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Tax Sensitive Fixed Income



Under Fire: Tax-Exemption of Municipal Bond Interest

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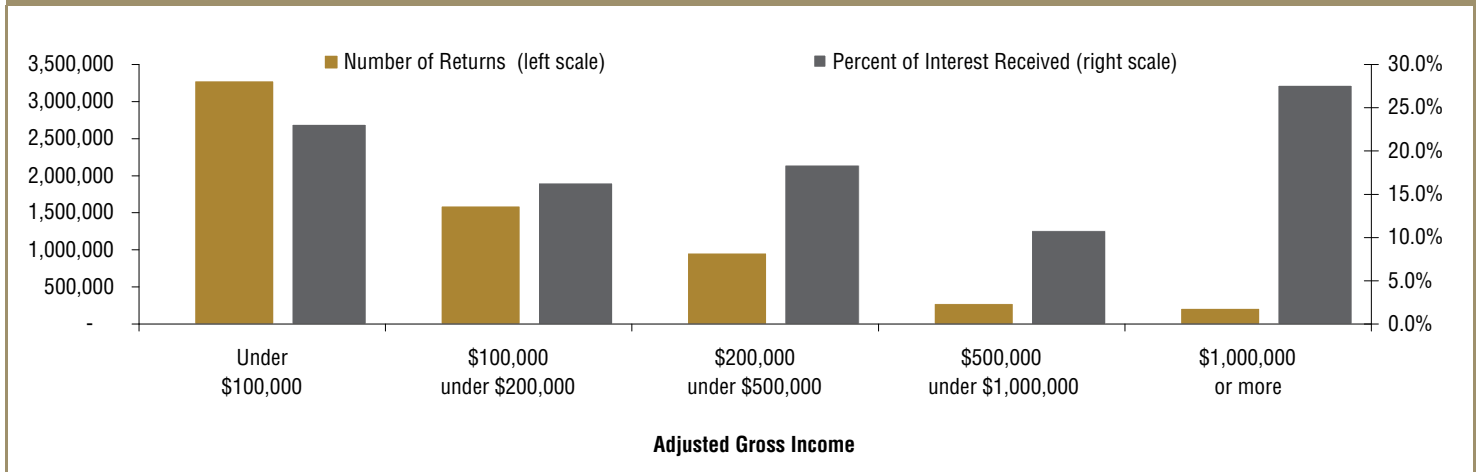
Tax-exemption of municipal bonds has come under fire once again. As Washington investigates every possible way to chop back the federal deficit, the tax revenue that might be extracted from municipal bond interest is becoming a tempting target.

Opponents of tax-exemption claim that enabling state and local governments to borrow at favorable rates is inefficient and disproportionately benefits the wealthy. On the other side, proponents point to the broad ownership of municipals and to the advantages of low capital costs in the financing and maintenance of this country’s essential infrastructure projects.

Municipals are Not Strictly for the Affluent

One of the key arguments in the debate over tax-exemption is that the tax benefits from municipal bonds are enjoyed only by the wealthy. The detailed taxpayer data, however, tells a different story. Indeed, in 2008, the last tax year for which the IRS provides information, more than half of the 5.5 million tax returns reporting receipt of tax-exempt interest were filed by taxpayers with Adjusted Gross Income (AGI) below \$100,000. This income group’s total share of declared tax-exempt interest reached \$18.4 billion, about the same as the “rich” cohort of taxpayers with AGI over \$1 million, who reported \$22.0 billion.

