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Muni Bond Games and the IRS' Lurking Arbitrage Vampires.

Today's interest rates may tempt public financiers to try to play the spread between tax-exempt and taxable bond yields. That invites heightened federal scrutiny, but there are some strategies likely to avoid the bite of the IRS.

America's public finance system is unique in its federalist heritage of allowing states and their localities to issue bonds whose interest is exempt from taxation by the IRS. The result is that interest rates on municipal bond debt are significantly lower than any other yields in the credit markets, which materially reduces the cost of financing essential public works.

Sometimes, though, unusual interest rate spreads invite a bond issuer to try to game the system, particularly by using low-cost proceeds from tax-exempt debt to find higher yields elsewhere in the markets. It's a potentially risky play given longstanding federal rules, but that's not to say there aren't some opportunities for savvy — and cautious — public financiers.

First, though, some relevant historical context: The issuance of tax-exempt bonds was long thought to be a constitutional right under the 10th Amendment and the associated concept of reciprocal immunity — that under the separation of powers, the two levels of government, state and federal, cannot tax each other. In 1988, however, the Supreme Court ruled that the federal tax exemption was not a constitutional right but rather a legislative grant to the states from Congress and thus subject to tinkering on Capitol Hill.

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