Key Private Bank

Key Questions

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Why are Municipalities Issuing Taxable Municipal Bonds and Who Buys Them?

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Municipalities issue taxable bonds due to annual caps on tax-exempt issuance, need for flexibility, and to advance refund an outstanding bond issue. The universe of bond buyers is ever-expanding, as are the benefits for investors.

When investors hear the phrase municipal bonds, they usually envision a fixed income instrument whose interest payments are exempt from federal income taxes. These securities allow municipalities to borrow at an interest rate lower than the rate on bonds whose interest payments are taxable to the bondholders. Tax-exempt securities are a valuable tool afforded to states and cities as it helps to keep their borrowing costs low.

Bonds that are taxable are not exempt from federal income taxes, and thus the interest rate the issuer pays to bondholders is higher.

This naturally prompts the question: If an issuer could borrow at lower rates in the tax-exempt market, why would they issue taxable securities at higher rates?

There are three main reasons a municipal authority would issue taxable municipal bonds:

1. It has reached its annual cap on tax-exempt issuance.
2. It wants more flexibility on the use of the funds.
3. The bonds are issued to advance refund an outstanding municipal bond issue.

Regarding caps on issuing bonds, some issuers face a limit on how much they can borrow in a calendar year using tax-exempt bonds. As far as flexibility, the IRS requires that the money borrowed using tax-exempt financing be used for a specific qualified project or purpose. For instance, a university may borrow using tax-exempt financing for a new building on its campus. However, it cannot use tax-exempt financing for an undefined project that it might later choose; it would have to issue taxable municipal bonds for this type of open-ended financing.

The most common reason taxable municipal bonds are issued is for the advance refunding (or refinancing) of an outstanding bond issue. Before changes in tax laws introduced by the Tax Cuts and Jobs Act of 2017, higher interest rate deals were usually refinanced using a tax-exempt bond issue. The law changed the rules: Now, if an issuer wants to refinance an outstanding tax-exempt issue prior to the date it is callable, it must be done with a taxable municipal issue.

The idea behind this change in law was to limit the amount of tax-exempt borrowing an issuer could have for any single project. Initially, this served to severely restrict the number of deals that could be advance refunded and led to a longer life of suboptimal financing by municipalities.

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With interest rates on Treasury bonds plummeting in the spring of 2020 due to COVID-19, the cost of financing using taxable bonds plunged: It made sense to refinance outstanding debt even if it had to be done by issuing taxable bonds. This practice led to the surge of taxable municipal bonds being issued in 2020 and early 2021.

This was not a popular change to the tax law for states or cities looking to refinance outstanding debt at the lowest possible rate. However, there is a good chance that Congress will attempt to overturn this 2017 tax law change if a comprehensive infrastructure bill is passed later this year.

So who should consider buying taxable municipal bonds? Traditional buyers of municipal bonds like them for their tax-free income and their safety. The tax-exemption characteristic is especially valuable to investors in the maximum tax bracket, currently at 37% and possibly on its way to 39.6%. Defaults are historically very rare in the higher-rated categories. When considering an investment in taxable municipal bonds, one should consider them an alternative to Treasuries, corporates, mortgages, and other high-quality taxable fixed income securities.

Investors interested in fixed income but are in a tax bracket of 24% or lower are probably better off buying taxable municipals and paying tax on the income rather than accepting the lower rate of return of a traditional tax-exempt municipal to avoid taxation. This relationship ebbs and flows, but the 24% tax bracket is a good rule of thumb for when taxable municipals might make more sense.

When comparing taxable municipals with corporate bonds, taxable municipals are usually considered safer than corporates: The historical default rate of municipals is much lower than that of corporates in the same rating category. Yields on similarly rated taxable municipals and corporates can vary, but often the taxable municipal offers a higher yield.

Historically, taxable municipals have frequently traded at higher yields because they are less liquid than corporate bonds, possibly affecting your total return if you do not hold the bonds to maturity. In recent years, the liquidity for taxable municipals has materially improved as market issuance has grown, and the universe of buyers has expanded. Buyers of taxable municipals now include overseas investors who face negative yields in their local fixed income markets.

Lastly, taxable municipals also offer diversification benefits compared with a portfolio of all corporates as they may be affected differently during times of economic stress. So as you move toward retirement and find yourself in a lower tax bracket, you might consider sticking with the municipal bond portfolio you have come to appreciate but expand your toolkit to include taxable municipals. We believe the benefits are multi-fold.

For more information, please contact your Key Private Bank Advisor.

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