Investment Insights

Changing Contractual Relationships: The Tax Cuts and Jobs Act of 2017

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Highlights

- The Tax Cuts and Jobs Act of 2017 is not likely to materially affect municipal bond prices broadly, though we expect some nuances in market dynamics.
- We expect a reduction in both supply and demand from the elimination of advanced refunding bonds on the supply side and fewer corporate buyers on the demand side.
- In the past, repatriation did not result in a big windfall for states; we expect the impact on credit quality to be neutral to positive.
- Bessemer's focus on high-quality municipal bonds and awareness of duration risks should mitigate the effects of the new tax environment.

As the title implies, the Tax Cuts and Jobs Act of 2017 has altered the contractual relationship between the federal government and both state and local governments and individual taxpayers. Residents of some states will benefit while other taxpayers, those who will no longer be able to fully deduct state and local taxes (SALT) on their federal returns, will see their after-tax incomes decline. The relative cost of living will change depending on location. Furthermore, state and local governments may experience resistance to tax increases and find it more difficult to maintain services.

In an attempt to blunt the disruption, politicians have offered creative solutions. One proposal would allow residents to sidestep the SALT deduction limits by contributing funds to newly created municipal charities instead of making traditional property tax payments. Another, proposed by New York's governor, would increase the payroll tax paid by corporations and lower state personal income tax rates; corporate payroll taxes remain fully deductible, but personal income taxes are subject to the SALT deduction limits. While these proposals sound interesting, our portfolio team believes there has been little focus on the complexities of implementation and probable challenges by the federal government.

There is no doubt that the Tax Cuts and Jobs Act will require adjustments by state and local governments and individual taxpayers — and likely to portfolio construction as well. Therefore, we thought it might be helpful to share how Bessemer has insulated fixed income portfolios from the major risks associated with the act and factors we will be monitoring to ascertain state and local governments' ability to succeed in the new environment.

Does the new tax system change the supply/demand dynamic in the municipal sector?

We do expect both the supply and demand for municipal securities to change materially. However, taken together, these should not impact municipal bond prices. The original House bill proposed the elimination of certain types of municipal bonds — specifically, advanced refunding and private activity bonds. The former allow state and local entities to refinance debt at lower interest rates, much the way homeowners refinance a mortgage. The latter are commonly issued by hospitals and universities. While the new legislation ultimately retained the ability to issue private activity bonds, the issuance of tax-exempt bonds for advanced refunding purposes was abolished.

Although the volume of advanced refunding bonds varies from year to year, a good indication is that new municipal supply will decline by about 20% in 2018. Less supply ordinarily boosts prices. However, we also believe that the demand for municipal bonds will decline as well.

In addition to the provisions discussed above, the Tax Cuts and Jobs Act lowers corporate income tax rates to 21%. Many investors believe that municipal bonds are the sole domain of individuals, but corporations actually hold about 25% of the outstanding supply. In our view, corporate buyers, dominated by banks and insurance companies, will find the tax exemption less attractive at the new lower tax rate. In fact, if tax-exempt bond values appreciate relative to taxable alternatives, we believe corporations may actually become sellers of their municipal holdings. We project that the new net supply/demand balance will ultimately favor municipal bond prices, but we also believe that this advantage will be greatly muted by reduced corporate demand.

What are the act's credit implications for state and local governments?

Although varying by issuer, at best, the impact of the Tax Cuts and Jobs Act will be neutral with respect to state/local government credit quality. As has been well publicized, the limitations imposed on the SALT and mortgage interest deductions will have a greater impact in high-tax states — a number of which have progressive income tax structures and provide a broader array of social services. Specifically, it will be more difficult to raise taxes on both the state and local levels.

In addition, home values and local tax bases could potentially experience pressure. Especially vulnerable are states confronting sizeable post-retirement liabilities, elevated fixed costs, and/or structural budgetary imbalances. In struggling states, local aid will likely be reduced, and costs will be shifted to local municipalities and school districts. These smaller units of government are generally less equipped to cope with increased responsibilities, particularly in the face of revenue declines.

How will Bessemer municipal portfolios fare post tax-reform?

Broadly speaking, Bessemer's focus on high-quality municipal bonds translates into state and local issuers better positioned to weather the effects of change versus issuers that have entered this period with weak credit fundamentals. Furthermore, our preference for conservatively structured special tax bonds (secured by the gross pledge of a dedicated/broad-based tax) and revenue bonds issued on behalf of municipally owned utilities, well-established transportation systems, and flagship public higher education institutions should serve to mitigate the negative effects of the Tax Cuts and Jobs Act. For example, both utilities and transportation agencies have a narrow service focus and the ability to increase fees/charges to recover costs without voter approval.