Tax Year 2008 Reported Recipients of Tax-Exempt Interest



Source: Statistics of Income Division, Internal Revenue Service

Tax Expenditures Under Fire

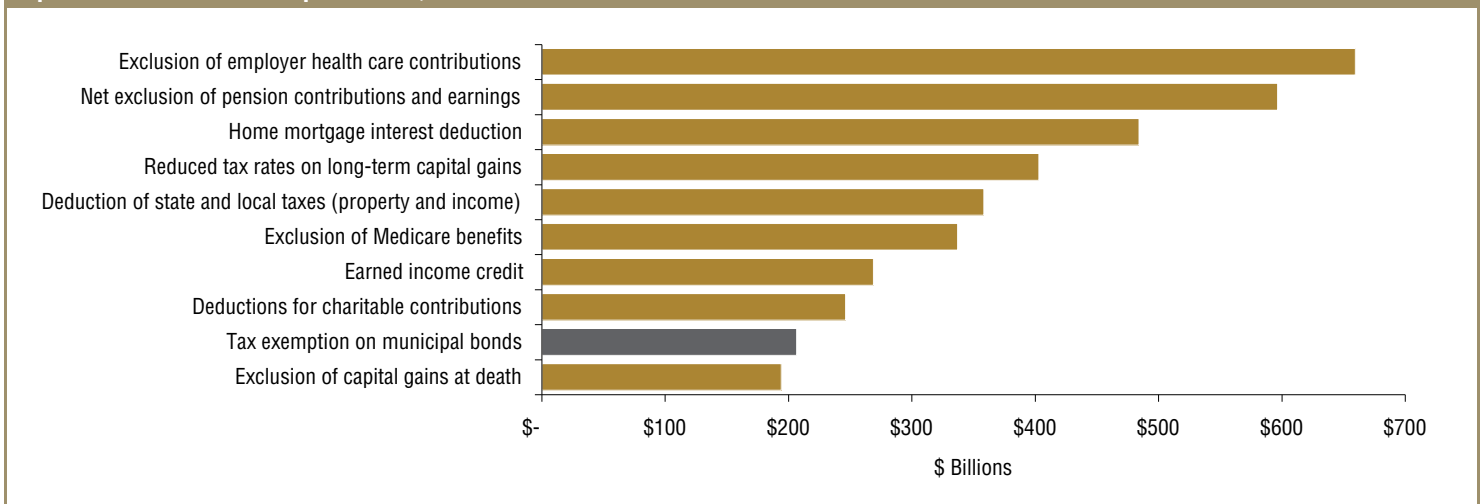
Largest “Tax Expenditures” May Be More Immediate Reform Targets

Standard & Poor’s recent alarms over the United States government’s debt rating have given the battle over tax reform a new sense of urgency. With an enormous budget gap to close, legislators and the administration will likely focus on the thicket of “tax expenditures,” which are defined by the Congressional Joint Committee on Taxation as “reductions in income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers.” In other words, the federal government can raise a great deal of revenue by eliminating loopholes that reduce individuals’ tax liabilities. The process is difficult, however: all of these loopholes are attached to politically-popular causes.

The Joint Committee estimated that the ten largest tax expenditures will cost the federal government \$3.75 trillion in foregone revenues over the five years from 2010 through 2014. Federal exemption of municipal bond interest is low on the list, generating only 5.5% of all projected losses. In contrast, the three largest items, which provide preferential treatment for employee-based health insurance, retirement savings and home ownership, together contribute 46.4% of the total figure.

The biggest tax expenditures will presumably garner the most attention from budget-writers.

Top Federal Income Tax Expenditures, 2010 - 2014



Source: Joint Committee on Taxation, December 15, 2010

Proposals Seek to Lower Deficits, Simplify Tax Code

Fiscal reform proposals floated since December, 2010 have aimed to revamp taxes broadly. Most seek to simplify the tax code, gradually eliminate tax expenditures and reduce marginal tax rates. Within the different reform proposals, three main options have been put forward to modify or eliminate tax-exemption of municipal bonds.

1. Swap Higher Borrowing Costs For Lower Tax Rates, Broader Tax Base

The first attempt at sweeping tax reform came from the National Commission on Fiscal Responsibility and Reform, also called the Bowles-Simpson Commission. Their December report, recently embraced by the President, called for eliminating special tax-exempt treatment of interest on all new municipal bonds. Tax rates for individuals would be lowered across-the-board under the Bowles-Simpson plan, and municipal bond interest would be taxed at the ordinary income rate.

House Budget Committee Chairman Paul Ryan’s 2012 budget proposal follows closely many of the Commission’s recommendations. The Wisconsin Republican’s resolution, however, would effectively do away with the special treatment of municipal bond interest by eliminating taxes on all interest, capital gains, dividends and estates.

Both proposals would prove painful for state and local bond issuers and, as a consequence, for infrastructure financing as well. Municipal bond issuers would have to pay higher interest rates in order to produce returns that are competitive with other fixed income assets. Many large fixed income investors, such as foreign governments, overseas funds, pensions, endowments and tax-sheltered life insurance companies, pay no federal income taxes, and demand comparable yields from similar corporate and municipal bonds. In fact, all but the most well-known, liquid municipal issuers would likely be assessed an additional liquidity

premium in the marketplace, driving yields on taxable municipals higher still. We recently witnessed this phenomenon with taxable Build America Bonds (BABs).

