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Congress Eyeing Munis?

Municipal bonds typically can be purchased individually or in mutual funds and other portfolios. Here are the essential tax elements of muni investments.

The interest paid on most muni bonds isn't taxable at the federal level — a benefit that also applies to fund shareholders.

Bond interest frequently also is exempt from state income tax for local residents. This includes thousands of Arizona bonds that are double-exempt.

Any capital gains earned when investors sell a bond for more than they paid are taxable. Tax-deductible losses also are possible. Capital gains or losses typically result from changes in the general level of interest rates, which affect bond prices.

Because they pay tax-free interest, muni bonds and bond funds aren't suitable for Individual Retirement Accounts, 401(k) programs and other tax-sheltered plans.

Municipal bonds pay tax-free interest — that's one of those constants on which conservative investors could always count, regardless of how tumultuous the financial markets became.

Even the latest fiscal-cliff tax deal left muni bonds and bond mutual funds pretty much alone. If anything, the legislation enhanced their appeal by excluding muni-bond interest from the new Medicare investment surtax that now applies to high-income individuals.

But muni-bond proponents — including officials representing various Arizona cities, counties and state agencies that issue debt — are starting to wonder whether Congress is getting ready to take them to the woodshed next. With huge federal deficits continuing, there's a strong sense that some sort of comprehensive tax-reform deal could get hammered out. If so, muni investments could be stripped of at least some of their favorable tax status.

"That risk is about as high as I've seen it in the 20 or so years I've paid attention to these issues," said Michael Decker, a managing director at the Securities Industry and Financial Markets Association, a trade association in Washington, D.C. "It's a political environment where everything is on the table ... there are no sacred cows."

Decker spoke last week in Phoenix at a muni-bond conference hosted by law-firm Ballard Spahr, Fitch Ratings, RBC Capital Markets and the Bond Buyer, an industry publication. The event attracted about 100 municipal officials, attorneys, investment bankers and others. The specter of tax reform was a hot topic.

Both political parties see something desirable in attacking muni bonds, observers say. Many Republicans are skeptical of offering tax-free subsidies to municipal entities, especially as an inducement to borrow more, while Democrats note wealthier Americans are most likely to buy bonds and thus reap the tax benefits. About 4 percent of households report (but generally don't pay tax on) municipal interest, according to Internal Revenue Service statistics.

Because muni bonds pay slightly lower yields than comparable taxable bonds issued by corporations and other entities, they make more sense for people higher up the income ladder.

A tax attack on munis isn't a certainty, nor are the details known at this stage. The Simpson-Bowles deficit-reduction commission called for no more tax-free bonds to be issued going forward. Other proposals range from capping the tax benefits for people in high-income brackets to disallowing tax-free financing done to help private enterprises.

A recent White House proposal would tax muni interest for people above the 28 percent bracket, meaning someone paying taxes at the top 39.6 percent rate would pay 11.6 percent on muni interest.

Chris Mauro, head of municipal research for RBC Capital Markets and another speaker at the Phoenix conference, said he doesn't expect any legislation in the current year that would impair the favorable status of municipal bonds. But he said that threat now hovers over the market and represents one more risk that investors must factor in.

Tax reform, if it passes, wouldn't apply to tax-free bonds only. Other changes could affect deductions for charitable contributions, mortgage interest, state income taxes and many more provisions.

Infrastructure impact

If Congress did strip away at least some of the tax-free status of munis, some investors would dump their bonds, pushing down prices and pushing up yields. The higher yields then needed to lure investors amid diminished tax appeal would raise borrowing costs for cities, counties and state agencies, with implications for taxpayers in those jurisdictions.

Given budget pressures, many municipal entities already have put capital-infrastructure projects on hold as they have grappled to bring operating costs in line with reduced revenues. Projects that have been tabled include roads, bridges, water-treatment plants, sewer systems, schools and a host of other infrastructure deals that typically have been financed by bond sales.

