Bond Market Perspectives

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The Taxing Issue of Municipal Bond Interest Taxation

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Highlights

Proposed tax policy changes from each presidential candidate, President Obama and Governor Romney, may negatively impact municipal bonds.

However, the ultimate market impact is difficult to assess, given the numerous uncertainties associated with the complexities of tax policy changes.

Municipal bonds may be adversely impacted as a result of the presidential election, no matter which candidate wins. The U.S. government continues to operate with a budget deficit that is likely to exceed $1 trillion for the fourth consecutive year. Proposals to increase taxes and cut spending are on the table, as each candidate seeks ways to both raise revenue and cut expenses in order to reduce the deficit. Both President Obama and Governor Romney have proposed changes to tax policy that reflect their school of thought: President Obama to raise revenue via higher tax rates for upper income households and Governor Romney to lower tax rates in attempt to boost economic growth, "broaden" the tax base, and increase overall tax revenues.

Aside from tax rates, the tax treatment of municipal bond interest income may come under scrutiny regardless of who wins the White House because the exemption of municipal bond interest income is one of the largest tax expenditures of the U.S. government. As Figure 1 illustrates, the exclusion of municipal bond interest income from taxes will cost the government almost $50 billion for the current (2013) fiscal year and just over $300 billion over the coming five years. Although $50 billion is a drop in the bucket for the budget deficit, it remains an option in Washington.

1 Municipal Bond Interest Income Is One of the Largest Tax Exemptions
Projected Top 10 Federal Tax Expenditures for Fiscal Years 2013–2017 $ Billions

Provision	2013	2013–17
Exclusion of employer contributions for medical insurance premiums and medical care	181	1,012
Deductibility of mortgage interest on owner-occupied homes	101	606
Exclusion of 401(k)-type plans	73	429
Accelerated depreciation of machinery and equipment	33	375
Exclusion of net imputed rental income	51	337
Lower rate for capital gains	62	321
Exclusion of interest on state and local bonds	49	307
Exclusion of employer-provided health care plans	52	298
Deductibility of non-business state and local taxes	46	295
Deductibility of charitable contributions	40	239

Source: White House, Office of Management and Budget (OMB) January 2012

Ranked by five-year totals and figures rounded to nearest billion. Foregone tax revenues, usually to provide a subsidy or create incentives, are labeled as tax-expenditures.

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Proposed tax policy changes from each candidate, President Obama and Governor Romney, contain elements that may impact municipal bonds. A closer look at each candidate's proposals reveals how.

President Obama's Proposal

2 Capping the Tax Exemption Reduces the Attractiveness of Municipal Bonds Relative to Other Fixed Income Options

Average Yields	10-year	15-year
AAA Municipal	1.8%	2.3%
Taxable Equivalent Yield at 35% bracket	2.7%	3.5%
Taxable Equivalent Yield at 28% bracket	**2.5%**	**3.2%**
Treasury	1.8%	2.3%
AA-Rated Corporate Industrial	**2.7%**	**3.2%**

Source: Municipal Market Advisors, Haver Analytics, Standard & Poor's, LPL Financial 10/19/12

On the surface, President Obama's proposal to let the Bush tax cuts expire and let the top tax rate rise to 43.4% (the prior 39.6% top tax rate plus a 3.8% surtax on investment income that begins in 2013, as part of Obamacare) seems positive for municipal bondholders. However, Obama's plan also relies on tax expenditure reform by reducing deductions via a 28% cap on tax-exempt interest income. An investor currently in a 35% tax bracket would therefore benefit less from owning municipal bonds because the tax exemption is reduced to 28%. Municipal bond prices may weaken as the after-tax yields become less attractive relative to other fixed income sectors for investors in the top tax brackets [Figure 2].

Fortunately for investors, municipal bonds still make a compelling option even at a lower tax bracket, especially compared to U.S. Treasuries. However, Figure 2 illustrates how top-rated municipal yields would become less appealing relative to high-quality corporate bonds. For 10-year maturity bonds, the 28% cap would translate to a lower after-tax yield compared to similar maturity corporate bonds (2.5% vs. 2.7% for the average corporate bond), and for 15-year maturity bonds, the yield advantage would be neutralized. Still, the now lower after-tax municipal yield may not be enough to prompt investors to make a shift as it involves moving to a lower rated investment. In the end, it may make it harder for investors to maintain yield in their portfolios and other investment options may be considered.

To be sure, the after-tax yield changes are modest but might be a catalyst for investors to sell nonetheless. Municipal bonds have outperformed Treasuries by a notable amount thus far in 2012, and the Barclays Municipal Bond Index is up 6.2% year-to-date through October 19, 2012. Lower taxable-equivalent yields on municipal bonds may be motivation for investors to take profits.

Governor Romney's Plan

In aggregate, Governor Romney's tax policy could potentially be more damaging to the municipal bond market. Governor Romney has proposed cutting current tax rates by 20% across the board, which would reduce the 35% top tax rate to 28% and create a result very similar to the Obama proposal outlined above.

