



## About Taxable Municipal Bonds

Interest on municipal securities may be tax-exempt<sup>1</sup> or taxable under federal tax law. Generally, taxable municipal bonds are issued by state and local governments to finance a project that does not meet certain public purpose or public use tests under the Internal Revenue Service requirements to qualify for tax exemption. For example, a state or local government issuer may issue taxable municipal bonds to finance sports facilities, fund industrial development, improve public pension funding levels or refund municipal bonds that have been previously refunded.

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### Taxable Bond Programs

There are also federal programs that support the issuance of taxable bonds by state or local government issuers. These federal programs promote a policy objective such as school construction or energy conservation and reduce the borrowing costs of the state or local government issuer by reimbursing the issuer of the taxable bonds for a portion of its interest cost through a direct payment or subsidy. With direct payments, bond issuers receive cash rebates from the U.S. Department of the Treasury to subsidize their net interest payments. With a subsidy, bond investors receive federal tax credits in lieu of interest payments. Both tax credit and direct payment bonds subsidize borrowing costs.

Such programs include Build America Bonds (BABs)<sup>2</sup> and Recovery Zone Economic Development Bonds (RZEDBs),<sup>3</sup> which were authorized by the American Recovery and Reinvestment Act of 2009 to encourage state and local government issuers to finance projects that would create jobs and stimulate the economy with the aid of a federal subsidy. The

program authorization expired in 2010. However, a significant number of BABs remain outstanding. Qualified tax credit bond programs for public schools include Qualified School Construction Bonds (QSCBs)<sup>4</sup> and Qualified Zone Academy Bonds (QZABs),<sup>5</sup> and for energy conservation, Qualified Energy Conservation Bonds (QECBs)<sup>6</sup> and Clean Renewable Energy Bonds (CREBs).<sup>7</sup> Similar to BABs, these programs entitle the issuer to elect to receive a direct pay subsidy or provide the investor a federal tax credit in lieu of interest.

### Considerations for Investing In the Taxable Municipal Market

The taxable municipal market may provide certain advantages over not only the tax-exempt market, but other fixed income taxable markets:

- Taxable municipal bonds can be exempt from state and local taxes for investors who reside in the state of issuance, which may cause the effective yield earned on the bond to be higher than the actual stated yield.

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## About Private Activity and Alternative Minimum Tax (AMT) Municipal Bonds

A municipal bond is considered a private activity bond if it meets two sets of conditions with certain exceptions: 1) more than 10 percent of the proceeds of the issue are used for any private business use (the "private business use test"); and 2) the repayment of the principal or interest is directly or indirectly repaid from, or secured by, revenues from a private trade or business.\*

Some bonds issued to finance governmentally owned and operated facilities are categorized as private-activity bonds. Interest on a private activity bond is taxable unless the bond is a qualified private activity bond and meets various other requirements. They include bonds issued for governmentally owned airports, ports and facilities for mass commuting; certain high-speed intercity rail; sewage disposal; solid waste disposal; local electricity or gas; local district heating or cooling facilities; hazardous waste disposal facilities; and residential rental projects. Typically, the operation of the facilities utilizes leases, management contracts and other arrangements with a private entity, resulting in more than 10 percent of the bond proceeds being used by a private business, and the payments from these businesses (such as airlines) are pledged to repay the bonds. These facilities are "exempt facilities"† under the federal tax code.

Private activity municipal bonds pay interest that is treated as a preference item for purposes of the federal alternative minimum tax (AMT). These municipal securities pay interest that is exempt from gross income under the ordinary federal income tax calculation but are nonetheless subject to AMT.

The yields on AMT bonds are higher, reflecting the risk that they could become taxable to some investors at some point in time. The tax treatment of AMT bonds and possible impact on an investor's tax liability may lead investors to require additional yield to compensate for other existing alternatives. Also, if an investor purchased an AMT bond before the investor is subject to the AMT, the investor achieved a higher yield at that time than if the investor had purchased a non-AMT bond. However, as financial circumstances may change, investors may find that they are now subject to the AMT tax.

Investors should read all of the offering documents to familiarize themselves with the tax status of the municipal bond and consult a financial or tax professional if the AMT is a factor in the investor's financial profile and the investor purchases municipal bonds.

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\* If a bond "fails" these two tests (that is, the private use and repayment or security amount is 10 percent or less), it is a governmental bond and the interest on the bond is tax exempt.

† The tax code contains an additional group of programs for which private activity bonds may be issued on a tax-exempt basis, provided the programs are "qualified" by meeting specific conditions and limitations. These include mortgage revenue bonds, veterans' mortgage bonds, small-issue industrial development bonds, student loan bonds, redevelopment bonds and §501(c)(3) not-for-profit organization bonds. A municipal security also is a private activity bond if, with certain exceptions, the amount of proceeds of the issue used to make loans to non-governmental borrowers exceeds the lesser of 5 percent of the proceeds or \$5 million.



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- Taxable municipal securities are suitable in tax-deferred accounts such as IRAs, 401Ks and pension funds since interest earned in these types of accounts is tax-deferred.
- Taxable municipal securities, just like their counterparts in the tax-exempt market, are still backed by state and local governments and may offer less exposure to risks that may have an impact on the values of other taxable products such as corporate bonds.

The following table illustrates the differences between tax-exempt and taxable yields. For example, the table shows that a taxpayer in the 28 percent tax bracket investing in a 3 percent tax-exempt security would need a taxable bond yielding 4.17 percent (assuming the bond was not purchased in a tax-deferred account).