2. Directly Subsidize Issuers, Not Bondholders

In March, the Congressional Budget Office (CBO) issued a report on spending and revenue options for reducing the deficit, which recommended replacing tax-exemption of municipal bonds with a direct federal subsidy paid to borrowers. According to the CBO, a direct subsidy is more cost-effective, as it can be specifically targeted to certain types of financings, as well as more transparent for federal budget-making. While direct subsidies were generally successful in the BAB program, CBO proposes paring the subsidy to 15% of interest costs, down significantly from the 35% federal payment used with BABs. The CBO acknowledges that even after the subsidy, borrowing costs would likely be higher than current tax-exempt rates, which could hamper issuance for infrastructure investments across the country. As an offset, they also considered a higher interest subsidy of 20% to 25%, but only for specially targeted state and local projects.

Representative John Tierney (D – MA) has announced plans to introduce a tax-reform bill in May with a 25% interest rate subsidy for borrowers in lieu of tax-exempt bonds.

Based on experience with the now-expired BAB program, direct subsidies proved to be expensive for the federal government and for issuers alike, while benefiting broker/dealers and institutional investors. One concern for federal budget-makers is that putting the US Treasury directly on the hook for a stream of payments extending 30 to 40 years into the future creates a new unfunded liability for the federal government, not a popular move in an environment where Washington is trying to cut back unfunded obligations. Furthermore, as interest rates rise in the future, the subsidy climbs in-step with interest costs, exposing the federal budget to interest rate risks as well.

3. Democratize Municipal Bond Holdings By Offering Tax Credits to Bond Buyers

The Wyden-Coats bill, submitted in early April by Senators Ron Wyden (D – OR) and Dan Coats (R – IN), seeks to spread the benefits of owning municipal bonds equally to all taxpayers, regardless of AGI. Their proposal would replace tax-exemption with a federal tax credit for bondholders equal to 25% of the interest earned.

While favorable tax treatment of municipal bonds might keep in place demand from individuals, at least when compared with fully taxable instruments, tax-credit bonds are difficult to account for and have been slow to catch on with investors. In 2009 and 2010, a tax-credit alternative was available in the BAB program, but went almost completely unused.

It is not clear that the proposed tax credit would be available to corporate taxpayers. If it is not, overall demand for municipal bonds from corporations and property and casualty insurers would likely shrink, leading to a potential increase in borrowers' interest costs.

Implications for the Municipal Bond Market

We believe, none of these proposals would be easy to enact. Borrowing costs would likely be higher under most options. We would expect a range of constituents, from governors and mayors to leaders of transportation agencies, hospital systems, colleges and universities, to raise formidable grass roots opposition to any effort to eliminate such a valuable financing tool.

Nevertheless, the urgency of solving the budget mess means that every tax expenditure will be dissected in the press and in Congress. Clearly, the enactment of a sweeping reform package which includes a change in the tax treatment of municipal bond interest would have an enormous impact on the entire municipal market.

No proposal has advocated eliminating exemption of existing municipals, paving the way for the \$2.9 trillion of outstanding municipal bonds with grandfathered tax-exemption to trade dramatically higher on scarcity value if exemption were eliminated.

Eliminating exemption potentially would change patterns of demand for existing tax-exempt debt as well. For example, investors may increase their buying of the longest maturities in order to lock in favorable tax treatment as far into the future as possible.

Passive and direct ownership, in a brokerage account or through separately managed accounts, would be rational in a shrinking market. Individual bonds would continue to deliver predictable cash flows from discrete maturities and regular periodic tax-

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exempt interest payments. In contrast, mutual funds would be forced to compete over an increasingly-scarce stock of tax-exempt bonds, pushing down distribution yields over time.

Finally, if borrowing costs do rise with the elimination of exemption, issuers would have little incentive to refinance existing debt. The likelihood that borrowers call outstanding bonds declines markedly if current tax-exempt debt can only be replaced with higher-cost taxable instruments. If calls were exercised less frequently, callable bond valuations would likely rise to approach valuations on non-callable obligations.

Conclusion

The urgent scramble to address the ballooning federal deficit will reasonably seek to uncover every scheme to broadly raise revenues, bringing all major tax expenditure loopholes under intense scrutiny. Municipal bond tax-exemption will, inevitably, capture the attention of budget-makers and the media.

We believe it is unlikely that municipal entities will be penalized with higher debt costs. Lack of public support, as well as the relatively small amount of incremental federal revenues collected, and the burdens which would fall on infrastructure development and the delivery of essential public services, all argue against a radical overhaul of the tax-exempt bond market.

If our prediction is flawed, and tax-exemption is eliminated, current bondholders would be likely to enjoy higher asset valuations. Conversely, state and local governments and agencies would bear higher interest costs from issuing taxable debt, further straining their budgets and curtailing the services they provide as well as future capital projects.

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