Information and Strategies for Municipal Bond Investors **Year-End 2005**

Municipal Advisor

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Do You Have a Strategy for Reducing Your Capital Gains Taxes?

Investors who have realized a gain from the sale of a security may be able to offset that gain with a loss in another security—potentially reducing their tax liability. Capital losses can be valuable since they can be used to offset capital gains and even ordinary income.

For those investors with short-term gains, offsetting those gains with capital losses can be especially worthwhile, as those gains would otherwise be taxed at the investor's ordinary Federal income tax rate—as high as 35%.

Any investor who has realized a gain and who also owns municipal bonds with a market value below their adjusted purchase price can potentially benefit from tax swapping.

Municipal Bond Tax-Loss Swaps

In a municipal bond tax-loss swap, a municipal bond that has declined in value is sold below its adjusted cost basis and a similar—but not substantially identical—municipal bond is purchased (please refer to The Wash Sale Rule on page 2).

If you are holding a municipal bond whose market value is lower than your adjusted cost, you may be able to realize that loss and use it to offset a gain—reducing your overall taxes and increasing your return (without compromising your original portfolio objectives).

Capital gains and losses can be summarized as follows:

- Short-term gains and losses are netted against each other, resulting in either a net gain or loss. Similarly, long-term gains and losses are combined, resulting in net long-term gains and losses. The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately. (IRS Publication 554.)
- Net short-term losses offset net long-term gains and the net gains remaining, if any, are "net capital gains" which qualify for the 15% tax rate.
- Net long-term losses offset net short-term gains and if there are gains remaining they are taxed at ordinary income rates.
- If capital losses exceed capital gains in total, the excess can offset up to $3,000 of ordinary income.
- The remaining excess, if any, is a "net capital loss" which is available for carryover to subsequent years and treated as if it had been incurred in that year.

Municipal bond swaps are frequently easier to accomplish than equity swaps because of the availability in the market of bonds that have similar characteristics to the bonds sold, yet are not "substantially identical."

Because a bond swap involves selling and simultaneously buying bonds, executing a tax-loss swap may provide the opportunity to change other portfolio characteristics as well by buying bonds with characteristics that are different from the bonds that are sold. *(Continued on page 2.)*

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Municipal Bond Tax-Loss Swaps

(Continued from page 1.)

One investor recently completed a tax-loss swap that maintained par amount and credit quality, extended maturity by three years and increased annual income while realizing a loss of over $11,000. (Assuming a Federal income tax rate of 35%, the $11,000 loss would result in a $3,800 reduction in taxes if the loss was used to offset short-term gains.)

Example of a Municipal Bond Tax-Loss Swap

	Sell	Buy	Change
Par Amount	250M	250M	Unchanged
Coupon Rate	3.00%	3.375%	+0.37%
Projected Annual Income	$7,500	$8,438	+$938
Estimated Market Value	$244,816	$245,019	($203)
Yield to Maturity	3.73%	3.87%	+0.14%
Average Maturity (Years)	5.07	8.07	+3.0
Profit / (Loss)	($11,518)		

This example is provided for illustration purposes only and is not intended to suggest a particular course of action for investors.

Identifying Swap Opportunities

The recent increases in the Fed Funds Target Rate have affected the shorter maturities of the municipal yield curve more than the longer maturities, so investors may find that municipal bonds acquired within the last twelve months that are due in about 10-years or less are the most likely candidates for a tax-loss swap. (See Municipal Bond Yield graph on page 4.)

Conclusion

Investors who have been reluctant to realize gains because of the possible tax consequences may wish to review their portfolio to see if they have other investments that can be sold at a loss to offset their gains.

Any municipal bond with an unrealized loss should be considered a candidate.

However, bond characteristics, market conditions, the structure of your portfolio and your situation will all affect the determination of whether or not a tax-loss swap is appropriate.

We recommend that you speak with your tax advisor for specifics on your personal tax situation prior to implementing a bond swap strategy. In addition, because of the potential complexities of executing a tax-loss swap, do not wait until the end of the year to determine if this may be an appropriate strategy for you.

While we do not provide tax, legal or accounting advice, your Financial Advisor can confer with you and your advisors to help them understand the investment implications of different securities and investment strategies.

Is it Long-Term or Short-Term?

If you hold securities for more than 1 year, any gain or loss is a long-term capital gain or loss. If you hold the property 1 year or less, any gain or loss is a short-term gain or loss.

Generally, the holding period begins on the day after the trade date on which you bought the security and ends on the trade date of the sale. (See IRS Publications 550 and 554 for additional information and exceptions.)

When you carry over a loss, it retains its original character as either long-term or short-term. (IRS Publication 554.) If you have realized short-term gains and you are going to realize losses, it may be advantageous to realize them sooner (as short-term losses) rather than later (as long-term losses).

While the best strategy is to try and match the term of your losses with the term of your gains, being able to do so will depend on your particular situation as well as prevailing market conditions.

