

Federal Tax Reform and the Municipal Bond Market by Howard Cure

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The consequences – intended and not – of the Tax Cuts and Jobs Act of 2017, or TCJA, are rippling through the United States. State and local governments are experiencing profound changes in their finances, which are starting to be reflected in the municipal bond market.

The Tax Cuts and Jobs Act of 2017 substantially altered the U.S. tax system. In addition to changes to the corporate tax rate and business tax deductions, it revised individual income taxes, including reducing the top rate to 37.0% from 39.6%, increased the standard deduction and child credit largely offset by eliminating personal exemptions, limited itemized deductions (primarily a \$10,000 cap on the state and local tax deduction), significantly raised the alternative minimum tax (AMT) eligibility thresholds, and implemented a 20% deduction for pass-through businesses (businesses taxed under the individual rather than the corporate tax, such as partnerships).

This piece focuses on three main issues: the increased burdens on individuals residing in high-tax states and the impetus to relocate, changes to state and local revenues, and supply and demand issues in the municipal bond market.

Individuals Residing in High Tax vs. Low Tax States

Now with enough tax data to begin to analyze the impact from the TCJA, studies are lending some insights into the consequences of the tax changes. A particularly interesting study from the Federal Reserve Bank of Atlanta posed a big question in its title: *Did the 2017 Tax Reform Discriminate against Blue State Voters?*

The paper estimated the differential effect of the TCJA on red- and blue-state taxpayers and investigated the importance of the state and

local tax, or SALT, limitation¹ to the differential. The authors found that the average percentage increase in remaining after-tax income under the TCJA is 1.6% in red states and 1.3% in blue states. Among the richest 10% of households, the differential is larger: These enjoyed a 2.0% increase in red states compared with a 1.2% increase in blue-state households. The gap is driven almost entirely by the limitation to the SALT deduction.

The paper also noted that among households with more than \$1 million in annual income, 13% fewer households are expected to itemize deductions in 2018 than in 2017. In contrast, among households with incomes below \$50,000, there's a 72% predicted decline in itemizers. Since the largest itemizable deduction for high-income households is SALT, the TCJA's limitation of the SALT deduction to \$10,000 is particularly onerous for higher income households living in high SALT states.

The biggest TCJA impact on middle- and lower-income households was through the elimination of exemptions, an increase in the standard deduction and, in families with children, an increase in the child tax credit. Because the standard deduction changed by such a large amount (to \$24,000 from \$12,700 for married couples filing jointly), the report concludes that relatively few people – 18 million down from 46 million – gain from itemizing their deductions.

The Tax Policy Center, a joint venture between the Urban Institute and Brookings Institution, noted in a report² that cuts in the corporate income and estate taxes drive much of the increase in after-tax income for the highest income taxpayers. The report emphasizes that when the TCJA established a new tax deduction for owners of some pass-through businesses³, qualified owners could deduct up to 20% of their net business income from their income taxes, reducing their effective income tax rate by 20%.

Besides the new pass-through business deduction, removing the SALT deduction limit would reduce the disparity in the tax cuts from the TCJA individual income tax provisions across taxpayers in different states. However, it would also increase the total tax cut for high-income taxpayers as a group and substantially increase the revenue cost of the legislation. The SALT deduction limit provided a large increase to federal tax receipts and helped to facilitate the corporate tax cuts. Consequently, it may prove difficult to fully remove the SALT deduction without inflicting an even larger operating deficit on the federal budget, assuming maintenance of the corporate tax cuts.

The tax law also largely scaled back the Alternative Minimum Tax, or AMT. About 62% of people making between \$500,000 and \$1 million paid the AMT before this tax year. Now only about 2% of those filers have to pay the AMT, most of whom are likely to be very high-income households that claim large, less-than-typical tax breaks such as tax-exempt interest on private activity bonds⁴. Scaling back the AMT, along with the SALT deduction limits, would also have an impact upon demand for municipal bonds for high net worth individuals.

Another study, this one from the Institute on Taxation and Economic Policy⁵, recognizes that while certain provisions benefiting high-income individuals (like the cut in the corporate tax rate) were made permanent in the TCJA, several other provisions benefiting this group (like the deduction for “pass-through” business income and the cut in the estate tax) are among the temporary provisions that expire after 2025. This is why an extension of the temporary provisions would mainly help the well-off. At the same time, the temporary provisions include some that can raise taxes on high-income households, like the SALT cap. The chart below highlights states that are particularly affected by the SALT cap (California, New Jersey, New York and Connecticut) and the no-income tax state of Florida.

