By Anthony P. Curatola, Editor

Proposed Tax Credit for Municipal Bond Interest

A bipartisan bill introduced in Congress contains an interesting provision related to the nonrefundable personal credit for interest on state and local bonds.

The introduction of tax bills in the House and Senate is a common event in Congress. The likelihood that the bill will make it to the President's desk—with or without changes to the initial bill—isn't so common. Hence, this column generally doesn't discuss an introduced bill or the possible changes to tax provisions. Recently, however, Senators Ron Wyden (D.-Ore.) and Judd Gregg (R.-N.H.) introduced the Bipartisan Tax Fairness and Simplification Act of 2010 (S.3018) into the 111th Congress. The bill was read twice on February 23, 2010, and then referred to the Committee on Finance, where it currently sits. Although this bill may or may not survive Congress, there's a particular tax provision that merits presentation.

The bill includes the permanent extension and expansion of the earned income credit and dependent care credit, the permanent extension of the child credit, and the elimination of the individual miscellaneous itemized deductions, to name a few. Likewise, the bill has a few changes proposed for the corporate and business area, including items such as reducing the corporate tax rate to 24%, providing unlimited expensing of depreciable assets and inventories for small business, revaluation of LIFO inventories of large integrated oil companies, and repeal of the lower of cost or market rule for inventory valuation.

But the interesting tax provision introduced in this bill appears in Section 110 and pertains to the nonrefundable personal credit for interest on state and local bonds. Let's take a look at the proposed change.

Proposed Legislation

At the moment, interest earned on state and local bonds is exempt from federal income tax and state income tax for those taxpayers living in the state where the bond is issued. Section 110 of S.3018, *if signed into law*, would create new IRC §25E. Effective for obligations issued after December 31, 2010, new IRC §25E would make three changes to the taxation of interest earned on state and local bonds that fall under IRC §103. First, the taxpayer would claim a tax credit in the amount of 25% of the interest earned. Second, the taxpayer would include the interest earned on the bonds in gross income. Third, and most interesting, the tax credit amount claimed by the taxpayer on the interest would be included in gross income, which is similar to the rules of IRC §§54(f) through (i)—credit treated as interest, S corporation and partnership, bonds held by real estate investment trusts, and credits may be stripped, respectively.

Although this proposed change doesn't appear to be tax simplification, the authors of the bill may see it as promoting fairness across taxpayers. So let's take a look at the issues of this proposal, and you can draw your own conclusion. Remember, this is only a proposed legislative change.

Taxpayer Impact

To best illustrate the impact of this provision, let's consider four taxpayers (TP1-TP4) with marginal tax rates of 15%, 25%, 35%, and 39.6% (see Table 1). The first three tax brackets coincide with existing tax law and with the tax rates in S.3018, and the 39.6% tax rate is scheduled to return in 2011. If we assume that the current rate of return for a state or local bond is 6% (pre-2011 issue), Treasury receives an inflow of new tax dol-

Table 1. Impact of Provision on Taxpayers

	TP1	TP2	TP3	TP4	TP5	TP6
Tax rate	15%	25%	35%	39.6%	35%	35%
Interest amount	$60	$60	$60	$60	$73.80	$60
Tax credit	$15	$15	$15	$15	$18.45	$0
Increase in federal income tax	$11.25	$18.75	$26.25	$29.70	$32.29	$0
Net tax payment increase	-$3.75	$3.75	$11.25	$14.70	$13.84	$0
Net return	$1,064	$1,056	$1,049	$1,045	$1,060	$1,060
After-tax return	6.38%	5.63%	4.88%	4.53%	6%	6%

Note: State or local bond par value is $1,000, and current rate of interest is 6%.

lars from all taxpayers except those with a tax rate below 25% (-$3.75) as seen in columns 1, 2, and 3 of Table 1. Likewise, the after-tax return for these bonds falls below the 6% yield resulting for the existing bonds. Moreover, the return declines as the taxpayer's tax rate increases. A market correction obviously will need to occur; otherwise, two equivalent bonds (except for tax treatment) issued by the same municipality yield different returns.

Bond Reaction

In general, one might assume that either or both of two market reactions may result: (1) The existing bonds may bring a premium to the current bondholders and thereby decrease the yield on those bonds in an effort to bring both the newly issued and existing bonds into an equal return position, or (2) the market may demand that the newly issued bonds increase their rates to a position that provides equality between both bonds. If we assume that the market demands a higher rate and is reacting to the highest tax rate bracket, the newly issued bonds would need an interest rate of approximately 7.38% to compete with the existing state and local bonds and have an after-tax return of 6% under the proposed legislation. This result is given in Table 1 under the columns for TP 5 (newly issued bonds with a rate adjustment) and TP 6 (existing state and local bond rules).

State Reaction

In the case where the market correction is simply an adjustment to the market value of the bonds issued before January 2011, state or local legislators see no impact with respect to the rate of return demanded by the market on the newly issued bonds. As a result, no additional sources of income are needed by the municipality to pay the premium being charged on the newly issued bonds. But in the case where the market correction is an adjustment in the interest rate for newly issued bonds, the state or local legislators will face additional costs to cover the higher rate of interest for issuing the new bonds. State and local legislators may not appreciate this added cost to their already strained treasuries.

Nonissuing states that have a state income tax may actually benefit from an increase in tax income as a result of this legislation. Owners of these bonds who have a primary residence outside the state issuing the bond may be required to include the tax credit as well as the interest on these bonds in their state gross income. Some states simply start with the federal adjusted gross income (also known as piggybacking off the federal income tax return), while other states apply a tax rate to the federal income tax amount. In either case, holders of state and local bonds from outside their home state could experience an increase in their state income tax liability.

The proposed legislation (and again, I reiterate the key word "proposed") by Wyden and Gregg for state and local bond interest doesn't really fit the caption of simplification, but it might be seen as equalizing the benefits of state and local bond interest across taxpayers. But how many taxpayers in the 15% and 25% tax brackets are likely to acquire state and local bonds? Better yet, there doesn't appear to be a lot of support on

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Capitol Hill for this legislative proposal at the moment, but we could see a swell of support for this legislation at a later time. **SF**

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