The Wash Sale Rule

Investors considering a tax-loss swap must be careful to avoid a wash sale.

According to the Internal Revenue Service, "a wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you buy substantially identical stock or securities." You would also have a wash sale if you sell securities and your spouse or a trust or corporation you control buys substantially identical securities. (See Internal Revenue Service Publication 550, Investment Income and Expenses.)

Municipal bond investors can avoid a wash sale by purchasing bonds of a different issuer. If the same issuer's bonds are purchased, there must be a "substantial difference" in both the coupon and the maturity. "Substantially identical" is not defined in the Internal Revenue Code or regulations. However, past experience has shown that decisive factors include risk, identity of the issuer, the security's coupon rate, redemption provisions and possible maturity date.

Looking Ahead: Tax Reform Proposal & Bond Redemptions

Tax Reform Proposal. Although it is too early to be able to speculate about the likelihood of enactment, there are a number of items from the tax reform plans proposed by the President's Advisory Panel on Federal Tax Reform that could affect the municipal bond market.

For example, both of the plans propose repealing the Alternative Minimum Tax, which could have an obvious impact on the market value of private activity bonds—which are subject to the AMT when owned by an individual subject to the AMT. Also, the proposed reduction in the maximum Federal income tax bracket from 35% to 33% (in the Simplified Income Tax Plan) or 30% (in the Growth and Investment Tax Plan) could affect the relative trading values of municipal bonds versus US Treasury and other taxable bonds. (For example, the Taxable Equivalent Yield for a 4% tax-free yield is 6.15% in a 35% income tax bracket, and 5.71% in a 30% bracket.) Both plans also call for the elimination of the deductibility of state and local taxes, which could actually stimulate demand for double-exempt municipal bonds in the states that levy income taxes.

Bond Redemptions. Municipal bond issuers continue to take advantage of the interest rate environment by refinancing older, higher-rate debt. In the first ten months of the year, the volume of refunding bonds is up 50% versus last year and represents 34% of all new issue bonds. The heavy refunding issuance may mean an increase in the number of bonds called away from investors.

As a result, year-end portfolio reviews should include a screen to identify near-term call risk. The table below compares this year's average monthly new issue volume for select states with next year's estimated redemption flows.

Note that total new issuance for 2005 is likely to set an all time record. If there is a decline in volume in 2006, it may make reinvestment more challenging. In addition, the redemption estimates are typically understated, as issuers call bonds throughout the calendar year. For the period 2002 – 2005, the estimates have averaged 75% of the actual redemptions.

Municipal Bond Supply & Redemptions for Selected States ($ Millions)

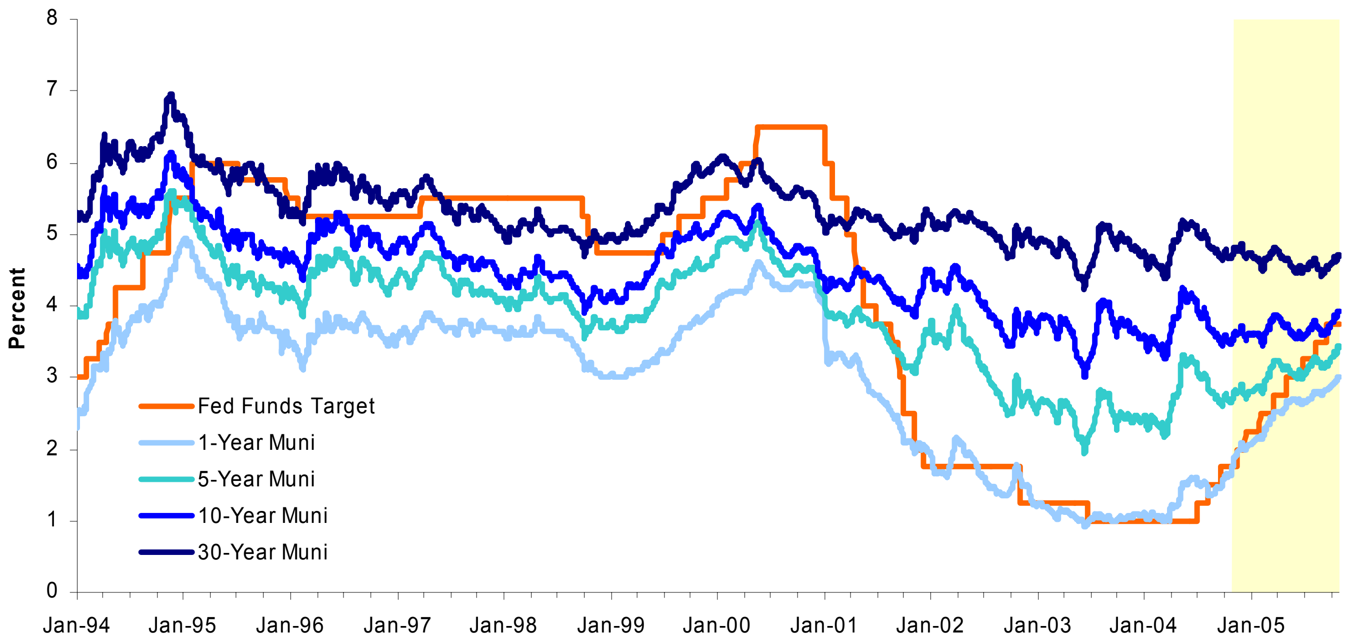
↑ = Monthly redemptions estimated to be heavier than the 2006 monthly average

