APPLETON *PARTNERS,* INC.

THE AMERICAN JOBS ACT, **A $447 BILLION LIABILITY LOOKING FOR AN OFFSETTING ASSET …**

On September 12th, 2011, President Obama sent the *American Jobs Act of 2011* to Congress for consideration. In the Bill, he proposes specific tax deductions and spending programs that would purportedly create jobs and put Americans back to work. Some of the proposals include: reductions in payroll taxes (for employers and employees), an extension of unemployment insurance, and re-hiring teachers and first responders. There are various infrastructure project recommendations as well: $50 Billion on Roads, Rails, and Airports, $30 Billion on renovating public schools, $15 Billion on rehabbing vacant property, and $10 Billion to create an Infrastructure Bank. If you think it sounds eerily like the $787 Billion *American Recovery and Reinvestment Act of 2009*, you're right! In 2009 however, the checkbooks were out and we were focused only on getting through The Great Recession. There was little or no resistance to the Bill, and even less time spent on vetting the details. Late in 2011, despite renewed economic weakness, there will be significantly more time spent analyzing the flip side of this stimulus Bill – *How will we pay for it?*

TAX PROPOSALS – A CAP ON THE DEDUCTIBILITY OF MUNICIPAL INCOME, MORTGAGE INTEREST, AND CHARITABLE GIVING - THE RULES OF ENGAGEMENT ARE CHANGING …

FOCUS ON MUNICIPAL BONDS:

It appears that tax increases on "The Wealthy" (those with incomes of $250M filing jointly or $200M filing as individuals) would in part, be supporting this program. According to the proposal, beginning in tax year 2013, holders of all outstanding Municipal Bonds who meet the income criteria, will have the exemption on their Municipal bond income capped at 28%. In today's environment, an investor who is in the 35% tax bracket would be paying a 7% surtax on the income generated by his/her bonds. The Bush tax cuts are due to expire at the end of 2012, and if they are not extended, the top rate will jump back to 39.6% - increasing the incremental tax liability on bondholders to 11.6%. Beyond the math and the tax implications for investors**, the most stunning characteristic of this proposal is its *retroactive nature* and the atmosphere of uncertainty that it promotes in the markets.** Investors in Municipal bonds have loaned money to Municipal issuers at "below market" rates over many years largely because of the tax benefit. Randomly adjusting the value of this benefit ***after*** the contract between issuer and investor has been sealed creates a breach of confidence that will have broad repercussions for investors and issuers alike.

IF THIS PROPOSED LEGISLATION WERE TO PASS – HOW DOES IT IMPACT ISSUERS AND INVESTORS …

With the tax exemption of this income reduced, investors will demand a higher risk premium to own Municipal debt, putting an additional debt burden on the issuers. The ratios of Municipal yields as a percentage of other investment grade fixed income asset classes would rise as investors look to be compensated for the new tax liability. Over time, the benefit of the 28% exemption (*assuming it never gets lowered and the highest income bracket doesn't go higher*),

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would probably be enough to keep a sustained interest in the asset class, but initially investors would vote with their wallets and demand higher yields on a relative basis. If there were to be a grandfathering provision that allowed for outstanding debt to be excluded from the new rule, the result would be a bifurcated market, where new debt would trade at a premium to outstanding debt.

MARKET IMPACT AND YIELD ADJUSTMENTS :

A 4.00% Municipal Yield today has the following impact on the taxable equivalent yields for all investors:

TAX RATE	INCREMENTAL SURTAX	TAXABLE EQUIVALENT YIELD
28.0%	0.0%	5.55%
35.0%	0.0%	6.15%
39.6%	0.0%	6.62%

A 4.00% Municipal Yield under the new Jobs Act would have the following impact on the taxable equivalent yields for investors *who meet the income hurdles*:

TAX RATE	INCREMENTAL SURTAX	TAXABLE EQUIVALENT YIELD
28.0%	0.0%	5.55%
35.0%	7.0%	5.55% (-60Bpts)
39.6%	11.6%	5.55% (-107Bpts)

In order to sustain the taxable equivalent yields that are provided in today's environment, market yields (the cost of borrowing) would need to increase:

TAX RATE	TAXABLE EQUIVALENT YIELD	REQUIRED MUNICIPAL MARKET YIELD
28.0%	5.55%	4.00%
35.0%	6.15%	4.43%
39.6%	6.62%	4.77%

An additional nuance in the Bill calls for the creation of an Infrastructure Bank (seeded initially with $10.0 Billion) that will put the control of certain future state and local infrastructure projects in the hands of the federal government. This type of access to funding would create a bureaucratic and political roadblock in an area that state and local governments have successfully managed through for many years - responding to voter referendums and efficiently accessing the Municipal markets.

WHERE THIS GOES FROM HERE …

While parts of this Bill have the possibility of passage, it is **highly unlikely** that the incremental tax on Municipal investors – and ultimately Municipal issuers – has any chance of passage. In the last item in the Bill (page 155), President Obama has "increased the target and trigger for the Joint Select Committee on Deficit Reduction" by amending the *Budget Control Act of 2011:* replacing the request for an incremental $1,500,000,000,000 from the Committee with a request for an incremental $1,950,000,000,000. It is interesting that the difference represents the cost of his program ($447 Billion). The tax manipulations we see in this Bill have appeared in the very recent past during the debt ceiling debacle – and they were flatly rejected then as they should be now. By increasing the bogie for the Super Committee, the White House has de facto admitted that Congress may embrace only discrete parts of this package, and few of its tax increases. The chances that the Joint Select Committee will promote passage of this 28% tax ceiling are slim as well. We do, however, feel that this topic will not go away when there is a broader discussion around tax reform – most likely after the 2012 elections.

In summary, if this type of legislation were to pass, it would cause market uncertainty and would prompt some investors to reposition. Municipal issuers would have to pay a premium to access the markets, and the derivative effect would be that all taxpayers would be paying higher income tax, sales tax, and property tax to offset the cost of services supported at the state and local level … not the desired outcome.