Year-End Strategies to Prepare for Lower Tax Rates

Earlier this week Congress passed the most significant tax reform in more than three decades, and the bill has now been signed by President Trump. It will lower tax rates for corporations and individuals in 2018 and dramatically change the federal tax code for everything from state and local tax deductions to immediate business expensing. The Baker Group is not an accounting firm and we recommend you immediately consult your accountants for a detailed analysis of the new legislation and how it might impact your bank. For now, we want to address how the drop in tax rates will impact community bank investing including the very time sensitive opportunity to take advantage of a once in a decade change in tax rates.

Bank Tax Rates in 2018

- C-Corporation banks will see their tax rate fall from 34/35% to 21%
- S-Corporation banks will see the top pass-through rate fall from 39.6% to 29.6%*
- The 3.8% Obamacare Investment tax remains (applies to passive shareholders)

*S-Corp shareholders are allowed to deduct 20% of bank earnings before applying their individual rate so the top rate is 37% * 80% = 29.6%.

Tax Rates to Use in 2018 for Municipal Bond TEY's

- C-Corp = 21%
- S-Corp for active shareholders = 29.6%
- S-Corp for passive shareholders = 33.4%

The drop in tax rates makes tax-exempt Municipal Bonds less attractive and makes taxable bonds relatively more attractive. However, this does not mean banks should avoid Municipal Bonds or sell them outright. Instead, banks should analyze the Tax-Equivalent Yields (TEY) using the new tax rates and determine if they are still the best relative value given their risk/reward characteristics. Current Municipal offerings indicate the drop in tax rates has lowered TEYs by an average of 50-70bp. Even at these lower TEYs, Municipals often still offer much higher spread to Treasuries than Agencies and similar or slightly better than MBS/CMO.

Interest rates have been rising steadily since September, driving up reinvestment yields but also causing market values to drop. The average bank on our Baker Bond Accounting (BBA) system saw their investment portfolios swing to an unrealized loss for the first time since March. Some banks welcome the recent sell-off as an opportunity to capture higher investment yields, but the drop in tax rates next year presents an even more rare opportunity to save taxes and improve portfolio performance for an uncertain future. The last time tax rates were cut was more than a decade ago when the Bush administration lowered the highest marginal tax rate from 39.6% to 35%, a 4.6% rate cut. Today's tax cuts are even more dramatic for banks: C-Corp banks will see a 13-14% rate cut and top S-Corp shareholders will see a 10% rate cut.

As of this publication, investors have a little more than a week to sell underwater bonds and let Uncle Sam pick up 10-14% more of that loss than they will next year. Moreover, the reinvestment of those proceeds into higher yielding bonds will result in more income in the future where a lower future tax burden will have a great impact on earnings.

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Table 1: Tax Savings and Pickup in Income Under Lower Tax Rates

	C-Corp		S-Corp	
Tax Savings on a $100,000 Loss	35%	$35,000	39.6%	$39,600
	21%	$21,000	29.6%	$29,600
Benefit in 2017 vs 2018		+$14,000		+10,000
After-Tax Earnings of $100,000 Income Pickup	35%	$65,000	39.6%	$60,400
	21%	$79,000	29.6%	$70,400
Benefit in 2018 vs 2017		+14,000		+$10,000

Suppose a portfolio manager is reviewing a tax loss strategy to liquidate a group of under-performing bonds at a $100,000 loss and replacing them with higher yielding bonds that will generate $100,000 of additional income. Normally a transaction like this would result in a break-even for the bank ($100,000 loss to increase income by $100,000) and the transaction would only be beneficial if it somehow improved the portfolio's risk metrics (reduced price volatility, improved credit, etc.). However, the drop in tax rates makes this otherwise break-even transaction economically beneficial and increases shareholder value. Table 1 breaks down the tax implications of taking a loss in 2017 vs. waiting until 2018 to execute the same trade. Realizing a $100,000 loss in 2017 will save a C-Corp bank up to $14,000 more in taxes than if the same bonds were sold next year. S-Corp shareholders in the top tax bracket would save $10,000 in the same scenario. If higher yielding bonds are repurchased to increase income by $100,000, the lower tax rates will result in approximately 16-22% higher after-tax earnings.

For investors looking to take advantage of this opportunity to save taxes in 2017 and potentially increase earnings in 2018, here are some suggestions for identifying the best bonds to sell:

- Bonds with the lowest book yields (improves portfolio income the most)
- Bonds with the lowest "takeout yields" or market yields (often represent cheapest cost of selling and best economic advantage)
- Lower coupon structures (many lower coupons have depreciated more than higher coupons)
- Bonds with the greatest degree of price volatility (reduces duration risk)
- Weak municipal credits or those with pension exposures and/or high debt burdens (reduces credit risk)

The Tax Cuts and Jobs Act of 2017 presents a unique opportunity to take advantage of tax policy changes that have only happened twice in the last 35 years under the Reagan and George W. Bush administrations. With a likely reduction in tax rates coming in 2018, banks have a little more than one week to take advantage of higher tax savings in 2017 by selling bonds at losses and reinvesting into higher yielding bonds to improve income in the future when tax rates will be lower. As always, banks should consult with their accountants regarding the tax implications of such a strategy.

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