The Future of Tax-Exemption [02-06-2025]

For the past two decades, we at RSW have been consistent in our views that any discussions regarding the potential elimination of tax-exemption on previously issued municipal bonds will prove fruitless and without merit. While some politicians may be attracted to revisiting a repeal of municipal bond tax-exemption, a complete understanding of the consequences reveals a more nuanced picture.

On many occasions since 1986, elected officials have broached the topic of declaring tax-exempt income on outstanding obligations to be subject to federal income taxes. As we all know, these endeavors have led to dead ends. There are varied reasons, but perhaps the most important is that the securities are issued with bond indentures that are legally binding contracts. With respect to coupon payments, the language in the documents specifies that the income paid to bondholders from the issuer will be free from federal income taxes.

Currently, the Department of Government Efficiency is looking under every rock to cut expenses. To that end, there is a possibility, no matter how remote, that future municipal bond issues could be subject to some federal income tax. We strongly believe that should this occur, the value of previously issued municipal obligations owned by our clients should rise precipitously.

Background:

- Today, tax-exemption affords state and local governments an ability to borrow monies independent of the federal government.
- The municipal market is the capital resource for most of the nation's infrastructure. This is recognized by both political parties.
- Municipal bonds provide a cost-effective way to finance and build the nation's vital infrastructure on a state and local level. The elimination of this benefit would only ultimately prove to significantly increase costs to governments and ultimately taxpayers and become a drag on productivity and GDP.
- Municipal bonds finance approximately 75% of U.S. infrastructure projects. Eliminating tax exemption would increase borrowing costs for state and local governments, leading to higher taxes, delayed projects, and/or reduced public services.
- Higher borrowing costs could also deter investment in critical infrastructure, negatively impacting job creation and long-term economic growth. For example, according to the US DOT, every $1 billion in infrastructure investment creates ~13,000 jobs — higher costs could stall projects nationwide.
- The largest issuers of municipal debt are populated "red" Texas and Florida and "blue" New York and California.
- Occasionally, since the inception of the income tax in 1913, tax-exemption has been challenged with rare and minimal success. In fact, the opposite is true; over the past 45 years, the size of newly issued municipal bonds has exploded from approximately $40 billion annually to almost $500 billion.

- Nevertheless, it is conceivable that some changes could be adopted. However, any such change would be at best a nibble on the "edges". As follows:
  - Tax Reform Act of 1986 culminated in a new category of "private activity bonds" including making housing, student loan, and various port and airport bonds subject to the alternative minimum tax.
  - President Obama's 2010 National Commission on Fiscal Responsibility and Reform recommended that tax exemption of municipal bonds be eliminated, however this reform proposal was never enacted. Ultimately the tax exemption of only advance refunding bonds was eliminated by the Tax Cuts and Jobs Act of 2017.

Conclusion

- It is important to note that tax exemption of municipal debt was incorporated within the origination of the first federal tax code in 1913 and has survived the test of time for good reason.
- This is not the first time the tax exemption of public finance has come under debate. Historically, tax exemption has always enjoyed broad bipartisan support, and we fully expect this to continue unabated.

Lastly, if the goal is to save money, the cost of litigation and likelihood of years of court battles would certainly enter the administration's contemplation for action. After all, it is probable that President Trump's term would end with this issue still being a long way from being resolved.

Robert S. Waas Chief Executive Officer / Chief Investment Officer	Matthew T. Werner Senior Portfolio Manager	Mark J. Tenenhaus Director of Municipal Research	Mark A. Scott Senior Trader	Randy J. Fox Portfolio Manager	Hernando S. Montero Municipal Bond Credit Analyst	Marites V. Pasturan Director of Software and Technology	Jeffrey S. Thompson Investment Reporting Analyst	Anthonio Bacchetta Client Service Associate	Andrew P. DeCeglie Trade Desk Support