

## Municipal Tax Exemption and the American Jobs Act

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### Proposal to Limit Municipal Tax Exemption

Legislators have been discussing possible changes to the municipal tax exemption for the better part of a year now, but the President's new American Jobs Act ("AJA") actually brings a formal proposal before Congress. The proposal applies only to those above a "high" income threshold (\$250,000 for couples, \$200,000 for individuals) and would take effect in 2013. The tax ramifications of this proposal for municipal investors are as follows:

(1) Investors paying a marginal rate of 28% or less would be unaffected; (2) Investors in the maximum 35% tax bracket would pay an effective rate of 7% on municipal interest income (if the Bush tax cuts are allowed to expire the maximum bracket rate would increase to 39.6%, and the municipal effective rate would rise to 11.6%). (3) As the taxpayer's marginal rate approaches 28% the rate would incrementally reduce to zero. One notable uncertainty is the impact of the bill on those subject to the AMT. Language exists within the proposal which seems to imply an additional tax for certain AMT taxpayers. As written, this calculation is highly complex, dependent on a wide range of variables, and would vary considerably depending on a taxpayer's particular situation.

The Bipartisan Deficit Commission started the ball rolling earlier this year by proposing to eliminate most tax exemptions (including the one for municipal bond income) in the future, while at the same time lowering marginal tax rates across the board.

The Deficit Commission's recommendation was expected to grandfather existing municipal issues though, so under that scenario the marketplace would move forward with two categories of municipal bonds: a slowly contracting sector of pre-change tax-exempt bonds and a growing sector of post-change taxable municipal bonds. This would be similar to the 1986 tax reform act where "pre-86" and "post-86" bonds had different tax considerations in many cases.

Should the AJA become law, we expect the relationship between municipal yields and other sectors to change and the slope of the curve to steepen to compensate for tax policy risk. Perhaps the most unsettling aspect is not the mathematical impact of the new tax on market yields but the retroactive nature of this legislation. For the first time in recent memory, the proposed municipal legislation would affect not only future issuance but existing bonds as well. Until now, the marketplace has operated under the assumption that any changes to the treatment of municipal tax exemption would not affect previously issued bonds. The introduction of a special tax rate for municipal bond income creates the risk in the future that the special rate can be changed, which would make "tax risk" a more tangible component of municipal pricing.

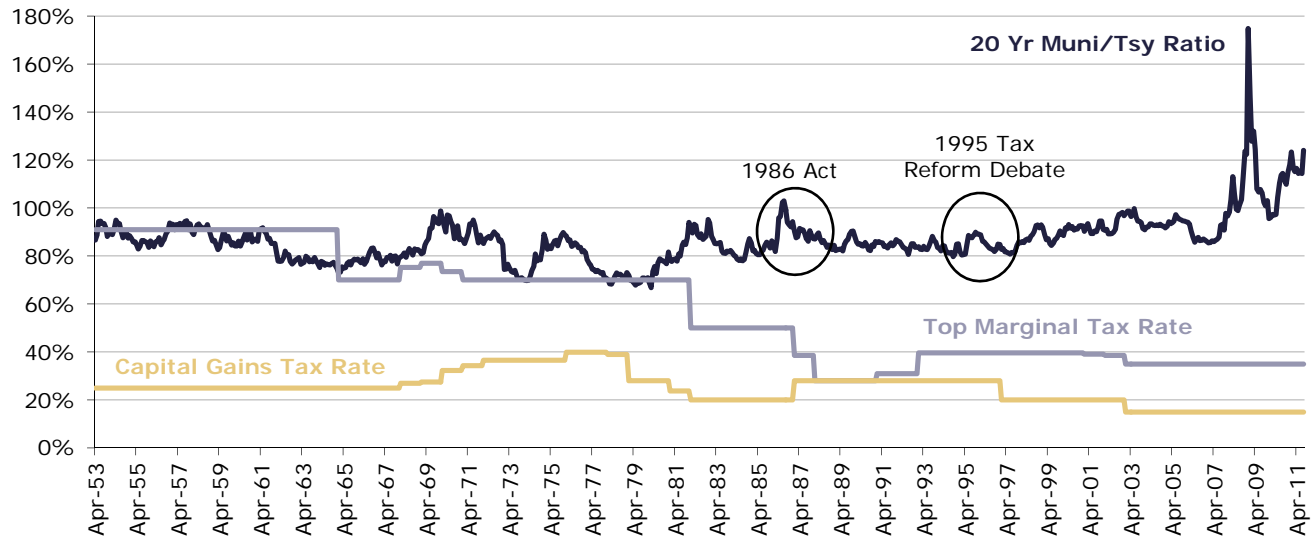
### Historical Context

To put the current discussion in historical context, it may be helpful to examine two of the more significant periods of tax reform-related volatility over the last three decades: the Tax Reform Act of 1986 and the tax reform debate of 1995.

The changes wrought by the 1986 Act were dramatic. It narrowed 15 marginal tax rates, ranging between 11% and 50%, to only four marginal tax rates, ranging from 15% to 28%. The 1986 Act also expanded the AMT to a larger group of taxpayers by targeting broadly used deductions – i.e., not just those used by the ultra-wealthy. The announcement, debate, and ultimate passage of the Act created significant turbulence in the municipal bond market. The ratio of long-term municipals to Treasuries rose from 82% to approximately 103% between February and June of 1986 – a previously unseen level in the history of the Fed's data series for 20-year municipal

bonds. Yield ratios fell to the low 90% range by the end of the year however, and then trended downward through 1987 and 1988. The ratio remained in a range of 80-90% of Treasuries for the next decade.

