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Trump Administration Tax Reform

2017

Discussions are beginning to formulate around the Trump Tax Proposal which has been released in a broad undefined format. The summary of the rough plan is as follows:

- Reduce the seven personal income tax rates to three — 10%, 25% and 35%. The top tax rate currently for individuals is 39.6%.
- Doubling the standard deduction for married couples.
- A zero tax rate for the first $24,000 of a married couples' earnings.
- Repeal the alternative minimum tax (AMT), which applies to most private activity bonds.
- Phase-out of the death tax.
- Eliminate the 3.8% tax on capital gains and dividends.
- Reduce the rate on corporations and pass-through entities to 15% from 35%.
- A one-time tax on the repatriation of overseas earnings.
- Elimination of tax deductions and loopholes for the wealthy.
- Eliminate the deduction for state and local taxes on Federal income tax.
- Preserve the deductions for mortgage interest and charitable contributions as well as the exclusion for retirement savings.

Initial Reactions and Potential Impacts to the Municipal Bond Market:

Tax Rate Reduction: Any reduction to tax rates, particularly those on the wealthiest earners, would in theory weaken demand for municipal bonds, given that the tax breaks would be less valuable. Yet, municipal bonds have outperformed since the beginning of 2017, even with whispers that the municipal tax-exemption could be done away with by Congress.

Alternative Minimum Tax (AMT): Among President Trump's proposals was phasing out the Alternative Minimum Tax. That could be a boon to the $140 Billion of outstanding municipal bonds that are covered by that tax. Those securities pay yields that are about half a percentage point more than traditional tax-exempt bonds because the interest is covered by the AMT. If President Trump succeeds in eliminating that levy, that gap should disappear. The spread between AMT and pure tax exempt municipal bonds have already closed the gap. With the potential repeal, any municipal AMT bond would trade pretty much equivalent to a tax-exempt municipals. This would mostly impact airports, housing agencies and non-profits.

Elimination of State and Local Federal Tax Deductions: May lead to more municipal bond demand in high tax states. With lower personal tax rates, President Trump's proposal would no longer allow Americans to deduct state and local taxes from their federally taxable income, a major deduction for residents of states with high taxes and property values, such as New York, California and New Jersey. That may actually prove positive for bonds issued by governments in those states, as residents continue to seek out tax benefiting investments.

Municipal Tax Exemption: The municipal market is worried as there is fear that the tax plan will eventually lead to the eliminations of "loopholes for the wealthy", including losing the tax exemption for municipal securities. However, this has not been confirmed. Tax exemption for municipal securities was not specifically mentioned. An administration official said that the plan has not gotten to that level of detail yet and is only currently focusing on the largest issues.

Eliminating the Federal tax-exemption for the entire market, including outstanding issues, would only raise an estimated $20 Billion per year while apparently working against the President Trump Administration's infrastructure plan. Every time tax reform or changes to the tax code come up, there is the fear that municipal bonds could lose the exemption status. Municipal bonds have been tax exempt since 1913 and every state, municipality and Governor would argue the added cost to each entity, if the tax status were eliminated, would be disastrous.

Deductions, except for charitable donations and mortgage interest, are currently listed in the proposal to be eliminated as a deductible item against Federal tax liability, including your state and local tax. Even if your personal level were to drop from 39.6 percent to 35 percent, the effective rate could be greater due to the loss of previous deductible items. As the effective tax rate moves higher, demand for municipal bonds, which are still Federal tax exempt under this proposal would become an increasingly more popular option for fixed income investors.

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