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MuniNotes
from our Credit Research Team

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How might tax policy changes affect muni bonds?

Municipal bonds offer unique advantages for both issuers and investors, particularly through their tax-exempt status. With the Tax Cuts and Jobs Act scheduled to sunset in 2025, the outcome of the U.S. election in November will determine the future of tax policy. Here we explore how potential policy shifts could reshape the muni bond landscape and provide updates on other key credit topics.

HIGHLIGHTS

- **The future of tax policy has implications for the municipal bond market**
- **FAFSA glitch pressures college enrollment process**
- **NCAA settlement further pressures financial performance of college athletic departments**
- **Florida land-secured bonds saw record issuance in 2023**
- **Court decision in PREPA case is positive for the municipal market**

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NOVEMBER ELECTION OUTCOME WILL IMPACT TAX POLICY RELEVANT TO MUNIS

The outcome of the U.S. presidential election in November will impact future tax policy, with implications for the muni market. The political party that gains control of Congress will also influence which public policies impacting munis are ultimately enacted.

TCJA scheduled to expire

The Tax Cuts and Jobs Act (TCJA), which became law in 2018, made major changes to the U.S. tax code. But many provisions were temporary, scheduled to sunset at the end of 2025. This means the current tax policy regime cannot be maintained without legislative action, making continuation of the status quo unlikely. Even in a split control scenario, lawmakers and the next president are likely to take action to address expiring tax policies.

The TCJA legislation reduced top marginal income tax rates, expanded tax brackets and encouraged corporate capital investment. If Donald Trump wins the election and Congress is controlled by Republicans, many TCJA provisions are more likely to be extended. If Democrats control the government, it becomes more likely that portions of the legislation will be allowed to expire or be modified.

The TCJA reduced the top marginal income tax rate for individuals to 37% from 39.6%. If the TCJA sunsets, the highest marginal tax rate would revert to 39.6%. Including the 3.8% ACA tax, the top marginal rate would increase to 43.4%.

A muni bond's taxable-equivalent yield increases as tax rates rise. In other words, the tax-exemption on muni bonds is more valuable for individuals who pay higher taxes. As such, we would expect increased demand for munis in a higher tax environment.

In general, if parts of the TCJA are repealed and marginal tax rates increase, the tax exemption would become more valuable and encourage muni bond demand. Investors may want to take advantage of the opportunity to buy munis now, getting ahead of the anticipated run-up in demand under this scenario.

The tax-equivalent yields on a tax-exempt municipal bond yielding 5.00% are 7.93% or 8.27%, respectively, for investors who pay a 37% or 39.6% tax rate.

More taxpayers could be subject to AMT

The TCJA also enacted a higher Alternative Minimum Tax (AMT) exemption and increased the income level at which the exemption begins to phase out. Estimates suggest TCJA reduced the number of taxpayers subject to the AMT to just 200,000 in 2018 from more than 5 million in 2017.

Projections now suggest that if the TCJA expires, the number of taxpayers subject to the AMT would significantly increase from the current level, still near 200,000, to 7.6 million taxpayers in 2026. This would lead to less favorable tax treatment for certain private activity bonds (PABs) subject to the AMT, muting the tax benefits accruing to investors subject to this tax.

The SALT cap is set to expire

Another TCJA tax policy that influences muni bond demand is the treatment of the State and Local Tax (SALT) deduction. The TCJA capped the federal SALT deduction at $10,000 for all income tax filers. Prior to TCJA, there was no limit on the SALT deduction taxpayers could use to reduce their federally taxable income. SALT deduction limits result in higher adjusted gross income (AGI) for high income taxpayers who itemize their deductions and would have claimed a much higher deduction reducing their AGI prior to TCJA. Higher AGIs increase the value of the muni tax exemption and support demand for muni bonds.

Importantly, allowing the SALT cap to expire disproportionately affects taxpayers located in high-tax states. This could mean the SALT deduction is more likely to be reinstated if Democrats control the government, which could benefit state and local governments in high-tax states such as New York and California. If the SALT deduction is reinstated, these high-tax states may experience reduced out-migration of high tax earners, which could benefit demographics, bolstering the credit quality of these states and local governments over time.