Bessemer's exposure to sectors we view most at risk in the face of tax reform is limited. These sectors include general obligation bonds issued by small local governments as well as bonds issued by larger cities with weak wealth indices, limited revenue flexibility, and sizeable post-retirement liabilities.

We believe school districts will be confronting elevated risk. School districts are dependent on local property taxes and state aid and have a limited ability to adjust expenses as class size, curricula, etc. are mandated at the state level. Therefore, the vast majority of Bessemer school district holdings are additionally secured by robust credit enhancement programs sponsored by well-managed states (e.g., the Texas Permanent School Fund, a constitutionally created fund dedicated to supporting Texas school districts and guaranteeing Texas school district bonds; as of fiscal 2016, the latest audited fiscal year, the fund's value equaled $37.3 billion).

Will repatriation impact the credit quality of state/local governments?

The press has reported that Apple will be paying $38 billion in repatriation taxes. However, this figure does not include taxes that may be owed to the State of California, Apple's home state. Despite widespread coverage of repatriation (and associated federal tax liabilities), the impact on state and local government revenue has yet to be determined. U.S. corporations went through a repatriation exercise in connection with the 2003 Bush-era tax reform package. The effect on state tax revenues and credit quality was muted as corporate income taxes represent a relatively small percentage of state-level tax revenue. In addition, states handled repatriation differently; for example, California taxed the repatriated funds, and New York granted corporations a tax holiday — perhaps fearful of alienating businesses.

In terms of the repatriation associated with the new tax law, we note that federal taxes applied to accumulated foreign earnings include all foreign earnings, not just those brought back to U.S. soil. Therefore, the dollar amount of repatriation taxes should be higher. Given the far greater significance of state-level income and sales taxes, states (as well as state/local government think tanks) are currently focused on the impact of SALT deduction limits. From a credit-quality standpoint, the effect of repatriation will be neutral to positive depending upon each state's tax treatment of repatriated amounts. Finally, due to prospective political limits on increasing SALT, we are not anticipating tax holidays this time around.

Will changes in relative tax burden cause corporate/individual taxpayer migration?

Businesses and, therefore, human capital are undoubtedly influenced by taxes — although not exclusively. Corporate locations are also determined by factors such as access to qualified job applicants, transportation and communication networks, and importantly, the quality of life in a particular area. For example, Los Angeles and New York City (both in high-tax states) are on Amazon's "short list" for the location of the company's second headquarters. Furthermore, despite higher taxes in a number of cities, it has been reported that millennials have demonstrated a preference for urban areas. Although longer-term population and job growth could be more muted than would otherwise be the case, Bessemer is not projecting a "mass exodus" from high-tax states.

What will we be paying attention to in the weeks and months ahead?

Bessemer has a rigorous credit review process including monitoring issuers' economic prospects, budget trends, debt burdens, and capital/debt issuance plans. Governance is key and includes the ability and willingness to alter revenue and expense bases, management of post-retirement liabilities, and adaption to change. Given our projection that the federal budget deficits will increase, Bessemer will pay very close attention to developments regarding entitlement programs, specifically those requiring significant outlays on the part of state, and in some cases, local governments (e.g., the Medicaid program). We are awaiting the release of President Trump's infrastructure plan to gauge the federal versus the state and local funding shares.

On a micro level, we will follow 2018 "state-of-the-state" addresses and state budget deliberations to ascertain states' responses to changes in the federal tax code. Will states increase corporate taxes, broaden the sales tax base, apply the sales tax to more online purchases, and/or shift expenses to local governments? We need to see whether difficult steps (e.g., raising revenue) will be taken to address post-retirement liabilities and budgetary imbalances in the face of limits on the SALT deduction and a likely decline in federal contributions for various social service programs. Given the short timeframe between enactment of the Tax Cuts and Jobs Act of 2017 and its effective date, 2018 will be a challenging year for state and local governments. It will be important to see how each state copes with the uncertainty and how unexpected revenue influxes or shortfalls are dealt with.

Will bonds issued by high-tax state/local governments lose value?

Most states exempt interest earned on in-state bonds from state taxation. Furthermore, a few states can be quite punitive in their tax policies regarding interest earned on out-of-state municipal bonds; for example, Connecticut taxes coupon income as opposed to the lower yield to maturity actually earned by investors on bonds purchased at a premium. Therefore, Bessemer projects the demand for bonds issued in high-tax states (where financial challenges could be the greatest) will initially increase as more investors seek to limit taxable income and state tax bills. Currently, duration — or interest-rate risk — in clients' portfolios is being maintained around 4.1, which is rather conservative, and exposure along the yield curve has a concentration in short-term securities. This makes it possible, if yields continue to rise, to continue reinvesting maturing securities at progressively higher yields while preserving capital value.

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