
Not All Muni Interest Reported by High Earners.

WASHINGTON – Nearly half the tax-exempt interest reported on 2013 individual income tax returns was reported on returns filed by single or married taxpayers or heads of households with adjusted gross income of less than $200,000, according to recently released Internal Revenue Service statistics.

But a majority of the returns showing tax-exempt interest were from a primary taxpayer who was at least 65 years old, the report showed.

"Tax exempt municipal bonds are held by millions of middle-class investors but, in particular, half the holders of these bonds are over 65 and have presumably chosen to invest in the safety of municipal bonds for retirement," said Jessica Giroux, general counsel and managing director of federal regulatory policy for the Bond Dealers of America. "This is a significant demonstration of support for municipal bonds as a solid investment and a secure source of financing for local governments."

The statistics are from the IRS' recently released complete report on tax year 2013 individual tax returns, which include the returns of those who are single and married. They are estimates based on a sample of unaudited individual tax returns filed by U.S. citizens and residents during the 2014 calendar year, the latest full year for which the data is publicly available. The tax-exempt interest reported by taxpayers includes interest on municipal bonds and tax-exempt dividends from mutual funds, the IRS said.

Typically, IRS annual reports about high-income tax returns focus on returns with income of over $200,000.

The report showed that most of the tax-exempt interest reported was from high income households. About 44.06% of the tax-exempt interest reported was from taxpayers with AGI of under $200,000 (including those with no AGI), and about 25.84% of the tax-exempt interest was from taxpayers with AGI of under $100,000. These percentages are similar to the ones in 2012, according to the IRS estimates.

However, most returns with tax-exempt interest were filed by households with AGI below $200,000. Specifically, almost 76% of the number of returns with tax-exempt interest showed AGI of less than $200,000, including no AGI.

Less than 4% of the number of all tax returns, regardless of whether tax-exempt interest was reported, were filed by taxpayers with AGI of at least $200,000, according to the IRS.

The income distribution of tax-exempt interest is not new and is probably a driver behind proposals to curb the municipal bond tax exemption for high earners, such as President Obama's proposal to cap the value of the exemption at 28%, said Michael Decker, managing director and co-head of municipal securities at the Securities Industry and Financial Markets Association.

But to the extent that the 28% cap would apply to a sizable amount of tax-exempt bond interest, it would cause changes in the market. A 28% cap would cause investors to seek higher yields, which would translate to higher borrowing costs for state and local governments, Decker said.

In 2013, married taxpayers filing jointly would be in tax brackets above 28% if they had taxable income of more than $223,050. Taxable income tends to be less than adjusted gross income.

Howard Gleckman, a senior fellow at the Urban Institute, said that the most successful argument for the muni market to make to preserve the exemption is not to focus on the investors but instead to focus on how it helps state and local governments finance projects. Democrats like new projects and Republicans would prefer that projects be controlled at the state and local levels, he said.

Most tax-exempt interest reported on individual tax returns in 2013 was reported on returns with primary filers on the older side. Roughly 3.15 million of returns, or a little over half of the returns with tax-exempt interest, were filed by primary taxpayers who are 65 and older. Returns from those taxpayers reported interest of about $42.4 billion. An additional 1.39 million of returns with a total of about $15.04 billion tax-exempt interest were filed by primary taxpayers with ages of 55 to 64. In cases of joint tax returns, the age is based on the primary taxpayer's age, the IRS said.

"Munis tend to be a good product for retirees who are living off their savings," said Decker, who added that people shift from investing in equities to investing in the fixed-income markets as they approach retirement because bonds are safe and income bearing.

But Gleckman said it doesn't always make the most sense financially for seniors to invest in tax-exempt bonds, for example, if they live in a state without state income taxes and don't make much money.

About 5.99 million of the returns reported tax-exempt interest in 2013 of about $68.1 billion in current dollars, the IRS estimated. The number of returns with tax-exempt interest was half a percent higher in 2013 than it was the previous year, but the dollar amount was 4.2% less than in 2012.

The increase in the number of returns with tax-exempt interest comes after a decline in that category each year since 2008. The amount of tax-exempt interest has declined every year after 2010.

Decker said that the decline in tax-exempt interest in 2013 could be due to the fact that the muni market shrunk during that time. Also, in the low-interest rate environment, bonds are being refinanced and investors are holding bonds with lower interest rates, he said.

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