Prior to the SALT cap, allowing 100% of local taxes paid to be deducted was one of the largest federal tax expenditures, costing the U.S. Treasury an estimated $100 billion per year. The high cost of fully reverting to the pre-TCJA policy makes the SALT policy more likely to be a point of negotiation, regardless of which party is in control.

Eliminating the muni tax-exemption is highly unlikely

By some estimates, fully maintaining TCJA provisions would cost the federal government an estimated $4.6 trillion over the next decade. Past tax-law deliberations have hinted at the potential for a rollback or curtailment of the federal tax-exemption for muni interest as lawmakers looked for ways to offset the cost of tax cuts. In fact, when the TCJA was enacted in 2017, muni issuers lost the ability to advance refund tax-exempt bonds with proceeds from another tax-exempt bond issuance.

If discussions around tax law changes seem to threaten the muni tax exemption, the market could see an acceleration of issuance, especially from sectors seen as more vulnerable to losing tax-exempt status like non-for-profit borrowers, such as private colleges, hospitals and charter schools.

Though it may be a point of discussion, we believe eliminating the muni tax-exemption is highly unlikely. The exemption is critically important to state and local governments, schools, hospitals and the electric utilities, water and sewer systems, airports and toll roads that form the nation's vital infrastructure. The cost to the U.S. Treasury of keeping muni bonds tax-exempt is about $40 billion annually, or $400 billion over 10 years — modest in comparison to the $4.6 trillion estimated cost of extending the TCJA for 10 years.

However, the tax exemption could be a part of a compromise in an extreme scenario. Any erosion to the tax-exempt status would mean more expensive debt for muni issuers forced to issue taxable debt and would impact the buyer base for munis. If the exemption were truly on the table, we would expect current tax-exempt muni bonds, if grandfathered into the exemption, to become significantly more valuable, thus benefiting current muni bond investors.

Environmental laws may be affected

Other impacts of a Trump election and red wave could include roll back of policies such as environmental laws that encourage electric vehicle purchases, subsidies for alternative power generation or enforcement of environmental regulations. These policy changes could impact public electric utilities or water/sewer utilities. However, many of the policies that impact credit quality in these sectors are driven by local and state laws that would not necessarily be impacted by a change in control at the federal level.

FAFSA GLITCH COULD IMPEDE FALL ENROLLMENT

Significant delays in the rollout of the "simplified" Free Application for Federal Student Aid (FAFSA) could pressure enrollment for the upcoming fall 2024 entering class. FAFSA is the gateway form for securing financial aid to help pay for higher education. An initial three-month delay in the launch of the new form, which was riddled with technical glitches and errors, has led to a significant reduction in the number of completed FAFSA applications for fall 2024.

The National College Attainment Network (NCAN), which tracks data on FAFSA and enrollment trends, estimates reduced FAFSA applications could translate to a 4% drop in collegegoers this fall, effectively erasing the 1.6% enrollment gain in 2023. Institutions with a higher percentage of students receiving federal aid and Pell Grants are likely to be impacted the most. Ironically, the revamping of the federal aid application process, which was meant to expand Pell eligibility and make college more accessible to lower-income families, has disproportionately affected lower-income families.

The delay in the availability of the form has snowballed into delays in colleges' admission schedules, with many students waiting on aid packages as decision deadlines loom. Without critical financial aid data from the FAFSA, colleges could not finalize their aid packages until April/May, compressing the timeframe between acceptance and commitment. This delay puts colleges at risk of losing admitted students to

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competitors with lower sticker prices or to colleges that can afford to commit to aid or scholarships without FAFSA results.

According to Fitch, deposit rates are down as some students postpone college decisions pending receipt of their aid offers, while some may consider forgoing college altogether.

NCAA SETTLEMENT HURT D1 UNIVERSITIES IN LOWER PROFILE CONFERENCES

On 23 May, the National College Athletic Association (NCAA) and the Division 1 Power Five conferences reached a historic agreement that allows colleges to pay athletes directly for playing sports — a first in the nearly 120-year history of the NCAA.

