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Muni Bond Tax Breaks On Table in Cliff Talks

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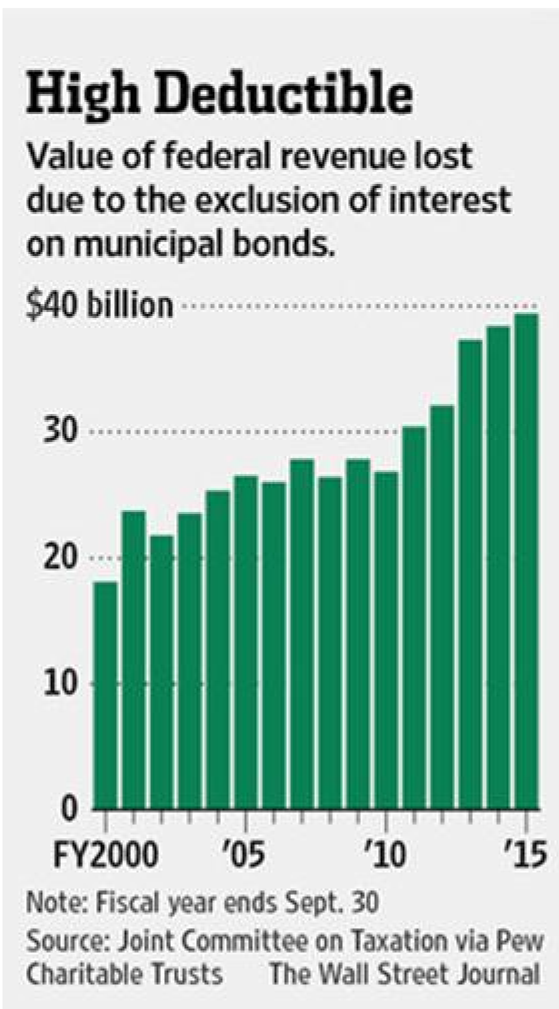
A rare area of potential agreement between the White House and Republicans in the fiscal-cliff debate could come as a surprise to many investors: both sides are willing to consider taxing at least a portion of municipal-bond interest paid to higher-income households.

President Barack Obama has advanced the idea twice, first in a jobs bill in 2011, and again in the budget he released in February. White House officials argue that too much of the roughly $30 billion a year in forgone federal tax payments from the interest exemption goes to higher-income households.



House Speaker John Boehner is willing to consider curbing the tax-exempt status of municipal-bond interest, subject to negotiations with the White House, according to a spokesman. Mr. Boehner is considering a range of options for curbing tax breaks as a way to raise tax revenues without raising tax rates.

By exempting municipal bond interest from federal taxes, the government creates an incentive for investors to buy them, which helps hold down the borrowing costs of the states, cities and other entities that issue them. Curbing the exemption would likely reduce demand for the bonds, pushing those borrowing costs higher.

State and local governments, dealers in the $3.7 trillion municipal-bond market, and other interest groups have mounted a lobbying effort to keep the tax out of any agreement forged by the White House and Congress to avoid the fiscal cliff.

Investors are willing to accept lower yields for municipal bonds because their income from the bonds is exempt from federal income taxes and from taxes in the state in which the bonds were issued. In some high-tax areas, such as California, the bonds are also exempt from local income taxes.

Even if the two sides reach a deal on the fiscal cliff—a combination of automatic tax increases and spending cuts is scheduled to hit in early January—it might not include taxing municipal bond interest. But the idea could resurface next year if Congress moves to overhaul the tax code, as many expect. It is unclear whether the approach would apply only to newly issued bonds.

Philadelphia Mayor Michael Nutter, a Democrat, said potential changes to the tax exemption are one of the top concerns for the U.S. Conference of Mayors, which he currently heads. States and localities argue that limiting the break would curtail a vital funding source for schools, libraries, bridges and roads. "The bottom line is all it really does is drive up interest costs, which cities like Philadelphia and many others can't afford," he said.

Mr. Obama's proposal would limit the value of all tax deductions and tax breaks—including the tax-exempt status of municipal bond interest—for singles making more than $200,000 a year and couples making more than $250,000.

Currently, households paying the top tax rate of 35% could reduce their tax bill by as much as $35,000 if they claimed $100,000 in itemized deductions. Mr. Obama's proposal would limit the savings to 28%, or $28,000—meaning a $7,000 tax increase.

That means a household with $100,000 in previously tax-free municipal-bond interest income would have to pay $7,000 in tax on it, all things being equal, if Mr. Obama's approach was adopted.

John Murphy, who's coordinating a newly formed coalition, Municipal Bonds for America, which includes a number of banks as well as issuers, said the group views recent discussions of curbing tax breaks to mean "we're very much at risk."

"Certainly we're working the issue right now because there's potential" for inclusion in an end-of-year deal, said Lars Etzkorn, program director at the National League of Cities. "The greater potential would be if there is tax reform taken up in the new Congress."

Long-term municipal bond funds have seen inflows of about $53 billion since the beginning of the year, according to the Investment Company Institute, the second-fastest on record in overall dollars. That indicates that at least some investors are moving into municipal bonds—even as yields are near record-low levels—as a hedge against the threat of higher taxes, said Matt Fabian, managing director at the independent research firm Municipal Market Advisors.

The average, top-rated municipal bond maturing in 10 years yields about 1.5%, compared with about 1.62% for a comparable Treasury note and about 3% for investment-grade corporate bonds, according to Barclays Inc.

A curb on the tax break would be even more significant if it affected existing bond issues as well as new ones. Municipal bond market experts believe the Obama administration proposal would have such an effect, although details would be subject to negotiations with Congress. A recent report by Citi Research estimates that a retroactive change would reduce the value of outstanding municipal bonds by about $200 billion.

Municipal-bond analysts say households earning less than $250,000 a year earn more than half of the municipal bond interest received by individual investors. But because higher earners pay higher tax rates, they receive more of the benefit. The Tax Policy Center recently estimated that about 85% of the tax savings for individuals accrues to households making mor than $200,000.

Obama administration budget documents argue that limiting breaks such as the municipal-bond interest break would "reduce the benefit that high-income taxpayers receive…and help close the gap between the value of these [breaks] for high-income Americans and the value for middle-class Americans."