Impact by State of the TCJA for Top 1% Income Group

STATE	RICHEST 1% BY INCOME	FAMILY AND INDIVIDUALS AVERAGE TAX (+ INCREASE/- DECREASE)
California	\$1,054,600 or >	+\$70,840
New Jersey	\$1,120,400 or >	+\$45,550
New York	\$1,049,100 or >	+\$77,900
Connecticut	\$1,134,000 or >	+\$37,710
Florida	\$802,600 or >	-\$21,880

The Family and Individuals Average Tax does not take into consideration taxes for estates, health mandate, pass-throughs and corporations.

Migration issues and the TCJA’s SALT Cap

Domestic migration patterns offer no discernible signs yet that the federal cap on SALT deductions is causing residents to flee high-tax states, resulting in population loss and hurting states’ credit quality⁶. Migration from high-tax states is lower than a decade ago and generally following established trends in the United States as a whole. The report notes that many people are moving from one high-tax state to another, with jobs and demographic trends, mostly retirement issues, continuing to influence relocation patterns more than tax

burdens.

Indeed, migration rates are lower than before the financial crisis and not particularly elevated in high-tax states⁷. Migration rates for the five states where the SALT deduction represents the largest share of total federal adjusted gross income – California, Connecticut, Maryland, New Jersey and New York – are still below pre-recession levels. Florida, with low taxes and a unique climate, is a popular relocation destination, but so are several high-tax states – New York is the most popular destination for movers from New Jersey and Connecticut. While Florida and other warm climate states continue to attract retirees of all income levels, it remains to be seen if higher net worth retirees will increasingly migrate to low tax, warm climate states⁸.

Job opportunities and demographic trends influence migration more than tax rates. States with vibrant economies face less risk of population loss from the SALT deduction cap. The jury remains out on the longer-term impact, however, especially among older, relatively wealthy residents. While older residents are less likely to relocate than young adults, high SALT states may still see out-migration among this demographic who could take with them a disproportionate share of the tax base. High-tax states that are slow growing, such as Connecticut and New Jersey, may not be able to offset this with new jobs to attract new residents⁹. Both states also lack vibrant urban centers that have attracted interstate migrants to other locations, although in the case of New Jersey, proximity to Manhattan and transportation connections have fostered growth in older, industrial urban centers.

State and Local Revenues

Income tax collections so far this year have lifted some of the uncertainty hanging over U.S. state finances since the federal government imposed the caps on SALT deductions. The imposition of SALT caps incentivized many taxpayers to accelerate their income tax payments into December 2017, but consequently made December 2018 tax payments (to be received in fiscal 2019) look smaller by comparison. It also further reduced December 2018 payments by lessening the incentive for many taxpayers to make early income tax payments. As a result, many states have seen slow revenue growth in the first half of the current fiscal year ending June 30, 2019.

Helping states catch up to budgeted revenue levels is the fact that a disproportionate share of income tax is collected in April, so higher growth rates result in larger absolute revenues. States with highly progressive income tax rates have been particularly favorably affected for stock market growth and consequent capital gains taxes. For instance, in New York personal income tax collections for the fiscal year ending on March 31 were \$2.3 billion lower than initially forecast. Especially difficult to manage was a significant revenue shortfall in the final months of the fiscal year and uncertainty around the fiscal 2020 revenue forecast. However, April 2019 personal income tax collections exceeded expectations and were 57% higher than the previous year¹⁰.

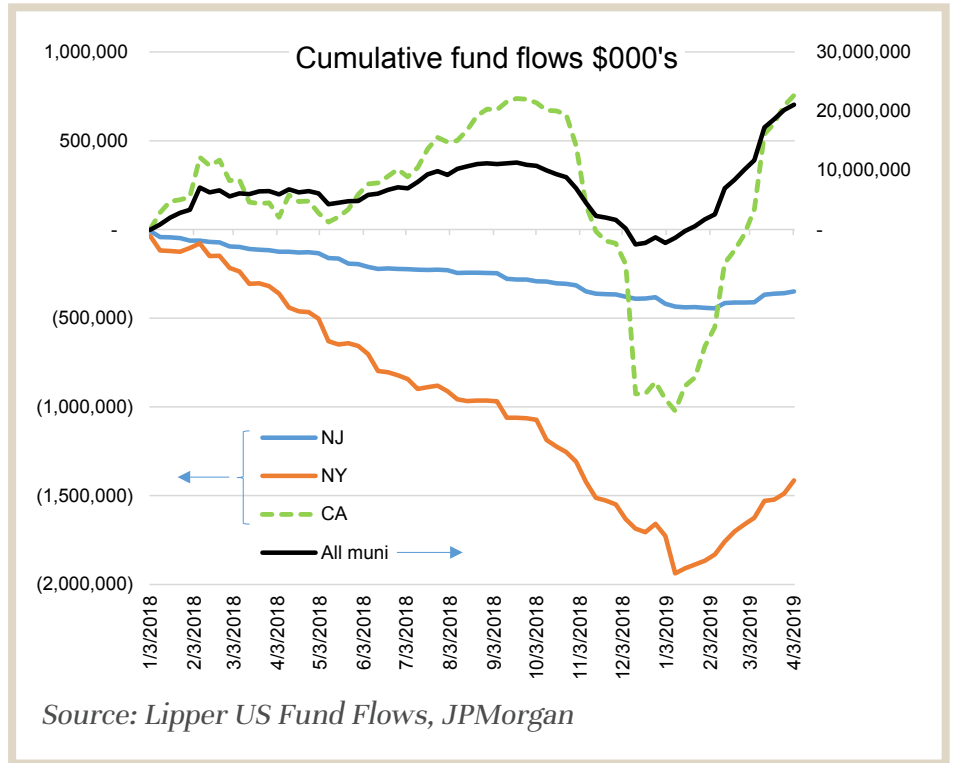
On the local government level, the concern is that the SALT deduction cap will curb home prices and housing supply. This may lead to lower inventory and sales, as well as lower prices, because buyers will want tax costs to be offset by lower prices and sellers will need time to adjust their expectations. If the limits on the SALT deduction also provide greater incentives for people to move to other locations, housing prices will be further suppressed. Another potential issue is that it may become more difficult for localities concerned about the SALT deduction cap to raise property taxes to secure bonds or implement additional special levies to help supplement city and school district operations.