		Investor Tax Bracket						
		10%	15%	25%	28%	33%	35%	39.6%
		Taxable Equivalent Yield						
Tax-Exempt Yield	1%	1.11%	1.18%	1.33%	1.39%	1.49%	1.54%	1.66%
	2%	2.22%	2.35%	2.67%	2.78%	2.99%	3.08%	3.31%
	3%	3.33%	3.53%	4.00%	4.17%	4.48%	4.62%	4.97%
	4%	4.44%	4.71%	5.33%	5.56%	5.97%	6.15%	6.62%
	5%	5.56%	5.88%	6.67%	6.94%	7.46%	7.69%	8.28%
	6%	6.67%	7.06%	8.00%	8.33%	8.96%	9.23%	9.93%
	7%	7.78%	8.24%	9.33%	9.72%	10.45%	10.77%	11.59%

The official statement for new municipal securities issues generally includes detailed information with respect to the tax status of the issue. The official statement also typically includes the opinion of bond counsel addressing, among other things, the tax status of the municipal bond.

While taxable municipal securities can certainly be advantageous under certain circumstances, an investor should consider the overall impact of federal income tax on interest. Investors should consult their tax advisor for personalized guidance on the specifics of tax liabilities related to municipal securities.

<sup>1</sup> State and local government taxation of interest income on municipal securities is determined by individual state laws. The specific provisions and conditions of such exemption vary from state to state, and not all states provide an exemption and many states provide residents with a state income tax exemption for municipal securities issued by the state but not for securities issued out-of-state.

<sup>2</sup> The two distinct types of BABs—Build America Bond tax credit and Build America Bond direct payment subsidy—vary by the structure of federal subsidy. Tax credit BABs provide a tax credit to investors in an amount equal to 35 percent of the total coupon interest payable by the issuer of the taxable government bonds. Direct payment BABs provide a refundable credit payment to state or local governmental issuers in an amount equal to 35 percent of the total coupon interest payable to investors.

<sup>3</sup> RZEDBs are taxable bonds that finance public infrastructure projects for which the federal government reimburses issuers located within a designated Recovery Zone to fund public infrastructure projects in support of economic development in the amount of 45 percent of the interest paid.

<sup>4</sup> Like BABs, QSCBs were also established under the American Recovery and Reinvestment Act of 2009 in order to fund construction of public school facilities. The QSCB program was funded with \$22 billion that was allocated by the federal government to the states through 2010. School districts applied for the QSCB funding with the state in which they are located. Upon approval of the application, the school district issues QSCB bonds, which generally are taxable bonds with a 15-year term, and then repays investors only the principal of the bonds. The investor receives quarterly tax credits from the federal government in lieu of interest on the loan.

<sup>5</sup> In general, QZABs are taxable bonds issued by a state or local government to improve certain eligible public schools. The QZAB program permits public schools serving large concentrations of low-income families to benefit from interest-free financing to pay for building repair, invest in equipment and technology, develop challenging curricula, and train quality teachers. The federal government provided this tool under the Taxpayer Relief Act of 1997 to help encourage the formation of partnerships between public schools and local businesses.



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An eligible taxpayer who holds a QZAB generally is allowed annual federal income tax credits in lieu of periodic interest payments. These credits compensate the eligible taxpayer for lending money to the issuer and function as payments of interest on the bond. The allowance of a credit is generally treated as if it were a payment of interest on the bond.

- <sup>6</sup> The QECB program does not presently sunset. Under the authorizing legislation, each state receives a formula allocation, which they then have to allocate to local governments in their state with populations of at least 100,000. QECBs can be issued for any “qualified conservation purpose.” Specifically, state and local entities can use QECBs for: a) Capital expenditures incurred for reducing energy consumption in publicly-owned buildings by at least 20 percent, implementing green community programs, rural development regarding electricity production, or any qualified facility; b) Expenditures regarding research facilities and grants, supporting research in ethanol or other non-fossil fuels, technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels, increasing the efficiency of existing technologies, automobile battery technologies and other technologies to reduce fossil fuel consumption, or technologies to reduce energy use in buildings; c) Mass commuting facilities and related facilities that reduce consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting; d) Demonstration projects designed to promote the commercialization of green building technologies, conversion of agricultural waste for use in the production of fuel, advanced battery manufacturing technologies, technologies to reduce peak use of electricity, or technologies for the capture and sequestration of carbon dioxide; and e) Public education campaigns to promote energy efficiency.

- <sup>7</sup> The federal tax benefit to the holder of a CREB is greater than the benefit derived from tax-exempt municipal bonds in that the tax credit derived from a CREB can be used to offset, on a dollar-for-dollar basis, a holder’s current-year tax liability, as opposed to excluding interest from gross income, as permitted for tax-exempt bonds. Unlike tax-exempt bonds, CREBs are taxable bonds, and the tax credits received are treated as interest and included in a bondholder’s taxable income. With a few notable distinctions, CREBs share many of the same features as qualified zone academy bonds (QZABs), which permit qualified schools and education agencies to borrow at a 0% interest rate, with holders of the QZABs receiving federal tax credits in lieu of interest.

Treasury sets the rate of the credit on a daily basis, at a level that permits the issuance of the CREBs without discount and without interest cost to the issuer. Credit rates are based upon a yield on outstanding AA rated corporate bonds of a similar maturity, as estimated by Treasury the day before the CREB is sold. When the bondholder purchases the bond, the credit rate is locked in for the term of the bond. The credit accrues quarterly and is included in gross income of the bondholder (as if it were an interest payment on the bond). The bondholder takes the amount of the tax credit as a credit against its regular income tax liability and alternative minimum tax liability.



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