The Financial and Estate Planning Council of Metropolitan Detroit, Inc.

August 2013

30600 Northwestern Hwy., Suite 208, Farmington Hills, MI 48334 • (248) 538-7654 • FAX: (248) 538-7656

President's Message

August is here, and the time we have shared together as Members of our Council has been beneficial and rewarding. Our Annual Members Meeting and the 7th Annual Charity Golf Outing were a resounding success. New friends were made and old friendship rekindled, and everyone had a grand time for a great charity: The Leader Dogs for the Blind.

I truly appreciate every Member's effort and each Volunteer's commitment to make this year's Charity Golf Outing the very best. I specifically want to thank Brad Kreiner, CFP®, AEP®, who served as this year's Golf Chairman, Teresa Schafer Sullivan, J.D., for her support and work ethic, and Kris Wolfe, CAE, the Council's Administrator, who without her tireless commitment and dedication, the Charity Golf Outing would be not possible.

Finally, I sincerely thank all the Members and their guests who participated in the Charity Golf Outing, and whose contributions and dedicated loyalty to the Council and its charitable efforts have always made a difference in our community.

With that being said, the Council has two terrific upcoming events for the Fall. The first event will be held at *The Henry Ford* on Tuesday, September 10, 2013, where Linda A. Wasserman, J.D., will make a presentation on private foundations. The second event will be held at the *Federal Reserve Bank of Chicago-Detroit Branch* on Tuesday, November 12, 2013, and will be split into an afternoon and evening program.

The afternoon program will have Mark Landau, J.D. and Alan J Roeder, J.D. presenting a three hour ethics course that will qualify for the State of Michigan Life CE credit, as well as for continuing education credits for attorneys and CPAs. The evening program will have a financial presentation by John Augustine from Fifth-Third Bank.

Please mark these two great events, at two great venues, in your calendar. They are sure to be educational and topical for all of our practice disciplines, and will be a great opportunity to continue our professional camaraderie in helping and supporting one another and our community.

To that end, I encourage your participation and support of these upcoming Council events as I sincerely believe they will be beneficial to your education and knowledge, as well as making our Membership stronger.

Best Regards,

Eric Carver, J.D., LL.M, President

WELCOME TO OUR NEW MEMBERS

Christopher L. Belcher, CFP®, CTFA
Rehmann
Sponsors: Tamra Teno and Tom Bergh

Sean H. Cook, CPA, JD
Warner Norcross & Judd, LLP
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Andrew J. McCulloch, JD
Law Office of Andrew J. McCulloch
Sponsors: Edgar Pugh, Jr. and Stephen Moore

Thomas E. Peck, CPA, CFP®
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Sponsors: Chris Belcher and Robert Perry

Richard J. Siriani, JD
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The Fallacy of Municipal Bonds

Thomas J. Raymond, Jr., CFA

Municipal bonds represent the nexus of taxes, public policy, and investments. On one hand, they serve as a contractual financing mechanism for cities, school districts, and universities, providing capital for their respective operating needs. They also function as an investment vehicle that can limit an individual's tax burden, as section 103 of the Internal Revenue Code (IRC) generally exempts the interest component from federal taxation. Yet, these generalities may do a disservice to investors and issuers alike. Municipal bonds are complex creatures. The ambiguous nature of municipal bonds largely stems from a web of taxation and legislation that should command greater attention.

A false pretense exists with municipal bonds which the legislative history refutes. Municipals have deceptively earned the label of "tax-free bonds" even though *South Carolina v. Baker* removed any constitutional impediments to taxing municipal income. This 1988 Supreme Court case overturned the 1895 ruling in Pollock v. Farmers Loan & Trust Co., which exempted municipal interest. While the federal government has largely steered clear of taxing municipal interest, no legislative barriers prevent change. Further, there may be a greater willingness to tax municipal interest as the federal government finances are in a dire state with close to $16 trillion in debt outstanding. As the fifth largest itemized deduction/credit, the exemption poses a ripe opportunity for the federal government to examine to raise revenues1.

