Tax-Reform Update

The most sweeping tax reform legislation in the U.S. since the Tax Reform Act of 1986, The Tax Cuts and Jobs Act (H.R. 1) was released and is expected to be voted on by Congress and signed into law this week. Tax rates were lowered for corporate, pass-through entities and individuals, and if passed, would be effective in 2018. We will focus on what we believe to be the most important aspects of tax reform to our customers in this Strategic Insight:

- The impact of tax reform on tax-exempt municipal bonds
- Re-evaluate deferred tax accounts and potential year-end adjustments related to potential tax-reform
- Consider taking losses in the bond portfolio and reinvesting before the end of 2017

Highlights of Tax Reform Legislation:

- Corporate rate reduced from 34% and 35% to 21%
- Top marginal individual tax rate lowered from 39.6% to 37%
- Seven individual tax brackets (rate cuts expire in 2025):

2017 Individual Tax-Brackets

	10%	15%	25%	28%	33%	35%	39.6%
Single	$9,325	$37,950	$91,900	$191,650	$416,700	$418,400	All Else
Married (Joint)	$18,650	$75,900	$153,100	$233,350	$416,700	$470,700	All Else

2018 Individual Tax-Brackets

	10%	12%	22%	24%	32%	35%	37.0%
Single	$9,525	$38,700	$82,500	$157,500	$200,000	$500,000	All Else
Married (Joint)	$19,500	$77,400	$165,000	$315,000	$400,000	$600,000	All Else

How to interpret: A single filer would pay 10% on their first $9,525 of taxable earnings, 12% on earnings above $9,525 up to $38,700, 22% on earnings above $38,700 up to $82,500, so forth and so on.

- Shareholders of select pass-through entities, including Sub S banks, are allowed to deduct 20% of their earnings before earnings are taxed at the respective marginal tax rates; reducing their effective marginal tax rate to no more than 29.6% (excluding 3.8% Net Investment Income Tax):

Pass-Through Income (Bank S-Corp)		
% Deduction Against Marginal Tax Rate		
0%	20%	
2017	**2018**	
10%	10%	8.0%
15%	12%	9.6%
25%	22%	17.6%
28%	24%	19.2%
33%	32%	25.6%
35%	35%	28.0%
39.6%	37%	29.6%
43.4%*	40.8%*	33.4%*

Bank S-Corp Pass-Through Example (Long)		
Step 1: Determine Taxes		
Taxable Income	$	100.00
20% Reduction	$	20.00
Net Taxable Income	$	80.00
Taxes @ 37%	$	29.60
Step 2: Determine After-Tax Income		
Taxable Income	$	100.00
Taxes from above @ 37%	$	29.60
After-Tax Income	$	70.40

Bank S-Corp Pass-Through Example (Short)		
Use the equivalent tax-rate instead		
Taxable Income	$	100.00
Taxes @ 29.6%**	$	29.60
After-Tax Income	$	70.40

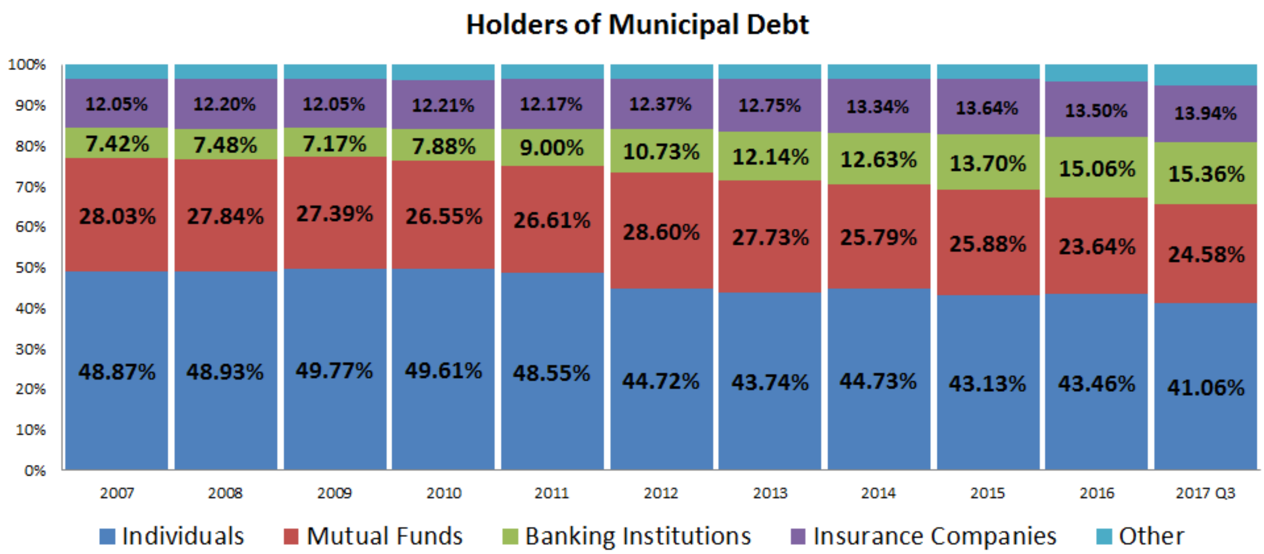
How to interpret:
* Includes 3.8% Net Investment Income Tax

