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Threats to Municipal Tax Exemption Could Loom in Washington

As Election Day draws closer, there has been increasing discussion among municipal market participants about the possible threats to municipal bonds' tax-exempt status. Both Presidential candidates have backed plans that would in some ways limit or eliminate the tax exemption for municipal bonds, leading to a debate over which candidate would be worse for the municipal bond market. With an eye toward reducing budget deficits and changing tax policy, whoever is elected is likely to at least explore changing the tax treatment of municipals as a way to enhance Federal revenues.

We advise investors holding municipals not to take any action out of concerns for what changes to municipal tax exemption could occur. It is impossible at this point to predict what changes to the treatment of munis might occur following the election. While the Presidential election may determine the direction proposals could take, the balance of Congress will likely play a much more important role in deciding what, if any, changes actually occur. Furthermore, actions on the part of state and local officials and the financial industry could play an important role in blunting the impacts of any proposals that actually do gain momentum in Washington. Ascent's approach is to continue to closely monitor developments on the Federal level. If it becomes clear that some meaningful change will be enacted, we will evaluate the expected impacts of policy changes at that time to determine the best course of action for our clients.

Are municipal bonds likely to lose their tax-exempt status? While this is the great fear voiced by municipal investors and the marketplace, it does not appear that there is any effort underway to repeal the tax-exempt status of existing municipal bonds. Rather, proposals for future treatment of municipal bonds fall into two broad categories:

1. **Limit the value of the tax exemption that investors are able to claim.** This approach, reflected in the Obama Administration's proposed Fiscal 2013 budget, would cap the value of tax exemptions at 28%, regardless of the actual tax bracket of the investor. There are multiple variations of this approach that have been discussed, some of which would affect all existing and future bonds beginning

Jan. 1, 2013. Other versions of this approach would apply only to bonds issued after 2012. (We discuss the potential effects of the Obama budget plan in more detail in the Feb. 21, 2012 *Municipal Market Comments*)

2. **Limiting the issuance of tax-exempt bonds.** This approach has been presented in a number of different formats. The Simpson-Bowles Commission proposed eliminating new tax-exempt issuance. Other plans, primarily advanced by Republicans including the Romney/Ryan campaign, have examined limiting or eliminating the tax exemption for advanced refundings, private activity bonds, or issuance by 501(c)(3) organizations (cultural institutions, hospitals, universities, etc.). With these plans, the tax-exemption of existing bonds has been assumed to be maintained, while only bonds issued prospectively would be subject to the new tax law limitations.

The potential impacts from a change in tax treatment on existing municipal bonds range widely depending on what one assumes will change. If the issuance of new tax-exempt bonds is eliminated going forward, the demand for existing bonds could drive a strong rally in muni prices. Likewise, any change in treatment of the tax exemption that affects future issues but holds existing bonds harmless would make outstanding munis more appealing as demand would far outstrip supply. Limiting the value of the tax-exemption would have a highly variable impact on investors, depending on their specific tax bracket and the nature of their income and deductions, but would likely drive down the value of existing bonds and the appeal of future issues.

In the past, a wide variety of governmental organizations and municipal market groups have strongly opposed efforts to change the treatment of tax-exempt municipal bond interest. We would expect this opposition to again be directed against whatever proposals appear to gain traction in Washington. Ultimately, we would not expect any meaningful change to begin taking shape until well into 2013 at the earliest. Prior to that, the make-up of the Administration and Congress after the election will begin to shed some light on what form, if any, changes in the tax treatment of munis might take.

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