**Historical Marginal and Capital Gains Tax Rates and 20 Year Municipal/Treasury Ratio**



Sources: Federal Reserve, Bond Buyer, Tax Policy Center

Since 1986, a high probability of tax reform was priced into the municipal yield curve only once, during the 10-month period between mid-April 1995 and February 1996. The ignition point for these concerns was a set of competing tax reform proposals announced by members of a newly emboldened Republican majority in Congress following the 1994 elections. The proposals ranged from consumption taxes to a flat tax, any of which would have reduced the attractiveness of municipal bonds for investors who, at that time, paid a maximum marginal rate of 39.6%. Ultimately the concept of radical tax reform was shown to be infeasible without tackling many other “third rail” issues as well, and the market reverted to more normal relationships by the middle of 1996. Although tax reform concerns were the primary drivers of weakness in municipals, yield ratios did not approach the extremes of 1986 during this period.

The Republican Presidential primary race quashed the possibility of radical tax reform as Bob Dole and Jack Kemp (historically an advocate of the flat tax) fought back the challenge of Steve Forbes’ flat-tax focused campaign.

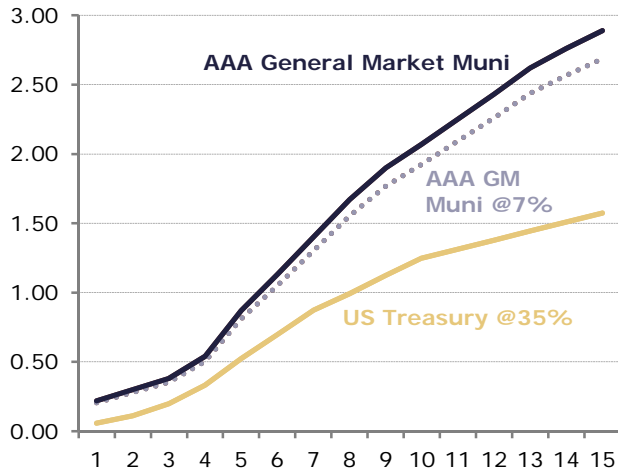
In both cases, a short term market jump to higher yields and ratios was followed by a longer-term return to more normal municipal/treasury ratios.

**Potential Impact**

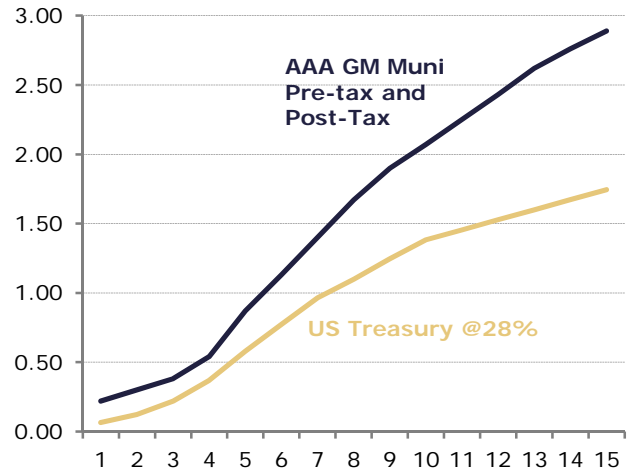
While the proposal is expected to have an impact on market yields, it may not materially change the attractiveness of municipals to taxpaying investors. Although marginal tax rates are an important factor in municipal pricing, credit quality and market risk premia also factor heavily into the valuation of municipals relative to taxable bond markets. In the current market environment, municipal bonds are relatively inexpensive when compared to US Treasuries, but that is more the result of extraordinarily low Treasury yields than municipal concerns. Today the municipal market would be the more attractive investment even after imposing the proposed tax on municipals. It should be noted that, although today’s municipal market is cheap by most measures, that has not always been the case historically and we would not expect that to be the case in an environment with higher Treasury yields.

Many municipal bond investors already have marginal tax rates below 35% (for example, AMT taxpayers pay 28% and insurance companies pay just about 30% due to some disallowance of tax free income).

**After-tax Yields for Maximum Taxpayer**



**After-tax Yields for AMT Investor**



Sources: Thomson, Bloomberg

While municipal investors will adjust their yield expectations according to the after-tax advantage of the sector over time, the brunt of the cost of those higher yields will be borne by the issuer community – state and local governments and their instrumentalities. The proposal represents a clear negative for municipal credit quality as the majority of issuers would face higher financing costs over the longer term. From a policy perspective, this could curb infrastructure investment at the local level while ostensibly transferring that activity to the federal level. Employment growth could slow even further given the longer approval process and implementation time typically required for federal infrastructure projects.

If the proposal in the AJA moves forward, we believe that it is fair to expect that the normal relationship between municipals and Treasuries will result in a higher ratio of municipal/Treasury yields – that is, marginally higher municipal yields over time. From an investor’s perspective, this means that more attention must be paid to achieving the appropriate allocation between federally taxable and federally tax-exempt investments, but it is not likely to require a wholesale shift in investment strategy. As the probability of opening this particular Pandora’s Box seems low at this point, the full long-term impact of such a change is difficult to assess. The current discussion of tax exempt income in Washington, while not new to the municipal market, is more tangible than usual and thus important to consider. The fundamental thesis of tax-efficient fixed income investing is to examine opportunities across taxable and tax-exempt sectors and construct the optimal allocation for a taxpaying investor based on their risk tolerance, return expectations and specific tax considerations.

**From a taxpaying investor’s perspective, if the proposal were to pass, the municipal market would continue to provide a high quality and uniquely tax-advantaged allocation for income generation and capital preservation, but with new pricing levels relative to taxable bonds due to the new tax rate and potential future uncertainty.**

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