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Why the Surge in Taxable Municipal Bonds?

Municipal bonds – debt issued by state and local governments and some nonprofit institutions – are attractive to investors because the interest is generally exempt from federal income taxes. As a result, investors are willing to accept a lower interest rate than they would otherwise demand, and the issuers get lower borrowing costs. But recently, there has been a surge in issuance of *taxable* municipal bonds—that is, bonds whose interest is taxable to investors. Between January and November of 2020, $129.3 billion in taxable bonds were issued (31% of all municipal bonds issued over this period), up from $67.3 billion in 2019 and $25.1 billion in 2018. Here we explain the tax treatment of municipal bonds and explore what's behind the recent surge in taxable municipal bonds.

WHAT DETERMINES WHETHER INTEREST ON A BOND IS TAXABLE?

The interest on bonds issued by state and local governments is generally tax-exempt at the federal level, unless more than 10% of the proceeds are used for trade or business activities by nongovernmental entities, including leasing a public building to a private entity for business use. And nonprofits with 501(c)3 status, including colleges and hospitals, can issue tax-exempt bonds provided that no more than 5% of the proceeds are used for private business unrelated to the nonprofit's charitable purposes. Regardless of whether the bond is taxed at the federal level, states independently determine whether they tax municipal bond interest. A 2008 Supreme Court ruling cleared the way for states and localities to exempt their own municipal bonds' interest from their own taxes while taxing interest from other state and localities' municipal bonds.

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