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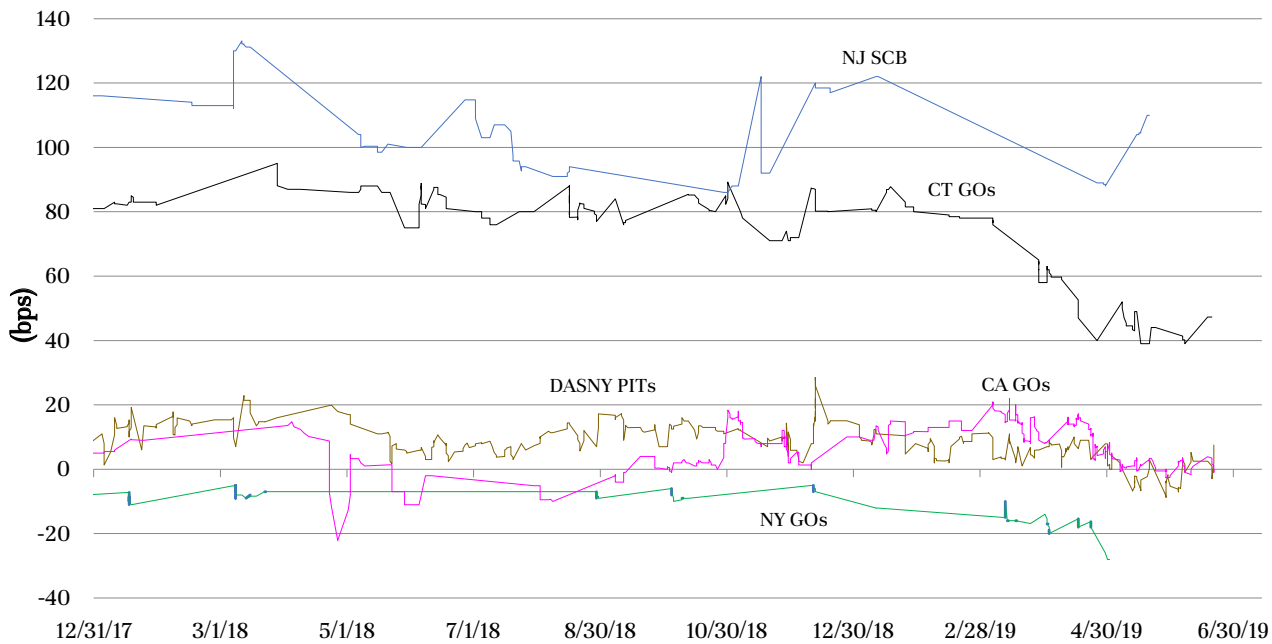
The TCJA has helped facilitate the shift from corporate holders, specifically banks and insurance companies, to retail holders of municipal bonds, as evident by individuals subject to tax rates holding 70% of the municipal market, up from 68% in the fourth quarter of 2018¹¹. With a reduction in the effective corporate tax rate, after-tax

yields on taxable securities will likely increase, reducing the attractiveness of municipals versus corporate bonds.

However, changes brought about by the SALT cap have prompted investors in higher-tax jurisdictions to seek tax-exempt income, which has led to significant inflows into municipal bond funds, especially funds targeted for residents in high-tax states. While the municipal market (and other fixed income markets) saw an outflow cycle in late 2018, due to the prospect of a hawkish Federal Reserve and further rate hikes, the abrupt turn in the Fed's monetary policy message early this year – as well as the first tax season under the TCJA – has led to record inflows to tax-exempt bond funds, especially in high-tax states, as shown in the chart to the right.



