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SALT Cap Hike Risks Denting Muni Appeal in New York, California.

A long-awaited House bill could dull the allure of municipal bonds in some states by tripling the federal deduction limit to $30,000, even as the legislation looks to keep the securities tax exempt.

Filers are currently limited to deducting no more than $10,000 of their state and local taxes (SALT) on their federal tax forms. That has helped buoy demand for tax-exempt debt sold in higher-tax states such as California, New York and New Jersey. Lifting the cap to $30,000 would make such debt less appealing to investors, potentially weighing on prices for bonds sold in those states, wrote Abby Urtz, head of product strategies and economics at FHN Financial, in a report Tuesday.

“Any increase in the SALT cap would be positive for credit quality in high tax areas but negative for spreads in these places as it would create less incentive to shelter income from taxes,” Urtz wrote.

States and cities sell tax-exempt bonds to pay for infrastructure upgrades on roads and bridges, school buildings, water and sewer systems, hospitals and mass transit. When investor demand for the debt declines, yields on the securities rise, increasing borrowing costs for public-works projects.

The House Ways and Means Committee released the tax bill on Monday. It allows the deduction for individuals making less than $200,000 and households earning less than $400,000. President Donald Trump in 2017 placed the $10,000 cap on the deduction, with that limit set to expire next year. Federal lawmakers are seeking to approve the bill sometime this year.

Raising the limit can benefit states. A higher limit helps states by giving their residents tools to ease their federal tax burden, said Matt Fabian, partner at Municipal Market Analytics.

“The SALT deduction is really about giving states operating flexibility,” Fabian said. “It’s giving the states a first crack at taxing their residents’ incomes.”

States are bracing for potential cuts in federal spending. The tax bill proposes states taking on more of the cost for the Supplemental Nutrition Assistance Program, known as food stamps. Republican lawmakers are also seeking to reduce Medicaid spending.

The deduction helps strengthen states’ credit quality and a higher cap could help states if the federal government pulls back on aide and grant funding.

“With all of the credit pressures coming for states, any little bit of additional operating flexibility allowing them to raise taxes a bit more or to relieve the economic burden from their current tax rates is all good,” Fabian said.

Bloomberg Markets

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May 13, 2025