However, Governor Romney has also proposed eliminating all taxes on investment income for those earning less than $200,000 per year, and competing investments would be much more attractive relative to municipal bonds. Without a tax advantage, municipal bonds would lose their appeal to a sizable number of investors. According to individual IRS tax filings through 2009, the latest year for which data is available, roughly 51% of all municipal bond interest income was claimed by investors who earned less than $200,000. Governor Romney's proposed exemption on investment income could lead to lower municipal bond prices, as these investors consider other investment alternatives.

Offsetting Positives

Several factors complicate the actual implementation of new tax policy and may maintain the status-quo for municipal bond investors. These include:

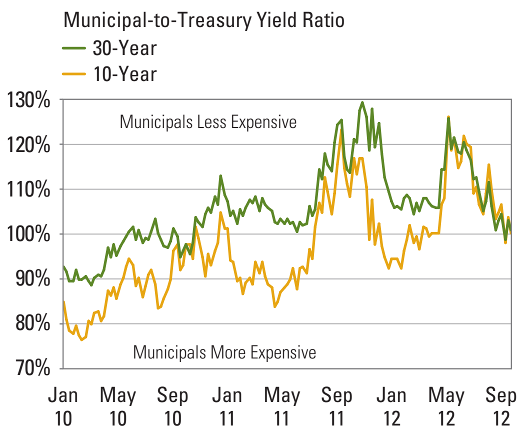
Higher borrowing costs. Perhaps the biggest argument against tweaking the current tax treatment of municipal bonds is the impact of new tax policy to state and local municipal issuers. By making municipal bonds less attractive and potentially sparking price declines, a new tax policy could raise borrowing costs for states and municipalities at a time when budgets remain under stress and economic growth is sluggish.

Lack of alternatives. Related to the above point, there is no ideal alternative to traditional tax-exempt state and local government financing, which means changes to tax policy are likely to result in higher borrowing rates for municipalities. The taxable Build America Bond (BAB) program was well received in the marketplace, as it opened up municipal debt to a wider and global investment audience. However, BABs require a subsidy from the government to the municipal issuer to offset the higher interest rate on the taxable debt. The cost to the government of BABs runs counter to deficit reduction. Furthermore, the Office of Management and Budget (OMB) recently stated that subsidies to BABs issuers would be reduced should spending cuts as part of the Budget Control Act of 2011, known as sequestration, take effect. The mere threat of subsidy reductions undermines the use of BABs as an alternative to traditional tax exempt municipal financing. Another alternative, tax credit municipal bonds, where the holder receives a credit to be redeemed when filing taxes, have never been well received by investors and are not a viable option.

Attractive valuations. Top-rated municipal bond yields are roughly in-line with comparable Treasury yields, meaning that investors are receiving the tax benefit for free [Figure 3]. Municipal-to-Treasury yield ratios have come down in 2012, but remain elevated by historical comparison. Relatively attractive valuations can help temper, but not offset, any adverse reaction in the municipal bond market. As Figure 2 illustrates, the change to taxable equivalent yields is a modest one.

Implementation issues. What is proposed in Washington does not always become law, and a multitude of wrinkles could also alter the ultimate market impact. Tax law changes will have to pass Congress, and proposed tax policy could be changed or stopped altogether by either the House or the Senate. The composition of Congress may change after the elections, which makes handicapping the successful passage of any new tax policy that much more difficult. Furthermore, both candidates may choose to implement new tax rates but delay changes to tax expenditures (deductions) as part of broader tax reform, which may not occur until late

3 Attractive Municipal Valuations Should Temper the Impact of any Tax Changes



Source: Municipal Market Advisors, LPL Financial 10/19/12

2013 or beyond. In this case, the higher tax rates proposed by President Obama would be a positive for municipal bond holders, as the tax-exempt interest would be more valuable. Finally, tax changes may be applied retroactively, as President Obama has proposed, or older municipal bonds may be grandfathered as suggested by the Simpson-Bowles commission in 2010. Grandfathering existing municipal bonds while applying tax laws only to newly issued bonds may boost valuations of existing municipal bonds as tax-advantaged investments become scarce. This is just one of several wrinkles that could alter any municipal market impact.

The issue of municipal bond interest taxation is a taxing one indeed, but we do not recommend municipal bond investors alter their investment strategy at this point. While both presidential candidates' tax proposals pose risks to the municipal market, the uncertainties over the elections, both presidential and congressional, and the variety of details to be finalized, are simply too great. It is important to realize that the municipal bond market has withstood multiple threats or changes to tax exemption over the years — most notably the 1986 Tax Reform Act, and more recently the 2010 Wyden-Gregg Bill and Simpson-Bowles commission of 2010 — none of which materially impacted the municipal market or came to fruition. Until we obtain further clarity on tax policy changes, municipal bonds remain one of our favorite high-quality bond options. At most, we view tax uncertainty as another factor that may slow municipal bond performance compared to what investors have experienced so far in 2012. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.

Bank Loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

The issuance of Build America Bonds (BAB) began in April of 2009. They were authorized by the ARRA economic stimulus of 2009 and can be issued for qualifying infrastructure projects. They are taxable municipal bonds and are considered a category of bonds.

Barclays Aggregate Bond Index: is comprised of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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