The AMT – Dreaded Tax or Income Opportunity

Today's Municipal bond market offers a wide range of opportunities among different categories of bonds and a fertile environment from which to seek value. One sector where we have identified a number of compelling opportunities is private activity bonds. Subject to the Alternative Minimum Tax (AMT), private activity bonds are more commonly referred to as "AMT bonds." Currently, we find valuations for these securities appealing for many Municipal bond investors. Furthermore, recent changes in tax policy will reduce the footprint of the AMT, increasing the value within this sector. In this commentary we will explore the AMT, bonds subject to the AMT, and highlight the AMT opportunities we have identified.

What is the Alternative Minimum Tax?

The AMT is a separate tax computation under the Internal Revenue Code that, in effect, eliminates many deductions and exemptions, thereby creating a minimum tax liability. The most common adjustments for individuals under the AMT system are the elimination of the personal exemptions and standard deductions, the elimination of state, local and property tax deductions, and the inclusion of interest on private activity Municipal bonds. For 2014, the AMT rate for individual and joint filers is 26% for income up to $182,500 and 28% in excess of this amount. Additionally, there are AMT income exemption levels of $52,800 for single filers and $82,100 for joint filers. An individual must pay the higher of the AMT or the standard tax calculation. Corporations can also be subject to the AMT, and like individuals, must pay the higher of the two tax liabilities. However, unlike the individual AMT rate, the corporate AMT rate is 20% with various exemptions for small businesses. Under the AMT system, corporations are prevented from using many business tax credits and must add back interest from Municipal private activity bonds. There are many factors that can trigger the AMT for both individuals and corporations. As such, over time, both investor categories are impacted by the tax.

The Shrinking Net of AMT

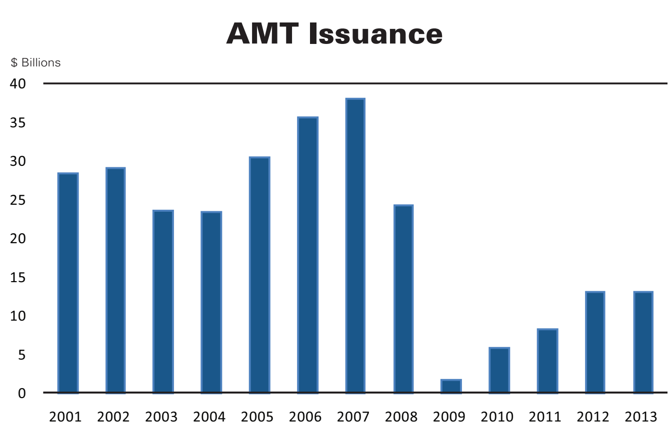
When introduced in 1969, the AMT was designed as a tax on the wealthy who used many deductions within the tax code to lower or even eliminate their tax liabilities. However, until last year, AMT income exemption levels were fixed and unadjusted for inflation, ensnaring a broad range of unsuspecting taxpayers. To lessen the reach of the tax, Congress periodically approved annual patches, which were temporary increases in AMT exemption levels. As part of the recent American Taxpayer Relief Act, the AMT brackets were permanently indexed to inflation, thus relieving a wide group of taxpayers from AMT concerns. Increased marginal rates on high income earners, also a result of the recent tax deal, will likewise reduce the number of taxpayers subject to the AMT given the increasing tax liability gap. Finally, further curtailing the influence of AMT, the reintroduction of the Personal Exemption Phase out (PEP) and "Pease" provision will limit exemptions and deductions available to high income earners. These two provisions, which have been dormant since the enactment of the Bush tax cuts, are once again part of the regular tax code, and raise the top marginal effective tax rate even further.

What is an AMT Bond?

In general, Municipal bonds will be subject to the AMT if at least 10% of the proceeds from the issue are used to fund private business, as opposed to public projects. Congress limits the use of tax-exempt bonds for qualified private activities by purpose and amount. Some of the qualified activities include facilities such as airports, docks and wharves, wastewater treatment, mass transit, as well as mortgages and student loans. Additionally, the federally-mandated debt issuance limits provide a maximum allocation for each state, which is regulated according to population. Unused amounts may be carried forward for three years. For 2014, the national volume cap for total private activity issuance was set at $33 billion. Actual issuance in 2013 was only $13 billion.

The Market for AMT Debt

At the end of 2008, the market for AMT debt was virtually frozen as financing for private activity projects "dried up". Furthermore, since many private activity bonds fund cyclically sensitive projects, the AMT sector came under additional pressure from the weak economy. To help ease funding costs for issuers, the American Recovery and Reinvestment Act (ARRA) provided for an exemption from the AMT for most qualified private activity bonds for 2009 and 2010. In addition, the ARRA extended the AMT exemption to refundings for bonds originally issued between 2004 and 2008. As a result, the only AMT deals during 2009 and 2010 were refundings of bonds originally issued prior to 2004. Following the near halt in new AMT issuance during this period, market conditions have recovered, but issuance remains below pre-crisis levels.