	Average Monthly Issuance 2005	Average Monthly Redemptions 2006	Estimated Redemptions				
			January 2006	February 2006	March 2006	Heaviest Month 2006	
Arizona	784.4	360.0	↑ 649.9	120.9	112.5	July	2,099.0
California	4,568.4	2,466.9	1,621.7	1,288.7	967.7	July	5,764.2
Colorado	593.3	365.0	235.4	105.9	113.1	June	1,101.0
Connecticut	379.2	367.8	358.2	269.1	304.8	Nov	510.1
Florida	1,637.6	967.8	↑ 1,065.6	517.0	328.4	Oct	2,378.8
Georgia	598.6	376.0	↑ **705.2**	329.2	254.0	Jan	705.2
Illinois	1,168.9	857.7	↑ 1,865.2	615.0	577.5	Dec	2,323.8
Kentucky	371.4	266.6	239.4	195.8	137.4	June	980.7
Maryland	407.2	287.9	282.8	↑ 308.9	↑ 297.6	July	536.2
Massachusetts	1,181.5	777.6	↑ 977.8	↑ 973.5	↑ 875.4	July	1,093.5
Michigan	1,343.2	646.5	444.5	351.7	393.0	May	2,141.8
Minnesota	661.5	456.8	392.9	↑ **1,492.6**	302.6	Feb	1,492.6
Missouri	518.8	305.5	256.3	↑ 430.7	↑ **740.8**	Mar	740.8
New Jersey	1,353.3	951.7	↑ 1,098.6	820.0	578.9	June	2,869.8
New York	3,440.9	2,337.2	2,073.2	2,184.2	1,724.3	June	5,416.0
North Carolina	695.2	340.5	↑ 478.8	↑ 498.8	↑ 593.3	June	707.0
Ohio	986.0	675.0	602.9	644.0	315.3	Dec	2,394.4
Oregon	351.1	245.0	198.9	75.3	↑ 513.6	June	763.6
Pennsylvania	1,388.6	888.2	↑ 1,057,6	645.0	682.4	June	1,286.8
Puerto Rico	388.2	220.8	135.1	65.0	55.0	July	1,349.5
South Carolina	440.9	221.2	↑ 372.6	149.5	↑ **491.0**	Mar	491.0
Tennessee	360.5	298.2	↑ 325.1	153.7	174.6	May	580.0
Texas	3,051.0	1,936.6	1,006.3	↑ 3,860.9	1,117.5	Aug	9,057.6
Virginia	808.5	405.9	↑ 448.0	322.8	186.1	July	771.4
Washington	797.0	491.8	↑ 941.3	190.1	156.6	Dec	1,413.7
National Total	33,613.2	21,224.3	↑ 22,602.5	19,353.1	14,414.2	June	34,229.5

Average monthly new issue volume is based on the first ten months of 2005, according to The Bond Buyer. Redemption estimates are according to MuniView, October 2005. Bold indicates heaviest estimated month of the year.

Municipal Bond Yields and Fed Funds Target Rate

As of Close, 3 January 1994 – 31 October 2005
Sources: Municipal Market Advisors, Inc.; Federal Reserve
Past performance is no guarantee of future results.
Shaded region highlights last 12 months.



Year-End Planning

By holding more of your assets in lower-yielding short-term investments than you require for near-term (immediate) needs, you may be placing yourself at a long-term disadvantage. Investors with new money to invest or matured principal to reinvest may wish to ask themselves:

- ✓ What do I need this money to do?
- ✓ How much income do I need?
- ✓ If my assumptions about the markets are wrong, what would the consequences be?

Municipal Bond Investor Checklist:

- ✓ Consult with your tax advisor to consider if realizing gains or losses could help in your tax planning.
- ✓ Consult with your tax advisor about your AMT status for this and the coming years.
- ✓ Do you need to review your investment holdings for sources of AMT taxable income?
- ✓ Review / update your projected cash needs for 2006 and review your holdings of cash and cash alternatives.
- ✓ Have you had, or do you expect to have in the current quarter—or the coming year—any maturing or called bonds?
- ✓ Review your portfolio's exposure to Call Risk, Credit Risk, Market Risk, Inflation Risk and Reinvestment Risk.

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Patrick Luby, National Municipal Marketing Group, 2 November 2005. MSG05-111