

# Taxable municipal bonds



Wealth  
Management

Municipal bonds are debt obligations issued by states, cities, counties and other governmental entities to raise money to build schools, highways, hospitals and sewer systems, as well as many other projects for the public good.

When you purchase a municipal bond, you are lending money to an issuer who promises to pay you a specified amount of interest (usually paid semi-annually) and return the principal on a specific maturity date.

Not all municipal bonds offer tax exemptions from both federal and state taxes. Taxable municipal bonds are taxable at the federal level, but may offer state, and often local, tax exemption on interest paid to investors who reside in the state of issuance.

## What are taxable municipal bonds?

Taxable municipal bonds exist because the federal government will not subsidize the financing of certain activities, which do not provide a significant benefit to the public at large. Investor-led housing, local sports facilities, refunding of a refunded issue and borrowing to replenish a municipality's underfunded pension plan are just four types of bond issues that are federally taxable. Taxable municipals offer yields more comparable to those of other taxable sectors, such as corporate or government agency bonds. The growth of the taxable municipal market in

recent years has been astounding. Since 2008, \$427 billion has been issued in the taxable space, including AMT.

## The advantages of taxable municipal bonds

Taxable municipal bonds provide investors with a number of appealing features:

- **Safety** — because of their municipal backing, taxable municipals are less susceptible to event risk versus other taxable products such as corporate or government agency bonds.
- **Value** — municipal bonds are second only to U. S. Treasury bonds when it comes to security. Taxable municipals offer higher yields than other government agency bonds and in many cases, corporate bonds.
- **Liquidity** — the highest percentage of taxable municipal bond issues goes to fund state/local pension shortfalls. This issuance is expected to grow, resulting in greater liquidity for this sector, which is still in its adolescence.
- **State tax exempt** — some taxable municipal issues are exempt from state and often local taxes, in which case, investors who reside in the state of issuance are not taxed on their interest earnings at the state level. Thus, the effective yield they earn on the bond will actually be higher than the stated yield. This is particularly appealing to investors in high tax states such as California, New Jersey and New York.

## Are taxable municipal bonds right for you?

Taxable municipal bonds may be appealing to investors who are seeking higher yields and call protection, while maintaining a strong credit rating. They may also be an option for investment accounts such as IRAs, 401Ks, and pension funds. Because interest earned in these accounts is already tax-deferred, they normally do not buy municipal bonds because of the lower tax exempt coupons. The higher coupons and high credit quality on taxable municipal bonds may, however, make them attractive to these accounts.

Any fixed income portfolio should be structured to balance reward, or after-tax yield, against risks and limitations. When planning a wealth management strategy, an investor's goal should be to balance risk while considering cash flow requirements, risk tolerance and other available assets. As with all fixed income securities, these bonds may be subject to market risk, credit risk, and reinvestment risk.

For more information you should consult with your RBC Wealth Management® financial advisor who will review your investment objectives and determine if taxable municipal bonds are an appropriate investment for you.