The NCAA and all D1 universities will pay $2.8 billion in damages to former and current athletes, as well as allow revenue-sharing for athletes starting in fall 2025. The settlement also eliminates caps on the amount of athletic scholarships D1 universities can provide. Though the terms depend on judge approval and will be subject to legal challenges, this landmark settlement will have substantial long-term financial implications — hitting the D1 universities in lower profile conferences harder.

Expenses will increase for all D1 universities. But the D1 universities in the lower profile conferences have more limited financial resources, fundraising and revenue upside to withstand the additional expenses associated with the settlement and paying athletes. Of the $2.8 billion settlement (paid over 10 years), $1.2 billion, or 42%, will be paid directly by the NCAA out of its own financial resources. The remaining 58% will be funded by the NCAA withholding 20% of future annual distributions to its members, resulting in a reduction in this revenue stream for all D1 athletic divisions.

The revenue sharing model, which allows universities to pay $20 million per year to athletes starting in fall 2025, is not mandatory, but will likely be used by the most competitive D1 universities to attract top talent. This increase in annual expense will further pressure the financial performance of college athletic departments, most of which already lose money. Removing caps on athletic scholarships will also increase expenses for the most competitive teams, particularly college football and basketball.

Athletic conferences with members with large financial resources or highly supportive and wealthy donor bases — such as the Ivy League, Big 10 and SEC — can absorb additional scholarship costs. Conferences comprising smaller privates or regional public universities may feel pressured to offer more scholarships without a corresponding increase in revenue streams. While this settlement resolves some legal questions around college sports, it remains a highly debated topic that will continue to drive a wedge between the most and least competitive schools.

FLORIDA REAL ESTATE BOND ISSUANCE IS SETTING RECORDS

Land-secured bonds in Florida, known as Community Development Districts (CDDs), are secured by annual assessments levied on each planned lot or land parcel through final maturity of the bonds. Nearly $6 billion in new money Florida CDD bonds were issued during the past five years. Most recently, issuance set a record in 2023 topping $1.5 billion.

This resurgence has been driven by the housing market recovery from the 2008-2011 downturn and ongoing demand from the homebuilder community to source developed residential lots. Developers remain interested in new land opportunities given Florida’s continued in-migration and high-income job growth. According to John Burns Research & Consulting, homebuilders in Florida plan to increase their actively-selling communities by 17% in 2024, which far exceeds expectations at the national level of 11%.

A greater percentage of new issuance over the past several years has originated around the broader Tampa area in the counties of Hillsborough, Manatee, Pasco and Polk. Over 350 individual bond deals have originated from these four counties, representing more than 40% of all Florida land-secured issuance.

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More recently, however, signs show the area's housing market is beginning to cool, with prices beginning to drop and homes taking longer to sell. Over the past 18 months, prospective homebuyers have focused on the new home market. Resale inventory is lacking since many existing homeowners are reluctant to list their homes in the current interest rate environment.

Because of elevated rates, homebuilders are actively using incentives such as base price reductions and buying down mortgage rates to improve affordability. Given their healthy balance sheets and ability to adjust pricing, homebuilding entities will be able to continue taking market share and this is supportive for Florida's master-planned residential communities.

PUERTO RICO BANKRUPTCY DECISION IS OVERTURNED

PREPA, Puerto Rico's electric system, has been in bankruptcy since 2017. The system has approximately $8.3 billion in debt outstanding. Last year, the Puerto Rico Oversight Board submitted a Plan of Adjustment that gave bondholders a recovery of less than 20 cents on the dollar.

A group of bondholders has challenged the plan as well as various decisions of the bankruptcy court, including the ruling by Judge Laura Swain that bonds were not secured by a lien on net revenue. On 12 June, the First District appellate court overturned Judge Swain's lien decision, ruling that the bonds in fact have a security interest in PREPA's net revenue, both current and future. The court also affirmed the market's general understanding of special revenue bonds, that is, that the lien on revenue continues even after a debtor or borrower files for bankruptcy protection.

The appellate decision was positive for the municipal market, with implications for special revenue bonds in general. The decision also calls into question the viability of the PREPA Plan of Adjustment and will doubtless prolong the PREPA bankruptcy to the end of the year and likely beyond.

For more information, please visit us at nuveen.com.

Endnotes

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