Speculation may occur regarding taxing municipal bonds, but they did enter 2013 with added appeal as their coupon escaped the clutches of the newly enacted 3.8 percent Medicare tax on unearned income above certain adjustable gross income (AGI) thresholds. Counter-intuitively, high income earners do not have a monopoly on municipal bond ownership, even though they would derive the largest tax advantage. Only 58 percent of municipal bond holders have an income greater than $200,000[2]. Therefore, to maintain progressivity, taxation on municipal interest would have to be targeted. Yet, a focused tax on municipals would likely bring unintended consequences rattling the entire market, beyond inflicting a higher tax burden on the affluent. The value of outstanding municipals could fall upwards of $200 billion as interest rates rise to adjust for their reduced after-tax appeal[3]. This diminution in value could prove temporary, but would exact some degree of pain on all municipal holders irrespective of income levels.

Despite being heralded as a tax-advantaged investment, municipals are a more significant public policy mechanism. Typically, municipals carry a lower coupon than corporate or sovereign bonds of comparable maturity and credit quality. As such, they serve as a cheaper financing tool for issuers. The Congressional Budget Office estimates that 80 percent of benefit of income tax exclusion and corresponding reduced financing cost flows through to the issuer[4]. The importance should not be understated as state and local governments employ 19.6 million people[5]. The public policy benefit appears to be of greater significance than the incremental tax advantage that accrues to the bond holders.

Municipalities will continue to have a borrowing need even if taxation on interest is enacted. If that occurred, financial plans would be recalibrated in recognition of increased borrowing costs. Higher interest rates could create unforeseen outcomes, such as reduced public sector employment, as more outlays are devoted to debt service. Importantly, nearly three-quarters of all infrastructure investments made in the United States, which typically create jobs, are financed by municipal bonds[6]. Our elected officials should examine all potential outcomes before proceeding with increased taxation of municipal bonds.

A. State Taxation

The municipal bond universe is decidedly eclectic with approximately 50,000 issuers7. Accordingly, the taxation at state and local levels is quite varied. Generally speaking, municipal interest is exempt from state and local level taxation, but only if the bond holder has primary residence in the respective area of the issuer. For example, a Pennsylvania resident may not be assessed state, local, or federal taxes on a Pennsylvania municipal. However, he would be assessed state and local taxes on a municipal bond from New York. The constitutionality of this tax scheme has been challenged. In 2008, the Supreme Court in *Department of Revenue of Kentucky v. Davis* upheld that the taxation of out-of-state bonds, but not in-state bonds, does not violate the Interstate Commerce Clause. Consequently, many residents of high tax states, such as California or New York, will continue to have a higher embedded hurdle rate to invest in out-of-state issues.

Oversimplification would not be advisable when considering local and state taxation of the municipal land-

THE FINANCIAL AND ESTATE PLANNING COUNCIL OF METROPOLITAN DETROIT
and LEAVE A LEGACY, Southeast Michigan

Present

"Ten Things You Need to Know About Private Foundations (and other exotic charitable beasts)!"

presented by:

Linda A. Wasserman, JD

Honigman Miller Schwartz and Cohn, LLP

TUESDAY, SEPTEMBER 10, 2013

THE HENRY FORD
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Linda A Wasserman is a graduate of the University of Michigan Law School and a partner and the Trusts & Estates Practice Group Leader at Honigman Miller Schwartz & Cohn in Bloomfield Hills, MI.

She specializes in personalized and sophisticated estate planning, including strategic philanthropic planning and representation of donors, in addition to the formation and representation of private foundations and public charities.

