Fixed Income Insight
June 30, 2003

Impact of Final Tax Plan on Municipal Bonds

On May 28, 2003, the President signed into law the *Jobs and Growth Tax Relief Reconciliation Act of 2003*. The tax plan, originally proposed by the President to cut taxes by as much as $726 billion, included provisions to eliminate stock dividend taxes on individuals. The final bill, which was a compromise between the House and Senate, promised tax reductions estimated to amount to about half the original amount, approximately $350 billion. The dividend tax cut, effective January 1, 2003, reduced the tax rate to a maximum of 15% on higher income individuals and as low as 5% on the two lowest taxpayer brackets through 2008. A capital gains tax reduction was also approved (effective May 6, 2003) that mimics the tax rates on dividends for high and low tax bracket investors (15% and 5%, respectively).

In our January 14, 2003 research comment (Municipal Bonds & the Bush Plan to Exempt Dividends and Lower Tax Rates), we reasoned that the 100% tax cut on dividends would have a modest impact on municipal bonds for several reasons:

- Most dividend yields were relatively low compared to all but the shortest of maturity municipals.
- Stock prices might have increased, decreasing dividend yields even more.
- Investors were likely to continue to recognize the relative lower capital preservation risk associated with most high grade municipal bonds versus stocks in investor asset allocation decisions.
- Municipal yield levels were trading (and still are) at relatively higher yield levels relative to Treasury bonds cushioning some of the impact of potential tax cut changes.

The above factors continue to apply today. Given the lower tax reduction on dividends than was originally anticipated as well as the sunset date applicable to the new law, the impact of the changes in the final tax plan are likely to have an even milder impression on municipal bond investment decisions relative to tax matters.

The accelerated reductions in the federal tax brackets are not likely to have a substantial impact on investor demand for munis as well. In comparison to Treasury bonds, municipal yield levels appear to have built in some protection from the reduction in tax rates per their high relative ratios to their respective Treasury bond maturities. To get comparable after tax yields to insured municipals you have to buy lower rated corporates. For borrowing costs, we believe that the cut in the dividend tax rate – rather than the elimination of the tax – appears less likely to mean any marked increase in interest costs for municipal issuers.

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We were concerned in our January research report that the dividend cut and the accelerated reductions in tax rates built into this tax act might have a somewhat negative impact on the income tax on state and local revenues. This would have been particularly true for nearly all states since most derive a major portion of their revenues from the adjusted income calculations tied to the federal income tax. However, this factor was largely offset by the final tax package in the 2003 tax act, which provided for federal payments under a temporary fiscal relief provision that makes payments to the states based on a pro rata population formula.

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