



UNDERSTANDING THE POTENTIAL BENEFITS OF OUT-OF-STATE MUNICIPAL BONDS

Introduction

Tax-free municipal bond investors do not pay federal tax on interest earned by their bonds.

At the state level, the interest could be taxable depending on each state's regulations; some states exempt in-state municipal bond interest from taxes but tax out-of-state bond interest.

Tax-exempt bond investors who do not consider out-of-state municipals may miss opportunities to enhance portfolio performance, risk management, and future investment opportunities. Breckinridge explores the potential of out-of-state bonds to benefit state-preference municipal bond portfolios.

“Assessing after-tax yields for out-of-state municipals is key to active portfolio management.”



WHY CONSIDER OUT-OF-STATE MUNICIPAL BONDS?

Out-of-state municipals can offer several advantages despite the potential for state taxes on interest:

- **Additional Income:** Out-of-state bonds may provide higher yields after paying state taxes.
- **Credit Diversity:** Out-of-state bonds can diversify portfolio holdings, helping to reduce risk, especially if the investor's state has a challenging credit outlook.
- **Increased Availability:** Out-of-state bonds expand the investment search, helping investors find more opportunities, particularly if their state has a limited supply.

EVALUATING OUT-OF-STATE BONDS

The following example shows how an out-of-state bond might add income after state taxes.

An investor who pays taxes in California can buy an in-state municipal bond yielding 3.30%¹ or a similar Texas bond yielding 3.85%. Texas was chosen for this example because it ranks among the states that issue the highest amounts of municipal bonds.² The depth of a state's bond market will greatly influence the opportunity set in that market—from yield curve positioning to sector and credit exposure to varying call and coupon structures—just to name a few.³

The investor is exempt from having to pay California's 13.3%⁴ tax on the interest the in-state bond will earn. On the other hand, the investor must pay 13.3% California tax on interest the Texas bond earns.

The after-tax yield for the Texas bond is calculated by multiplying the 3.85% yield by a number resulting from subtracting the 13.3% California tax rate from the number 1. The equation looks like this:

$$3.85\% \times (1-0.133) \text{ or, simplified, } 3.85\% \times 0.867 = 3.33\% \text{ after-tax yield.}$$

The Texas bond's 3.33% after-tax yield is higher than the California bond's 3.30% tax-exempt yield.

Choosing the Texas bond for this California municipal bond portfolio would provide more income, even after paying taxes, add geographic diversification to the portfolio, and potentially increase trading options in the future as market conditions change.

EVALUATING OUT-OF-STATE BONDS WHEN INTEREST RATES CHANGE

Interest rate environments can affect the attractiveness of out-of-state bonds. Considering the previous example, if yields increase and the California bond yields 3.65%, while the Texas bond yields 4.20%.

Once again, calculate the after-tax yield for the Texas bond:

$$4.20\% \times 0.867 = 3.64\%$$

After factoring in the 13.3% California tax, the Texas bond's after-tax yield becomes 3.64%, making the California bond's 3.65% tax-exempt yield more favorable.

CONCLUSION

Actively managing municipal bond portfolios for tax-efficiency by including consideration of out-of-state bonds can yield opportunities to enhance income and tax benefits, diversify credit risk, and expand investment opportunities. Assessing after-tax yields for out-of-state municipals is key to active portfolio management.

1. The yields used in these examples are for illustrative purposes only and not intended to be representatives of specific bonds issued by the states discussed.
 2. California, New York, Texas, Illinois, and Florida account for nearly half of the bonds in the municipal market. Source: National Association of State Budget Officers (NASBO), Fall Fiscal Survey of States (1989 - 2023) and Spring Fiscal Survey of States (2024). Survey data were self-reported by executive state budget officers.
 3. Another reason to consider purchasing bonds issued by zero-tax states, such as Texas, is that bonds from zero-tax states tend to trade at higher yields than bonds from high-tax states due to the demand, or lack thereof, from in-state residents trying to avoid the state tax liability. Bonds of states with higher demand tend to push yields lower on average.
 4. The top marginal personal income tax rate in California is 13.3%, according to [The Tax Foundation](#).



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