AGENDA:		
	6:00 p.m.	Complimentary Cocktails Promenade/Clocktower Area
	7:00 p.m.	Presentation
	8:00 p.m.	Dinner

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scape. In fact, there are several states that do not tax their residents on ownership of out-of-state bonds. At the same time, there are some states that do tax their residents on their respective issuance. Yet, many of these latter states do exempt certain municipal issuance. Utah is an interesting case as it exhibits a protectionist approach. It only taxes income earned on a municipal bond issued by another state if such other state imposes a tax on Utah issuance. Without a close examination of the state specific particularities of the municipal landscape an investor could be subject to sub-optimal results.

B. Relationship between Yields and Taxation

The relationship between yield and tax rates is inexact. For instance, with the current highest marginal federal tax bracket at 39.6 percent, one would intuitively think that the yield of a municipal bond would be 60.4 percent of a taxable issue, such as a US Treasury bond, of comparable maturity. This relationship tends not to exist. There will surely be some bond issues in the over $3 trillion municipal universe that at a given point exhibit this yield harmony, but that situation is very much an exception.

Prior to 2008, municipals had a mean yield of 76 percent and 88 percent to comparable Treasuries for five and thirty year maturities, respectively[8]. There appeared a natural arbitrage opportunity, particularly for longer maturity issues that traded closer to Treasuries as a result of an embedded risk premium due to future tax policy uncertainty. This relationship broke down in 2008 as the financial crisis engulfed the economy and fear was ubiquitous. To help resuscitate the economy, the Federal Reserve embarked on an unconventional quantitative easing program that purchased Treasuries to drive down yields and corresponding borrowing costs. Concurrently, investors fled to Treasuries due to their perceived safety. The Municipal/Treasury ratio has resided above 100 percent in large part since and even temporarily exceeded 200 percent for certain maturities during the heights of the financial crisis. This yield disharmony illustrates that multiple factors impact municipal pricing, not just taxes alone.

C. Build America Bonds and Private Activity Bonds

Precedent already exists for taxable municipal bonds. In an effort to stimulate the domestic economy, the 2009 The American Reinvestment and Recovery Act created section 1531, launching the Build America Bond (BAB) program. The intent of the BAB's program was to lower the cost of borrowing for state and local governments paving the way for large scale, job creating projects, including infrastructure initiatives. The federal government directly subsidized 35 percent of the borrowing cost, which effectively made a component of the coupon a Treasury bond. Therefore, part of the yield for BAB's was taxable at the federal level and the coupon increased commensurately. This enticed a new ownership constituency, such as foreign buyers, which had largely avoided municipal bonds as they derived no tax benefit.

The BAB's program expired at the end of 2010, but it impacted the municipal market in several ways. The reduced borrowing costs helped save billions at a time when municipal balance sheets were in a precarious state as a result of the recession. For instance, the state of California, which issued about $14 billion of BAB's, reportedly saved in excess of $1 billion in borrowing costs[9]. Also, because the BAB program was temporary, municipalities expedited bond issuance knowing that their future financing costs could escalate. Consequently, BAB's issuance in 2010 was almost twice that of 2009. This had the effect of cannibalizing future supply as overall issuance in 2011 fell by close to $145 billion. Wary of the impact of excess supply on bond prices, investors retreated and the municipal market experienced negative monthly fund flows from November 2010 to May 2011. The combination of diminishing investor demand and escalating supply led to a -1.8 percent return for the Barclays Municipal Index (1-10 Year Maturity) in the last two months of 2010. Municipal pricing cannot escape the fundamental force that if demand cannot absorb new supply, pricing will be affected adversely.