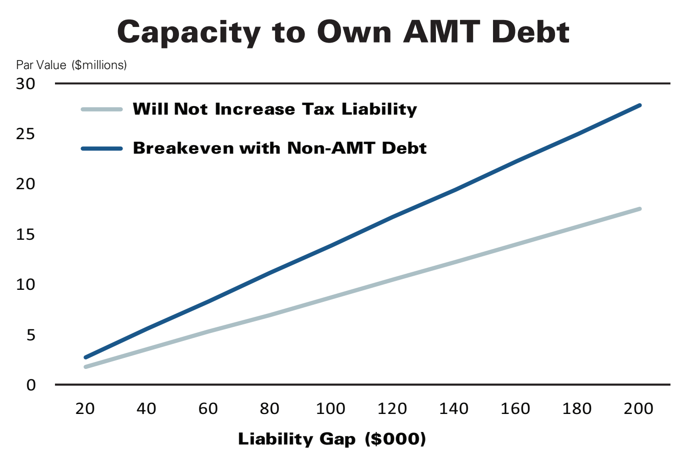


Source: Bond Buyer

Why Are AMT Bonds Attractive to Some Investors?

AMT bonds provide incremental income for investors who are not subject to the tax. The extra spread over traditional tax-exempt bonds helps compensate for the uncertainty that investors may be liable for the tax at some time in the future. It can be difficult to forecast the AMT status of an individual taxpayer over the life of a bond, but each has a capacity to own AMT bonds in a given year. An investor can own AMT debt without incurring additional taxes, as long as the amount of taxes owed under the AMT calculation remains below that which is owed under the regular tax system.

This is best illustrated by an example. Let's assume an individual's regular tax liability is $100,000, while their AMT liability is just $80,000. This implies that they can earn $20,000 of AMT bond interest without increasing their overall tax liability in that year. This small liability gap can mean a large capacity to own bonds subject to the AMT, which can provide incremental income over similar non-AMT bonds. In this example, the investor could own an additional $1,785,000 in AMT bonds yielding 4% before introducing an AMT-driven liability. Furthermore, there is a breakeven level at which an investor would be indifferent between holding the two classes of debt. This represents a larger allocation to AMT bonds as the extra income will offset the additional tax liability up to a point.



Source: BBH Analysis

Valuations for AMT Debt

Historically, an investor in AMT debt received an additional 30bps of yield over non-AMT debt of the same issuer. Although the market has recovered from extreme valuations during the financial crisis, AMT bonds still offer an additional 40bps of spread over comparable non-AMT debt. We feel this level of compensation is attractive, particularly for investors not subject to AMT. Furthermore, using current valuations, there may also be economic justification for holding AMT bonds in situations where an investor may be responsible for the tax during some period throughout the life of the bond. As a compliment to this idea, taxpayers may get a credit for AMT paid in prior years, reducing the likelihood of being subject in subsequent years. Using a 10-year, non-callable, AMT bond priced at +40bps to a non-AMT bond, an investor could be subject to AMT for 4 out of 10 years during the bond's tenor, and still receive a greater return at maturity than if they purchased the non-AMT bond.

	Non-AMT	AMT		AMT	
Par	1,000,000	1,000,000		1,000,000	
Coupon	3.60	4.00		4.00	
Price	100	100		100	
Time (Yrs)	Cash Flows	Cash Flows	Subject to AMT	Cash Flows	Subject to AMT
0	-1,000,000	-1,000,000	-	-1,000,000	-
1	36,000	40,000	-	40,000	-
2	36,000	40,000	-	40,000	-
3	36,000	40,000	-	40,000	-
4	36,000	40,000	-	40,000	-
5	36,000	40,000	-	40,000	-
6	36,000	40,000	-	40,000	-
7	36,000	40,000	-	28,800	✔
8	36,000	40,000	-	28,800	✔
9	36,000	40,000	-	28,800	✔
10	1,036,000	1,040,000	-	1,028,800	✔
Yield	3.63%	4.04%		3.63%	

Source: BBH Analysis
For Illustrative Purposes Only

We expect to see downward pressure on AMT spreads with the tax becoming less relevant given its shrinking footprint. In the meantime, opportunities are plentiful, particularly in the Airport sector. Airports serve both public and private purposes and as such, issue both AMT and non-AMT debt. We continue to find durable credits within this sector that are attractively priced. The extra yield for AMT only increases their allure. Currently, Airports represent one of our largest holdings within the Revenue sector.

Conclusion

We believe that the attractiveness of AMT bonds is quite evident for investors not subject to the tax. In addition, we feel they may still offer value for some investors who face uncertainty about their AMT status. It is understandable that some investors avoid AMT bonds, since they prefer the certainty of never paying Federal taxes on their Municipal holdings. However, given recent marginal tax rate increases, including personal exemption and deduction phase-outs for top earners, AMT opportunities become more valuable for traditional tax-exempt investors as the likelihood of being subject to the AMT decreases. At current levels, we feel AMT bonds offer attractive compensation for most Municipal investors, and should play an important role in our client portfolios.

Christian Romaglino, CFA
Vice President
Municipal Portfolio Manager