benefits.”

Like Rai, Sean Carney, head of municipal strategy at BlackRock, does not believe the tax-exempt status of municipal bonds is at risk even as discussions around it tend to intensify during election cycles. In his view, the positive outcomes that municipal bonds provide to state and local governments, as well as to the investors who hold these investments, are “widely understood.”

Carney is bullish on muni bonds heading into the second half of 2024, partially because of the widespread belief that taxes will inevitably rise due to the massive deficits being run up in Washington.

“I think it also comes from people looking for an allocation to higher quality, less volatile assets like you get in municipal bonds. And then municipals also help you keep a little bit more of what you earn, which is always important,” said Carney.

And while the federal government is sitting on a mountain of debt, Carney says state and local government debt is at record lows while revenues are at record highs.

“As we look at the state and local governments, we know that as they came out of the Covid era and all of the fiscal stimulus they received, they were very strong. We’ve been keeping a very close eye on how the states are spending coming out. But pension fund ratios are elevated. Rainy day funds are at record highs,” said Carney. “So on the fundamental side, things are very good.”

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By Gregg Greenberg

July 23, 2024