Non-Callable 5% Cpn Secondary Trades -- Spread to MMD



Source: Loop Capital Markets

This, in combination with relatively stable state finances driven by an improving economy and stock market, has resulted in tightening of credit spreads in four major high-tax states: New York, California, New Jersey and Connecticut, as shown in the chart on the previous page.

The trading value of each state's general obligation state lease or special revenue debt to the AAA scale has most recently narrowed, particularly since the beginning of the year, owing to structural improvements to state finances, increased demand, a decline in supply and the tax implications from the TCJA.

Conclusions

From an individual taxpayer's perspective, the TCJA provided savings for most people, with only those in the top 1% income bracket of high-tax states experiencing a tax increase¹². However, the savings were not distributed equally within the United States. There has been a distinctly greater savings in lower tax states where the impact of the SALT cap has not been as severe. The drop in federal tax rates, the larger standard deduction and expanded tax credit, as well as the rollback of the alternative minimum tax and the ability of some wealthy individuals to take advantage of the tax deduction for owners of pass-through businesses, has helped to mitigate the blow. However, while the TCJA didn't generally increase the overall tax burden for individuals, it has further skewed the relative burden between high and low tax states.

There has not yet been an exodus of citizens of higher tax states to lower tax states as a result of the TCJA. Job opportunities and demographic trends are much more influential on migration patterns than tax rates for most people, excluding retirees. It should be noted that 2018 was the first year people filed their taxes with the SALT cap in place, so it is still hard to know what the ultimate effects will be. Also, it remains to be seen whether the SALT cap will have a negative impact upon property values in high-tax states, which would severely impair local municipal finances. In the municipal bond market, there has been a further shift away from corporate holders of municipal debt (traditionally banks and property and casualty insurance companies) toward individuals seeking one of the last refuges for tax exemption. This, in combination with an improving state fiscal outlook, has resulted in tightening credit spreads.

We expect the debate about the fairness of the changes to the individual income tax rates to continue pitting red states against blue states. These changes took effect on January 1, 2018, but unlike the corporate tax changes, expire after December 31, 2025. The party that controls the federal legislature and White House at the time of the individual income tax expiration date could determine the contentious SALT deduction issue.

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¹ Among other personal tax changes, the TCJA introduced a \$10,000 limitation on the amount of state and local taxes that can be deducted. Previously, there was no limit, except for those subject to the Alternative Minimum Tax.

² Tax Policy Center Urban Institute & Brookings Institution, "The Effect of the TCJA Individual Income Tax Provisions Across Income Groups and Across the States," Sammartino, Stallworth and Weiner, 3/28/18.

³ A pass-through business is any business that is owned and operated through a pass-through business entity; a sole proprietorship, a partnership, an S Corporation, a limited liability company or a limited liability partnership.

- ⁴ “Why You Probably Won’t Have to Pay the AMT Again” Jeanne Sahadi, CNN Money, 1/18/18. The TCJA made three big changes that drastically reduce who ends up owning the AMT. 1- There are higher exemption levels with the amount of income automatically exempt from the AMT calculation increased to \$109,400 for joint filers, up from \$84,500. 2- There are higher exemption phase-out levels – which is the income level above which you gradually lose your income exemption, until it disappears completely. The phase-out levels were raised to \$1 million for joint filers, up from \$160,900. 3- There are fewer tax breaks under the regular tax code such as personal exemptions, and it has limited the value of others, such as the state and local tax deduction.
- ⁵ Extensions of the New Tax Law’s Temporary Provisions Would Mainly Benefit the Wealthy – April 2018, Institute on Taxation and Economic Policy.
- ⁶ “Migration Driven by Jobs and Demographic Trends More Than SALT Deduction Cap” Moody’s Investors Service, April 8, 2019.
- ⁷ Brookings: “How Migration of Millennials and Seniors Has Shifted Since the Great Recession, William Frey, 1/31/19.
- ⁸ The Tax Cuts and Jobs Act doubled the estate tax exclusion amount from \$5.6 million to \$11.2 million. Twelve states and the District of Columbia have an estate tax. For the ones that conform to the federal estate tax, doubling the threshold could mean less revenue. For the states that do not conform, this could create more of an incentive for taxpayers to locate to a state that does not levy one.
- ⁹ Connecticut and New Jersey have experienced below average job growth since the end of the last recession. New Jersey ranks 38th and Connecticut 48th in the pace of job growth since 2010.
- ¹⁰ Moody’s Investors Service, State of New York Credit Opinion, 6/19/19.
- ¹¹ JP Morgan Municipal Markets Weekly; 6/14/19.
- ¹² Extensions of the New Tax Law’s Temporary Provisions Would Mainly Benefit the Wealthy – April 2018, Institute on Taxation and Economic Policy.

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