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Municipal Taxation in the Spotlight as 2013 Looms

As we look ahead to 2013, the most significant issues for municipal investors revolve around the extent of possible changes in the tax treatment for interest earned from municipal bonds. Some of the change is clear - the Affordable Care Act's (ACA) investment income surtax kicks in on January 1st. Much more, however, remains unclear and will be the subject of heated debate in Washington.

Without knowing what changes will ultimately be adopted, it is impossible to predict how changes in tax law in 2013 will affect investors' holdings and the municipal market generally. Many of the provisions being discussed in Washington appear to have opposing impacts – some raising tax rates, others dampening issuance or boosting demand. Furthermore, the political process is often slow and provisions that appear to be in favor today can end up looking vastly different by the time legislation is finally passed (if it ever gets passed). ***For these reasons, we generally do not recommend changing investment strategies on the basis of the prospect of changes in tax law. Fixed income investors are typically best served by taking a conservative approach that changes strategy only in reaction to actual changes in rules and regulations affecting their investments***.

The calculus of whether, on the balance, tax law changes will increase the relative attractiveness of tax-exempt bonds depends on the sum total of the policies which end up being enacted. The list below outlines some of the issues currently being discussed as they relate to municipal bond investors:

- **The investment income surtax:** The ACA's 3.8% surtax on investment income is scheduled to go into effect on Jan. 1, 2013. Municipal bonds are one of the few investments not subject to the surtax, which hits taxpayers with adjusted gross incomes above $200K ($250K for joint filers). Investors would presumably increase demand for tax-exempt bonds in reaction to the investment tax.

- **Fiscal Cliff tax impacts:** If Congress and the President are unable to reach an agreement on extending the current income tax rates and we go "over the Fiscal Cliff," the marginal tax rates would increase on virtually all taxpayers, with the highest tax bracket rising back to 39.6%. Expiration of the various tax cuts enacted over the past 12 years would also entail steep rises in capital gains taxes, estate taxes and the elimination of the temporary AMT exemption for millions of taxpayers. Higher tax rates generally drive increased demand for tax-advantaged investments like municipal bonds.

- **Negotiated tax increases:** Should Congress and the President successfully negotiate a tax and spending structure that includes increases in marginal tax rates for top earners, we would also expect an increase in demand for municipal bonds. Taxpayers in the highest tax bracket account for the vast majority of municipal bond holdings by individuals.

- **Changes in tax treatment for municipals:** In the ongoing political battle over the Federal budget, numerous approaches involving changes to the tax treatment of municipal bonds have been discussed by members of both parties. At this time, the one that appears to have the most support in Washington is the President's proposal to cap the value of tax exemptions at 28%, including interest from municipal bonds. This proposal (discussed in greater detail in the Oct. 29, 2012 edition of *Municipal Market Comments*) would have a net effect of imposing a 7% tax rate on municipal bond interest income for investors in the 35% tax bracket (35% marginal rate minus the 28% exemption). Taxation of municipal bond interest would dampen demand for municipals.

- **Limitations on issuance of tax-exempt bonds:** Another approach to raising revenues on the federal level is to limit the use of the tax exemption. Eliminating the federal tax exemption for certain types of bonds that are currently tax-exempt, such as industrial development bonds issued by tax-exempt conduits for private obligors, would depress the supply of new tax-exempt bonds.

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