

>> PORTFOLIO MANAGEMENT

# Life and taxes

A drop in tax rates would have an impact on investments.

By Jim Reber



### Boon to income...

At the risk of being Master of the Obvious, the vast majority of community banks, being profitable and taxable, will have an improved after-tax bottom line if the maximum corporate tax rate gets cut. Especially so if the cut is from 35 percent to 15 percent. And more so if Alternative Minimum Tax (AMT) is eliminated. And still more so if the cuts apply to pass-through businesses.

Given that about a third of all banks are now S corps, a large portion of ICBA's membership would potentially enjoy a windfall of tax savings. AMT elimination would also create some permanent benefits for many community banks.

But there will be a new list of "don'ts" for the management of these banks' investment portfolios. For example, the benefits that accrue from tax-advantaged strategies will fall dramatically.

### ...bust for munis?

Here is one example. A community bank in the 35 percent tax bracket has recently been able to buy bank-qualified (BQ) AA-rated municipal bonds with eight-year maturities at tax-equivalent yields of around 3.00%. If the marginal rate gets cut to the 15 percent number being discussed, the price on that bond will have to fall more than 4 percent for the tax-equivalent yield to reach parity.

There are other variables that make "before/after" comparisons difficult, including the fact that TEFRA penalties will decline, because less tax liability is being avoided. There also is the reality that if secondary market prices drop from premium to discount territory,

## ICBA VOICE

**Jim Reber** ([jreber@icbasecurities.com](mailto:jreber@icbasecurities.com)) is president and CEO of ICBA Securities, ICBA's institutional, fixed-income broker-dealer for community banks.



been welcomed by the ICBA and the community banking industry in general, as well it should.

There would be some effect on the management of the investment portfolio, and it

**T**he Trump administration has proposed a dramatic decrease in the maximum rate of income tax at the corporate level. The proposal would include "pass-through" businesses such as S corps. This news, in a vacuum, has

would not all be favorable. While acknowledging we're very early in the game of negotiating such a landmark piece of legislation, this column will point out some of the results a substantial tax cut would have on your community bank's income statement and balance sheet.

Approximate market correction necessary to create similar tax-equivalent yields*		
Maturity in years	Decrease in price	Increase in taxable yield
8	4.21%	0.53%
10	4.96%	0.55%
12	6.68%	0.68%
15	8.81%	0.78%

\*Assumes marginal tax rate declines from 35 percent to 15 percent; assumes cost of funds of 2.00 percent; ignores capital gains tax liabilities.

durations will extend, and capital gains tax liability to future investors could rear its head.

As many engaged ICBA members know well, political advocacy is a necessary and sometimes untidy endeavor. We can expect lobbyists for municipal issuers to weigh in on their opposition to this tax-cut proposal, because cities, counties and states will all have costlier debt if tax rates fall. In our example above, the tax-free rate of a relatively short bond would have to rise about 50

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basis points (.50 percent) to create a similar tax-equivalent yield. Stated another way, municipalities will have to pay more to borrow.

From a supply standpoint, could this then create a growth market for taxable munis at the expense of tax-frees? It stands to reason. And


if the cost to the federal government from the BQ loophole declines as the TEFRA hit drops, does that improve ICBA's argument for permanently increasing the size of a BQ issue above \$10 million? I would argue yes.

**Strategies will change**

Another difference in portfolio management is a change in the dynamics for the strategy known as a tax swap. The tax code allows community banks to deduct the loss on the sale of an investment security from ordinary income and yet avoid tax on the reinvestment of the proceeds if the "new" bond is a tax-free muni. This tax advantage allows an investor to make up that loss at an accelerated pace. While the benefits will still exist, that make-up period will have an extended break-even date, as the tax savings are less.

What else on a community bank balance sheet has tax benefits? Bank-owned life insurance (BOLI). BOLI yields will automatically decline, much like tax-free munis. One advantage of a life insurance contract versus a bond is there is no mark-to-market accounting required. Still, the long duration of a BOLI contract means the lost effective income will be around for quite some time.

None of this is to say that a tax cut is bad news for ICBA members. Quite

the contrary: It would enable much quicker capital formation, or allow for investment in marketing, technology and (gasp) compliance, or create higher after-tax returns. All of which are beneficial to the industry. Stay tuned and engaged. 



**Education on tap:**

**» A tale of two TEFRA's**

Vining Sparks, ICBA Securities' exclusively endorsed broker-dealer, has published a Strategic Insight, "A Tale of Two TEFRA's." This research report explains the difference in investing in bank-qualified municipals versus general market paper. For your copy, contact your Vining Sparks sales rep or visit [viningsparks.com](http://viningsparks.com)

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ICBA Securities will host the 2017 edition of the ICBA Bond Academy on Oct. 23-24 in Memphis, Tenn. This event will equip attendees with the basic tools to plan, build and maintain a high-performing investment portfolio. Twelve hours of CPE credit are available. To register, visit [icbasecurities.com](http://icbasecurities.com)