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Alert: Muni Tax Exemption Under Threat?

Municipal Bonds in the News

March 28, 2025

Last week, unsettling headlines hit mainstream news outlets as an informal advisor to the Trump administration began publicly advocating to end the federal tax exemption for municipal bond interest payments to bondholders.[1]

Importantly, we note that at this point no Trump administration officials or Congressional Republicans (who currently control both the House of Representatives and the Senate) have floated any such proposals - for now it's purely in the realm of speculative 'chatter' in political forums. However, as we expect there will be further headlines on this issue going forward, this *Alert* will briefly explain what's happening and our current thinking.

Context - Why?

The apparent motivation behind this idea is linked to the ongoing and fluid negotiations around federal government tax policy currently percolating in Washington, D.C. The Trump administration and Congressional Republicans are seeking to extend politically popular provisions of the 2017 Tax Cuts and Jobs Act that are set to expire later this year (e.g. absent new legislation, individual and corporate income tax rates will automatically reset several percentage points higher, and estate tax exemption thresholds will drop to half their current levels). A simple extension, however, would result in reduced federal government revenues and higher budget deficits. Consequently, speculation is ripe that offsetting measures to raise new revenue or cut other existing expenses are also being considered.

Without going too far into the weeds, we note that for budgetary purposes lawmakers consider the municipal bond tax exemption a federal 'subsidy' for bond issuers (since tax-exempt rates are nearly always lower than fully taxable rates, the tax exemption reduces a borrower's cost of financing). As a result, the foregone additional revenue that the federal government would theoretically collect from muni bondholders is considered an 'expense' that would otherwise reduce the federal deficit if it were eliminated or dialed back. This 'deficit reducing' motivation is the only reason why this idea is currently being raised.

An important aside: there is no reason to suspect that the exemption of muni bond interest from *state and local taxes* (where applicable) is in any danger.

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[1] "Trump Adviser Calls to End Muni Tax Break in Threat to Market," Bloomberg News, 3/21/25, https://www.bloomberg.com/news/articles/2025-03-21/trump-adviser-calls-to-end-muni-tax-break-in-threat-to-market

Context - What?

At this point, we can only speculate on the nature of any potential changes to the municipal bond tax exemption that may be floated over the coming months. We can think of several possible modifications, ranging in severity from draconian treatment of existing munis to relatively mild and limited penalties:

- Full repeal of the exemption for *existing and future* muni bonds (i.e. no 'grandfather clause' and all munis become federally taxable)
- Repeal of the exemption *only for future* muni debt (i.e. a 'grandfather clause' for *existing* muni bondholders)
- Limiting the amount of muni bond interest that can be shielded from federal taxes (e.g. either a hard dollar limit or capping the total value at a certain percentage)
- Preserving the current muni tax exemption only for state and local government issuers, and eliminating or reducing the ability of non-governmental entities to issue tax-exempt debt going forward (e.g. not-for-profit institutions)

While each of these modifications would generate their own unique set of consequences for muni bond investors (in some cases even positive ones), discussing them is beyond the scope of this brief *Alert*. Moreover, the legality of the more draconian ideas (particularly a no 'grandfather clause' retroactive taxation of existing muni bonds) is questionable.

Although we won't belabor the details, we also note that the past couple of decades witnessed several formal proposals to change the muni tax exemption, and none of them ultimately rose to the level of a serious threat before falling by the wayside.

Treasury Partners View

To reiterate: although negotiations on new tax legislation are currently ongoing, no appointed or elected official has put forth any proposals for modifying the existing municipal bond tax exemption, either in the possible forms listed in this *Alert* or otherwise. But as we've written in years past, it pays to remember that "Politics is a contact sport" – anything can happen. Adverse changes to the muni tax exemption are firmly within the realm of possibility, and we're keeping a very close eye on developments.

We continue to assess the risk of any adverse changes to *existing* muni bondholders as a very low probability. In addition to the logistical and legal challenges that would arise from any efforts to retroactively tax currently outstanding muni bonds, there are many good reasons why it doesn't make much logical sense to target the muni tax exemption in the first place. To name just a few:

- The overwhelming majority of American public infrastructure spending is done at the state and local level, and tax-exempt municipal bonds are the primary tool used by state and local government to finance those infrastructure needs. Raising the cost of funding for these projects would lead to less infrastructure investment, an outcome that is in direct conflict with the stated policy goals of the Trump administration.

- The muni bond market is a truly national one, with heavy and far-reaching participation from governments and investors across both traditionally 'red' and 'blue' states. The pressure on elected representatives to spare their muni bondholder constituents from a retroactive tax hit (and their state and local government counterparts from higher financing costs going forward) would be bipartisan and widespread, likely amplifying the difficulties Republicans already face in passing controversial legislation with razor-thin Congressional majorities.

- In the strange world of federal 'budget math,' lawmakers tend to focus on proposals that have the greatest impact on reducing the deficit, ones which either materially raise revenues or decrease expenses (i.e. their focus is usually on the 'biggest bang for the buck'). By this arcane logic, cutting the municipal bond tax exemption doesn't provide much in the way of a 'bang,' ranking below many politically vulnerable spending programs whose elimination would have a substantially larger impact on these calculations.

- Moreover, 'budget math' is often a poor reflection of the real world. For several reasons, the federal government's true 'savings' from eliminating or reducing the muni bond exemption would likely be far smaller than the number assumed for budgetary purposes. Stated differently, it's unlikely it would make much of a dent in *actually reducing* the size of the federal deficit in real world conditions, especially when measured against the new added costs that would subsequently be pushed down to state and local governments.

The municipal bond market is currently taking the news in stride, and we observe that muni bond yields are largely unchanged since the negative headlines first came out. We expect this to remain the case so long as this threat remains hypothetical, with sustained upside or downside reactions only coming in response to any formal proposals ultimately released by lawmakers or Trump administration officials.

If and until that happens, we will continue to take advantage of the opportunity to add municipal bonds at elevated long-term rates. High-grade long-term munis are currently trading at 4%+ tax-free yields, levels which we believe are attractive compared to the strong fundamental credit quality of the underlying muni issuers.

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