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Trump Tax Plan, if It Emerges Intact, Would Dull Munis' Allure

Cuts to individual, corporate rates would make munis' tax protections less valuable relative to other bonds

By Daisy Maxey

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President Donald Trump's plan to cut taxes—if it's approved along the lines of its current form—stands to weigh on prices in the $3.8 trillion municipal-bond market.

Cutting personal and corporate income-tax rates, as Mr. Trump has proposed, will make the tax protections muni bonds offer less valuable relative to taxable fixed-income investments. That's because investors in taxable fixed-income investments, such as Treasurys, would pay less tax on the interest their bond pays while munis wouldn't derive any benefit.

As a result, investors would likely demand a greater yield to invest in munis, which would send prices lower as yields move in the opposite direction. Such a decline would hurt the individual investors who make up the majority of muni-bond holders.

"Owners of muni bonds are not the rich guys; they are retirees," says Christine Todd, president and head of tax-sensitive and insurance strategies at Standish, a unit of Bank of New York Mellon Corp. Among the tax returns that claim muni income, 70% are from those who earn less than $200,000, Ms. Todd says, and the average age of a muni-bond holder is 62.

Muni bonds are typically issued by state and local governments to fund infrastructure projects. The bonds generally offer interest that's exempt from federal income tax and often exempt from the state and local income tax in the state where they're issued. About 70% of muni bonds are held by individual investors.

If Mr. Trump's plan were approved in its current form, it would be bearish for munis, says Vikram Rai, head of Citigroup's municipal strategy group. Reducing the corporate tax rate to 15% from its current 35%, as Mr. Trump has proposed, would reduce the appeal of tax-exempt munis for the banks, property and casualty insurers and other insurance companies that account for more than one-quarter of the muni market, Mr. Rai says. Such entities buy munis for the tax advantage they offer, but the incentive would decline with a 15% corporate rate, he says.

The impact on munis outstanding might be limited, Mr. Rai says, because corporate investors tend to hold munis to maturity to match long-dated liabilities on their balance sheets, Mr. Rai says. Insurance companies and banks are buying fewer long-dated munis, he says, as they await clarity on what will happen with corporate rates.

But Robert Gordon, president of Twenty-First Securities, a brokerage firm in New York known for its tax strategies, says that a 15% corporate tax rate would be "a big change in the underlying value of muni bonds versus taxable bonds." Crossover buyers—those who aren't eligible for the muni tax exemption, such as foreign buyers—would invest, but munis wouldn't be attractive to them until their prices have fallen substantially, a blow to current muni-bond holders, he says.

Not all munis would lose their allure under Mr. Trump's tax plan. His plan to eliminate the federal exemption for the state and local taxes that individuals pay and to repeal the alternative minimum tax—which was created to keep wealthy taxpayers from using breaks to avoid paying or greatly reducing their tax burden—would likely make munis more attractive to some investors.

If the AMT were cut, says Ms. Todd, it could boost the prices of municipal bonds that are subject to the AMT. About $150 billion of outstanding muni bond are covered by that tax, according to Ms. Todd. The elimination of the federal deduction for state and local taxes would likely raise demand for tax-free muni bonds from individuals living in high-tax states, such as California, New York and New Jersey, she says.

But other proposals in the tax outline would likely lessen demand if they become reality. Lowering the top personal income-tax rate to 35% and eliminating the 3.8% net investment-income tax would depress demand, triggering price declines as the muni market adjusts yields to attract buyers, Mr. Gordon says.

Investors who are concerned about the impact of tax reform should stay with muni bonds with maturities of seven years or less, says Richard Ciccarone, a muni specialist who heads Merritt Research Services in Chicago. As investors move to longer maturities, they should require a more attractive yield to compensate for the risk that bond prices will be adjusted downward, he says.

The muni market has already factored in some degree of tax reform, says Peter Hayes, head of municipal bonds at BlackRock Inc. The muni market is still trading "fairly cheaply" after a substantial selloff in the wake of Mr. Trump's election win, he notes.

The market now anticipates a corporate tax rate somewhere in the 20% to 25% range, Mr. Hayes says. The worst-case outcome for the market in terms of corporate demand would be a corporate tax rate of 15% with the alternative minimum tax remaining in place, which is not widely expected, he says.

Mr. Gordon believes muni-bond prices haven't fully factored the impact of tax reform. The impact won't be felt until a tax plan takes effect and people begin making investments, he says.