Issuers Should Care That Municipal Bonds Remain In Legislators Crosshairs

Members of Congress and their staff continue to have the tax exempt municipal bond market in their legislative crosshairs. As Washington investigates every possible way to reduce the federal deficit, the tax revenue that might be extracted from municipal bond interest remains a tempting target.

With the so-called "Taxmageddon" or the "Fiscal Cliff" hitting 12/13/2012, legislative action is very possible by the end of 2012. Taxmageddon and Fiscal Cliff refer to the expiration of the Bush Tax Cuts and the $500 billion in separate cuts to defense and domestic entitlements that will automatically take effect if Congress fails to pass a broad debt reduction package by the end of 2012.

What Has Been Proposed. Proposals targeted to reduce the costs to the Federal Government of the tax exemption for municipal bonds continue to be drafted. Most major fiscal reform proposals floated since the end of 2010 have aimed to revamp taxes broadly, seeking to simplify the tax code, to gradually eliminate tax expenditures and to reduce marginal tax rates. Those proposals affecting the tax exemption of municipal bonds include the following.

The Bowles-Simpson Commission 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 tax rate.

House Budget Committee Chairman Paul Ryan's 2012 budget proposal follows closely many of the Bowles-Simpson recommendations. The Ryan 2012 budget would effectively do away with the special treatment of municipal bond interest by eliminating taxes on all interest, capital gains, dividends and estates.

For his part, the President has proposed modifications or elimination of the tax exemption of municipal bonds in his American Jobs Act of 2011 (the "Jobs Act") and Debt Reduction Act of 2011 (the "Debt Reduction Act"). The Jobs Act would limit for certain individual taxpayers the value of certain deductions and exclusions, including the exclusion for tax exempt interest, to 28% irrespective of the actual marginal tax rate imposed on such taxpayers. The Debt Reduction Act would establish a steadily declining ratio for debt as a percentage of Gross Domestic Product and would impose a penalty in the event that Congress failed to meet the requirements, including automatic sequestration of spending and the reduction in the value of certain tax incentives, including interest on tax exempt municipal bonds, potentially (in the extreme) eliminating the exemption from taxation that tax exempt municipal bonds held at the time of issuance.

The Wyden-Coats bill seeks to spread the benefits of owning municipal bonds equally to all taxpayers, regardless of adjusted gross income. This proposal would replace the tax exemption of municipal bond interest with a federal tax credit for bondholders equal to 25% of the interest earned.

Why Issuers Should Care. If any of these proposals to limit the municipal bond tax exemption were enacted, issuers of municipal bonds would have to pay higher interest rates in order to produce returns to investors that are competitive with other fixed income instruments. One market analyst has stated that all but the most well-known, liquid municipal issuers would likely be assessed an additional liquidity premium in the marketplace, driving yields higher still.

If any of these pass in their current formulation, the resulting higher interest costs to issuers may not always be able to be passed on to taxpayers. This further strains issuers' budgets and credit ratings. Issuers may be pressured to further curtail the services they provide as well as limit future capital projects. Issuers would also have a much reduced incentive to refinance existing debt. The likelihood of issuers calling outstanding bonds declines markedly if current tax exempt debt can only be replaced with higher cost debt instruments.