State Taxation of Municipal Bonds for Individuals

State	Tax Assessed on State's Own Bonds	Tax Assessed on Other State's Bonds
Alaska	No	No
District of Columbia	No	No
Florida	No	No
Illinois	Yes	Yes
Indiana	No	No
Iowa	Yes	Yes
Nevada	No	No
Oklahoma	Yes	Yes
South Dakota	No	No
Texas	No	No
Utah	Yes	Yes
Washington	No	No
Wisconsin	Yes	Yes
Wyoming	No	No

Source - FMS Bonds, 2009

Private activity bonds are akin to BAB's in that they are a breed of taxable municipal bonds. To maintain a limited tax-exempt status, the bond proceeds must be used for a qualified purpose as defined in sections 142 through 145, and 1394[10]. They are often used as a financing tool for larger projects undertaken by a private group, such as high-speed rail facilities and airports. Yet, the boundaries for application of the bond proceeds are quite broad as issuance for student loans, mortgages, and farm property may achieve qualified status.

The benefit of these bonds has the ability to directly accrue to a private constituency, more so than the general public[11]. Generally, private activity bonds meet the following thresholds:

a) More than 10% of proceeds for private business use and

b) More than 10% of principal or interest payment is secured by property interest for private business use or derived from payments for property for private business use.

Also, a bond may be classified as private activity bond if 5 percent or $5 million (whichever is less) of proceeds is used to originate or finance loans to a non-government entity. Thus, these bonds may resemble a corporate issue. To rein in potential abuses, section 146 stipulates a volume cap for certain types of private activity bonds, such as high speed rail facilities. Another defining feature is that, irrespective of the end use of the proceeds, private activity bonds are subject to the federal Alternative Minimum Tax. Consequently, the interest rate for private activity bonds typically carry a higher rate due to their less attractive tax attributes.

D. De Minimis Rule

Bond prices do fluctuate and realized gains from municipal bond ownership do not escape taxation as it falls under the reach of section 1222 [Other terms relating to capital gains and losses]. Also, municipal bonds are subject to the de minimis rule, which does not get much discussion given the general elevated state of bond prices (low yields). Ordinary income rates are assessed to the bond appreciation if purchased at a discount to face value in excess of 0.25 percent per year between the time of acquisition and maturity. Alternatively, if the appreciation is less than the formulaic threshold, capital gains rates will apply. Bond buyers will want to carefully consider bonds trading close to the de minimis threshold level to maximize their after-tax results.

E. Concluding Remarks

A fallacy exists and continues to perpetuate that municipals are "tax-free." This fiction exists in large measure due to the maze of information, which lends itself to oversimplification. However, complexity creates opportunities for the well-versed and disciplined. For instance, taxes should not be the primary driver of municipal pricing, but short term pricing dislocations may surface. Price dislocations tend to be short lived, particularly ones created by emotions and hearsay. Emotion laden transactions seem to be common for the municipal market as misinformation is in surplus and this opens the window for patient investors to capitalize. Further, a better understanding of the municipal market can limit potential mistakes that might elevate an individual's tax burden or help issuers more effectively manage their liabilities. A premium should be placed on municipal market information.

Thomas J. Raymond, Jr., CFA, is a vice president for Abbot Downing, the multi-family office for Wells Fargo. Tom has over ten years of experience in the investment field and is a voting member for the Abbot Downing Asset Allocation Committee.

1 IRS Statistics and JP Morgan

2 Obama's Job Bill Would Hit Munis, Barron's, September 13th, 2011 & IRS Tax Statistics

3 Tax Breaks on Muni Bonds Draw Scrutiny, Wall Street Journal, December 11th, 2012

4 Municipal-Bond Interest Exclusion, Wall Street Journal, December 23rd, 2012

5 Census Bureau - Annual Survey of Public Employment and Payroll Summary Report: 2010

6 House of Representatives Resolution 112, March 13th, 2013

7 Top 10 Differences Between Municipal Bonds and Corporate Bonds, Fitch, February 1, 2010

8 Source – Ned Davis Research

9 Another Blow to State Budgets: Build America Bonds End, CNN Money, December 22, 2010

10 IRS Publication 4078 (Rev. 9-2005) - Tax-Exempt Private Activity Bonds IRS Compliance Guide

11 IRS Publication 550 (Cat. No. 15093R)

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