"Investment in infrastructure has been put on the back burner," said Gary Yaquinto, executive vice president of the Arizona Investment Council. "Arizona is a new state but has aging infrastructure, much of it nearing capacity."

Prior to the recession, many Arizona cities were busy building infrastructure to stay ahead of projected population growth, but more recently the focus has been on rehabilitating and maintaining what already was built, said Jeff DeWitt, chief financial officer for Phoenix.

Eventually, though, officials at many Arizona municipalities still expect to dust off blueprints for bridges, roads, water-treatment plants and other projects and finance them at least partly with money raised in the bond market.

Kristine Ward, assistant director of finance and accounting for the Arizona Department of Transportation, said her agency faces an estimated \$63 billion funding gap through 2035. The financing pressures have been exacerbated by federal-revenue shortfalls and by declining state-tax revenue whenever gasoline prices shoot up and motorists cut back on driving. Pump prices above \$3.50 a gallon seem to be the catalyst for that, she said.

Scope of the market

Phoenix ranked as Arizona's largest municipal-bond issuer with \$7.1 billion of outstanding debt as of

a mid-2012 study by the Arizona Department of Revenue, with the Arizona Department of Transportation fifth at \$2.2 billion. The other top-five debt leaders were Salt River Project, the Arizona Health Facilities Authority and the Maricopa County School District.

Cities, counties, state agencies and other issuers look at muni-debt issuance differently today from the way they did in years past, when population and economic growth were more robust. The debt total for all Arizona municipalities roughly doubled from \$20.7 billion in fiscal 2002 to \$41.2 billion in 2009 but has increased only marginally since then. It actually declined a bit last year to \$43.3 billion from \$44 billion one year earlier, according to a mid-2012 report from the Arizona Department of Revenue.

And while Arizona entities did sell \$5.5 billion of new bonds in the latest fiscal year, more than half went to refinance existing debt at lower interest rates, much like homeowners have obtained new mortgages to cut their monthly housing payments.

Nearly all sizable muni-bond issuers in Arizona have maintained top ratings of either double-A or triple-A, despite the challenging economic environment. In general, investors “have a fair degree of confidence in Arizona,” said Jaime Durando, a managing director at RBC Capital Markets.

Favorable factors

While municipal officials wouldn't welcome tax reform, in some respects it could come at a reasonably good time, all things considered.

Much of the Arizona infrastructure built in anticipation of population growth is still fairly new and in good shape, said Steve Murray, a senior director covering Southwestern states for rating-agency Fitch.

Also, the general level of interest rates is so low that borrowing costs are still historically very cheap. Tax reform would cause prices to drop and yields to rise but it's uncertain how sharp the reaction might be, and it would be starting from a very low interest-rate level.

Even amid a lengthy and powerful stock-market rally, munis and other types of bonds are holding their own. Bond mutual funds in general have added about \$1 trillion in net new cash flow from investors over roughly the past five years — at the same time that stock funds have lost about \$500 billion in net cash, according to Investment Company Institute data.

Investors continue to favor conservative assets including muni bonds, and an aging population suggests that trend will continue.

Claims under scrutiny

Hundreds of Arizona cities, counties and state agencies issue municipal bonds, and officials must be careful not to make public statements that are misleading or conflict with what they provide to investors in disclosure documents.

In separate cases, the Securities and Exchange Commission recently asserted fraud against officials representing Harrisburg, Pa., and the state of Illinois for making statements about their financial situations that were incomplete, outdated or otherwise didn't mesh with what they told muni-bond investors. Both Illinois and Harrisburg are having financial difficulties.

In the Harrisburg situation, the SEC for the first time asserted fraud for comments made outside of disclosure documents, said Anastasia Khokhryakova, a partner at law-firm Ballard Spahr, speaking

in Phoenix.

Although not citing any Arizona examples, Khokhryakova said any municipalities could face liability over comments made by officials that conflict with what's provided in their bond-disclosure documents. As smart practices, she suggests municipalities adopt formal policies to communicate with the public, designate an official spokesperson and provide ongoing training.

— Russ Wiles

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