"28% Cap" Unlikely to Trigger Wave of Municipal Bond Tax Calls

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Market commenters have suggested that billions of dollars in municipal bonds may be subject to par redemptions if the much-discussed “28% cap” on the value of certain federal income tax deductions or exclusions is enacted and if the capped items include municipal bond interest. While such commenters flag an issue worthy of consideration, enactment of a 28% cap applicable to muni interest should not result in a wave of unanticipated tax calls.

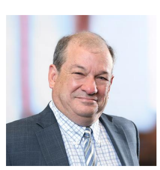
Tax call language comes in a variety of permutations. The language of most tax calls focuses on whether interest on the bonds is excluded from gross income.   Legislation implementing a 28% cap may or may not be written in a manner that directly includes a portion of the value of tax-exempt interest in gross income (versus, for example, using an alternative tax calculation methodology, as is used in calculating the AMT tax).

Even assuming that a 28% cap clearly includes a portion of municipal bond interest in gross income for higher tax bracket holders, it is far from clear that tax call language would apply. Many variations of tax calls distinguish between taxability caused by the issuer/borrower versus by change in law. Those that don’t make such a distinction typically are written (as is the case with the particular tax call language referenced in a recently disseminated article sounding the alarm on tax call risk) to require a redemption of all of the bonds upon an IRS or judicial (or in some cases bond counsel) determination that interest on “the bonds” is not excluded from gross income. Such redemption language suggests a triggering event that affects all the interest on all the bonds - otherwise it is overkill. It seems unlikely that a court would interpret such language as permitting or requiring an issuer to redeem all its bonds because a portion of interest on some of the bonds (those held by higher bracket bondholders) is or may be taxable.

It is possible that there are some specially negotiated tax call provisions among the billions of dollars of municipal bonds that are triggered by absence of full tax exemption on any of the bonds, but those would be outliers. (Such specially negotiated provisions would likely be bondholder-friendly and therefore would likely involve a redemption premium rather than a par redemption.)

In any event, concerned holders will want to look at the specific tax call language in their bonds and perhaps seek a bond or tax lawyer’s interpretation if the language seems unclear in the context of a potential 28% cap. But the odds are against tax calls being triggered on a widespread basis.

Authors



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Leonard Weiser-Varon is a Mintz Member who handles municipal and corporate debt transactions. Len represents state sponsors and private program managers of Section 529 and 529A savings programs. He often speaks on securities and constitutional law matters.