BusinessWeek
SEPTEMBER 3, 2007

Shaky Times For Munis

The fate of state-tax exemptions may rest with the Supreme Court.

Compared with the stock market, subprime mortgages, and debt-starved megadeals, the $2 trillion municipal bond market is hardly worrisome. But depending on how the U.S. Supreme Court rules on an obscure point of tax law in its next session, the normally sleepy market could be turned upside-down.

At issue is whether Kentucky can, like 41 other states, tax the income from muni bonds issued in other states but, for its own residents, exempt the interest paid by bonds issued within its borders. The Bluegrass State is appealing a decision by its own Court of Appeals that the exemption is discriminatory and violates the U.S. Constitution's commerce clause.

That state income tax exemption is a powerful incentive for muni bond buyers to keep their investments close to home. It also allows big issuers in high-tax states such as New York and California to get by with paying less interest on their borrowings.

If the high court upholds the ruling, the value of billions of dollars of tax-exempt bonds will be in question. In fact, the Securities Industry & Financial Markets Assn. has filed a friend of the court brief saying a loss by Kentucky may result in "instability and price uncertainty in the municipal bond markets."

Particularly hard-hit will be the more than 600 single-state mutual funds and closed-end funds, which hold about 13% of all munis. These funds are marketed to home-state investors as double or even triple tax-exempt, since the interest income from the bond escapes federal, state, and local income taxes. Those exemptions really add up. A New York City investor in the highest federal and state tax brackets earning 4% on an in-state bond or bond fund is earning the equivalent of 7% on a taxable bond. "Basically it's going to be a thumbs-up or thumbs-down on state-specific muni investing," said Ronald Fielding, who oversees the municipal funds group at OppenheimerFunds. If it's thumbs-down, single-state mutual funds will become obsolete.

What makes the situation uncertain is that the impact on bond prices will depend on each state's response to an adverse ruling. "States will have the unenviable choice of either making all bonds tax exempt or all taxable," Jay Abrams, chief municipal credit analyst at FMSbonds, a muni bond brokerage, says in an e-mail. "States will either have to relinquish the income they derive from out-of-state bonds or begin taxing state residents on the interest they earn from in-state-issued bonds."

TAX STRATEGIES

Muni experts advise investors to sit tight. "The tax consequences of selling bonds now may be greater than the loss of principal" from the states' losing their case, said Chris Ryon, who oversees Vanguard Group's muni bond portfolio. Oppenheimer's Fielding estimates upholding the lower court ruling would push down the value of New York State and California bonds by 2% to 4%.

Some tax pros also are advising investors with large muni holdings to file "protective refund claims." These claims, available in many states, would prove valuable if Kentucky loses and their own states respond by making all muni-bond interest--from both out-of-state and in-state sources--tax-exempt. The claims would allow taxpayers to ask for refunds of taxes already paid on out-of-state muni bonds, plus interest, if such bonds are made tax-free retroactively. The flip side, taxing all muni income, will be tough. In states such as California, that would take a constitutional amendment. States that make changes legislatively might hit new bond issues, but any attempt to tax existing bonds will be sure to draw legal challenges.

By Jonathan Berr