** Bank S-Corp pass-through earnings enjoy a 20% taxable reduction. In effect, the tax-rate applied would be 80% of the stated individual rate. For example, tax filers in the 37% bracket would owe taxes at a rate of 37% * 80% = 29.6%

- Alternative Minimum Tax (AMT) eliminated for corporations, retained for individuals, but at higher income exemption levels
- Capital projects allowed immediate expensing for 5 years
- Private-activity municipal bonds retain tax-exempt status, while advance refundings ("pre-res") do not, if issued after December 31, 2017
- Net operating losses (NOL) deduction limited to 80% of taxable income; two-year carryback repealed and carryforwards are indefinite.

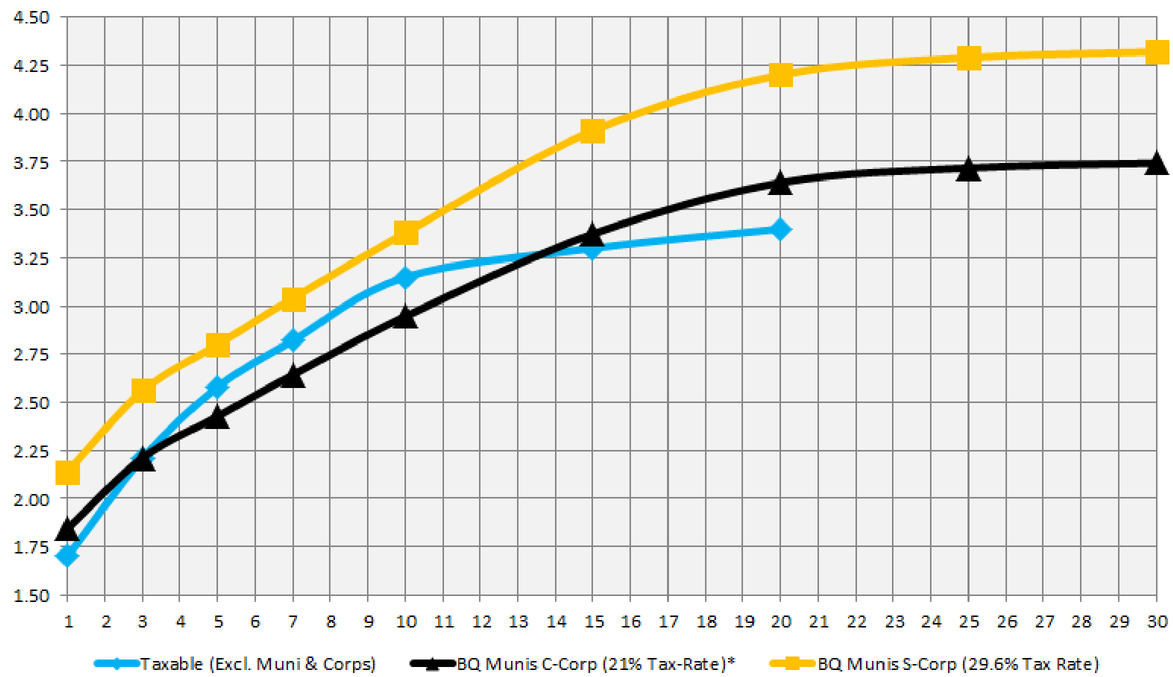
<u>Tax-exempt municipal bonds:</u>

To understand the impact on the municipal market, an investor should know the holders of municipal debt and the changes to the tax rate for each investor class. The $3.8 trillion municipal market is largely held by individual investors or within mutual funds substantially owned by individuals. Approximately 29% of the municipal market is currently held by financial institutions, including banks and insurance companies, and the remaining 71% of the market is held by individuals, mutual funds and others.



We expect the price impact on the tax-exempt municipal market to be mitigated because a large percentage of the municipal market is held by individuals assumed to be in one of the highest marginal tax brackets, and the highest marginal rate is only slightly lower (39.6% to 37%) in the tax reform bill. Individual investors can and do crossover between Bank Qualified (BQ) and General Market (GM) tax-exempt municipal bonds when yield discrepancies exist. If BQ munis experienced a price decline that pushed their yields higher than GM munis, cross over buyers (individuals and mutual funds) would likely move-in to restore the balance. Unlike banks which are subject to TEFRA, the difference between BQ and GM status to individuals is meaningless. If BQ bonds yield equal or higher than GM munis, it would make sense for individuals to invest in BQ munis rather than GM bonds, and could create some support for BQ yields.

