Conference Call on Proposal to Tax Municipal Bond Interest
Summary
September 15, 2011

President Obama has proposed that a portion of the interest paid on municipal bonds be taxed. The rate of the tax would be determined by subtracting 28 percent from the taxpayer's marginal income bracket. As an example, if the taxpayer were in the 35 percent bracket, then the rate of tax would be 35 minus 28, or 7 percent. The tax would apply to all municipal bond interest, including interest on outstanding bonds.

The Bond Dealers of America (BDA) hosted a call on September 15, 2011 to describe the President's proposal, to review the prospects for its enactment and to discuss possible responses. Michael Nicholas, CEO of BDA, William Daly, Senior Vice-President of Governmental Relations of BDA, John Buckley, former Chief Tax Counsel of the House Ways and Means Committee, and Mitch Rapaport, Partner at Nixon-Peabody participated on the call.

A more detailed description of the proposal is attached. The proposal is an expansion of a proposal that the Obama Administration has been making for several years to limit the benefit of itemized deductions to the 28 percent bracket. The new element in this proposal is to also apply the limit to tax-exempt interest. The earlier proposal was not well received in Congress and got little support even when the President's party controlled both houses of Congress and it went nowhere. It is highly unlikely that this proposal will be received any better, at least in the context of paying for the additional spending proposed by the President.

However, staff of the BDA had several meetings with Congressional staff in the three days between the announcement of the President's proposal and the September 15 conference call. It was particularly notable that staff were very careful to say that although they did not anticipate support for the President's proposal in the context of paying for spending or for deficit reduction, they would not make the same commitment when it came to tax reform.

In other words, the municipal tax exemption is definitely on the table to pay for rate reductions in tax reform.

The rationale for both the President's proposal and for repeal or curtailment of the exemption in tax reform is that, according to the way Washington looks at the proposal, the burden will fall on upper income taxpayers. This is viewed as "fair", either because upper income taxpayers are not now paying their share of taxes or because they will benefit from the rate reductions in tax reform.

But that analysis ignores the fact that what those upper income investors are focused on is their after-tax return. Increasing their taxes will only make them demand a higher rate of return from states and localities so that they maintain the same after-tax return. The upper income taxpayers will end up with the same amount of money in their pockets. It will be the state and local taxpayers and rate-payers who will bear the burden of the tax through sales taxes, property taxes and water and sewer fees. The people who will ultimately pay are not upper income.

The result of the President's proposal, or other proposals to restrict or eliminate the municipal tax exemption, will be higher state and local taxes and fees or fewer necessary infrastructure projects, such as schools, roads, bridges, water and sewer projects.

The President's proposal focuses attention on what the municipal tax exemption actually does and how it works. It provides an opportunity for municipal market participants to educate members of Congress and their staffs for what will be the real game, the fight over tax reform.

BDA members can help by ensuring that their issuer clients are informed and by encouraging them to contact their members of Congress.

BDA will provide its members with talking points and sample letters for them to use and to share with issuer clients.

Administration Proposal to Limit the Municipal Tax Exemption

What is the proposal? The proposal would tax part of the currently tax-exempt interest on municipal bonds earned by high-income taxpayers. It is a part of the Administration's jobs bill that would limit all itemized deductions and some other exclusions. In total, the limitation on all of the exclusions and deductions would pay for about $400 billion of the $450 billion cost of the jobs bill, but there is no specific estimate of how much the part affecting municipal bond interest would raise.

What does the proposal do?

The proposal would:

- tax a portion of the currently tax-exempt interest on municipal bonds for individual taxpayers with adjusted gross income (AGI) above $200,000 and for families with AGI above $250,000;
- impose a tax at a rate that would be the difference between 28% and the taxpayer's bracket (if the taxpayer were in the 35% bracket, the rate of tax would be 7%)
- apply to interest received on or after January 1, 2013;
- apply to both new **and outstanding** municipal bonds.

Who is affected?

- **Investors**—Based on their AGI, some investors would be taxed a portion of their municipal bond interest. Investors would also face an erosion of the value of existing bonds in their portfolios.
- **Issuers**—The market could demand higher yields, so issuers will face higher issuance costs.
- **Broker/Dealers**—As investors become more conscious of the new restrictions, they could alter their investment strategy and look for alternatives to investing in municipal bonds. As higher-income investors seek alternatives, BD's may have to find new investors for tax-exempt bonds.

What will happen?

- If, as is likely, the proposal is not approved as a part of the jobs agenda, it (or something like it) will probably be considered in overhauling the federal tax code.
- This proposal provides an opportunity to focus issuers and investors on the potential for curtailing or eliminating the tax exemption, even for outstanding bonds, and to reach out to members of Congress.