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## **Taxes Done Right: New Analytics for Municipal Securities**

The U.S. municipal securities market is a prominent part of the fixed income landscape, with municipal bonds (e.g., debt offered by states, counties, cities) and municipal fund securities (e.g., 529 and ABLE savings programs). With municipal bonds in particular, issuers usually enjoy special taxation status and, as a result, investors seeking tax-efficient investments might generally assume they're tax-free.

But this is not exactly true. When modeling municipal bonds, it becomes immediately clear that tax-exempt status is not absolute. The payments investors receive from the bonds are usually a mixture of tax-free interest and potentially taxable principal cash flows.

Therefore, investors may still be subject to taxation—in particular, to capital gains tax or even ordinary income tax due to the de minimis rule. This impacts investors' after-tax cash flows, thus changing the bonds' risk and return properties.

From an analytics perspective, it presents a problem since one cannot treat all cashflows equally and discount them with a tax-free discount curve that is normally used for the municipal market. So, what to do?

To avoid the proverbial apples and oranges conundrum, it is necessary to convert all cash flows to "after-tax" status; in other words, cash flows an investor receives after paying all taxes.

For the conversion, one can use the following expression to compute the tax due for all relevant cashflows.

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**FactSet**

By Rustem Shaikhutdinov | February 1, 2023

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