While banks and financial institutions currently own approximately 15% of the municipal market, the municipal bond sector allocation as a percentage of the total portfolio is typically between 25% to 50% for banks (Vining Sparks Bond Accounting Stats – Sept. 2017). While this allocation may decline as a result of tax reform or due to various other factors, we expect allocations to the municipal sector will remain high and the sector will continue to be a key component of consistently high performing portfolios.



* For TEFRA calculations, 1.25% COF assumed for maturities 10 years or less, 2.00% COF assumed for maturities > 10 years

	Yields by Maturity or Equivalent Average Life (Sorted Low-to-High on 7yr)								
	1yr	3yr	5yr	7yr	10yr	15yr	20yr	25yr	30yr
US Treasury Securities	1.66	1.97	2.19	2.34	2.42	2.51	2.60	2.69	2.78
Agency Bullets	1.70	2.02	2.24	2.45	2.74				
Mortgage Backed Securities*		2.21	2.50	2.60	2.94				
BQ GO A Rated (C-Corp 21% TEY)	1.84	2.21	2.43	2.64	2.95	3.37	3.64	3.72	3.74
FNMA DUS Bonds			2.58	2.68	3.00				
SBA DCPC			2.55	2.73					
AGY Callables (NC 1yr Cont)		2.12	2.34	2.82	3.15	3.30	3.40		
A Rated Industrial Corporate	1.94	2.34	2.61	2.87	3.18	3.54	3.70	3.71	3.73
Taxable GO A Rated Muni	1.86	2.27	2.69	2.88	3.07	3.46	3.67	3.80	3.93
BQ Rev. A Rated (C-Corp 21% TEY)	2.11	2.48	2.69	2.92	3.22	3.70	3.96	4.08	4.15
A Rated Financial Corporate	2.03	2.48	2.76	3.03	3.33	3.69	3.85	3.85	3.87
BQ GO A Rated (S-Corp 29.6% TEY)	2.14	2.56	2.80	3.04	3.38	3.91	4.20	4.29	4.32
BQ Rev. A Rated (S-Corp 29.6% TEY)	2.44	2.86	3.10	3.35	3.74	4.28	4.56	4.70	4.77

* 10yr MBS for 3yr, 15yr MBS for 5yr, 20yr MBS for 7yr, 30yr MBS for 10yr

Deferred Tax Assets (DTA):

Changes in tax rates and tax laws require a re-evaluation and adjustment to deferred tax accounts when tax law changes are signed into law, not when the tax laws changes are effective. Most banks are in a net deferred tax asset (future tax deduction) position, which arises from various timing differences, but is primarily the result of timing difference resulting from loan loss allowance provisions and reserves that are expensed for book purposes, but are not deductible for tax purposes until loan losses are charged off. Deferred adjustments due to the lowering of the corporate tax rate from 34% to 21% should result in an approximate 38% reduction in net DTA accounts that will reduce capital this year (if signed into law by December 31, 2017) as an adjustment to income tax expense.

Based on our analysis from Q3 call report data for C-Corp banks under $10 billion in total assets, net DTA account balances total $10.48 billon. Assuming the worst case and the entire net DTA adjustment runs through earnings, we estimate the adjustment could potentially reduce annualized after-tax earnings by approximately 16.3% and reduce ROA from 1.04% to .87%. Please consult your accounting and tax advisors to assist with the deferred tax evaluation.

Recommended Action Items:

- Consider taking losses in the bond portfolio prior to year-end and other strategies to accelerate losses and expenses this tax year.
- Analyze how your tax-equivalent (TE) yields are impacted by tax reform by running a Performance Profile report or utilizing our online portfolio tool, Performance Architect. On some shorter municipal bonds, it may make sense to extend into longer tax-exempt municipal bonds or to swap them for a taxable investment in some circumstances. To request this analysis, contact your Sales Representative.
- Re-evaluate deferred tax accounts and potential year-end adjustments related to potential tax-reform. For many banks, this could result in a significant adjustment to income and capital this year.

The implications of tax reform are complex and, in most cases, depend on many different factors that are specific to each institution. We encourage you to contact your accounting and tax advisors to assist you in evaluating the impact of tax law changes. Please reach out to your account representative and we will be happy to assist.

Dan Stimpson, CPA
SVP, Investment Strategies
dstimpson@viningsparks.com

Kevin A. Smith, CFA
Manager, Strategic Analytics
ksmith@viningsparks.com