Tax-Exempt Debt Arbitrage

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ABSTRACT

U.S. individuals and corporations subject to high tax rates can reduce their taxable incomes by borrowing and using the proceeds to invest in tax-exempt bonds. The value of this strategy is reduced, however, by the low interest rates available on tax-exempt bonds and a tax rule that limits interest deductions of taxpayers holding tax-exempt debt. Prior to 1986 U.S. banks did not face the interest deduction limitation, and as a result used tax-exempt debt to reduce their U.S. tax liabilities by roughly 40 percent. This paper examines the factors that determined tax-exempt debt holding, and how they changed after 1986. The results suggest that banks aggressively managed their tax positions, but also that the unpredictability of taxable income may have limited tax avoidance.

JEL Classifications: H25, H74, G21.