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Investment Opportunity in AMT Municipal Bonds

Summary:

The Alternative Minimum Tax (AMT) affects the tax-exempt status of certain municipal bonds, particularly private activity bonds, making their interest income potentially taxable for some investors.

Legislative changes have reduced the number of taxpayers subject to the AMT, but future exposure remains uncertain, especially for high-income individuals.

Investors who are not impacted by the AMT can benefit from higher yields and broader market opportunities, notably in sectors like transportation and BBB rated bonds.

Introduction

Municipal bonds have long been a cornerstone for investors seeking tax-advantaged income and portfolio diversification. However, the presence of the Alternative Minimum Tax (AMT) introduces complexity to the tax treatment of certain municipal securities, particularly those classified as private activity bonds. Understanding the mechanics of the AMT, its interplay with certain private activity bonds, and current market dynamics is essential for municipal bond investors when evaluating opportunities in this segment.

The Alternative Minimum Tax is a parallel tax system designed to ensure that individuals and certain entities pay a minimum level of federal income tax, regardless of deductions, exemptions, or credits that might otherwise reduce their liability. The AMT recalculates taxable income using a broader base and disallows certain preferences, including the tax-exempt interest from some municipal bonds. As a result, investors exposed to the AMT may find their tax-exempt income partially or wholly subject to federal taxation, reducing the after-tax benefit of their municipal bond port-folios.

Private activity bonds are a subset of municipal securities where private entities significantly bene-fit from the financed facilities; examples include airports, and industrial development bonds. While these bonds may receive tax-exempt treatment due to their public benefit, the interest income is often subject to the AMT. This distinction is crucial for investors, as owning an outsized allocation to AMT bonds can inadvertently increase their tax liability if they become subject to the AMT.

Legislative Changes

The 2017 Tax Cuts and Jobs Act (TCJA) significantly changed the rules that determine who fall within the AMT by increasing both the amount of income exempt from the AMT calculation and the threshold at which the exemption begins to phase out. Consequently, the number of taxpayers affected by the AMT dropped from over five million for tax year 2017 to approximately 200,000 for tax year 2018. However, these provisions were temporary as they expired after the 2025 tax year. The One Big Beautiful Bill, which was passed in July 2025, made permanent adjustments by in-creasing the exemption amount further and keeping a high threshold for the phase out as com-pared to before the TCJA. However, the phase out of the exemption happens quicker as income increases which will likely lead to more very high-income investors paying the AMT.

Current Market Conditions

Due to past legislative uncertainty and evolving tax rules, the market for AMT municipal bonds has experienced notable shifts in yield spreads. Looking at yields within the Bloomberg Municipal Bond Index, AMT bonds are out yielding non-AMT bonds by 75 basis points. That is well above the 10-year average of 55 basis points. This premium may reflect heightened investor caution as many investors have yet to file their 2025 tax returns and some may be unsure of their AMT status. Also, retail separately managed account (SMA) mandates frequently exclude AMT bonds, and the two largest intermediate passive municipal ETFs avoid them entirely.

Bloomberg Municipal Index: AMT vs Non AMT Yields

Source: Bloomberg as of 2/2/26.

Investors who can buy AMT bonds also have the advantage of investing in attractive portions of the municipal market. Within the Bloomberg Municipal Bond Index, 35% of the transportation sector, most notably the airport subsector, are AMT bonds. The airport revenue bond sector has shown significant growth in new issuance in recent years. According to data from J.P. Morgan, last year's airport issuance was 61% higher than the 5-year average. A recent new issue for a large airport had both AMT and non-AMT bonds. The AMT bonds with maturities out to 10 years had yields that were more than 50 basis points higher than the non-AMT bonds. Additionally, AMT bonds represent 28% of BBB rated securities in the index. For investors willing and able to hold AMT bonds, this broadens the opportunity set and gives greater access to higher yielding sectors.

Conclusion

The primary challenge for investors lies in accurately determining their current and future exposure to the AMT, given the changes to the tax code and the interplay of individual factors. Many investors are understandably hesitant to add AMT bonds to their portfolios without fully understanding their tax situation. Nonetheless, for those who are confident they will remain outside the scope of the AMT, the rewards are tangible: higher yields and easier access to higher yielding sectors such as transportation and BBB rated bonds.

Glossary

Bloomberg High Yield Municipal Bond Index flagship measure of the US municipal tax-exempt non-investment grade bond market.

Bloomberg Municipal Bond Index tracks the performance of investment-grade, fixed-rate municipal bonds with maturities greater than two years.

Bloomberg US Aggregate Total Return Index measures the performance of the U.S. dollar-denominated, investment-grade, taxable fixed-rate bond market.

Credit risk, also known as default risk, is the likelihood that a borrower won't repay a loan or meet their debt obligation**.**

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. Rating agencies assign letter designations such as AAA, AA and so forth. The lower the rating, the higher the probability of default. Credit quality does not remove market risk and is subject to change.

Duration is the measure of price sensitivity to changes in interest rtes. In general, the higher the duration, the more a bond's price will drop as interest rates rise. This also indicates a higher level of interest rate risk.

An exchange-traded fund (ETF) is a security that tracks an index or asset like an index fund, but trades like a stock on an exchange.

Federal Funds rate is the interest rate banks charge each other for overnight loans.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

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Municipal Bonds: Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax exemption applies if securities are issued within one's state of residence and, if applicable, local tax exemption applies if securities are issues within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Municipal to Treasury Ratio compares the yield of municipal bonds to the yield of U.S. Treasury bonds This ratio helps investors assess the relative value of municipal bonds, especially considering their tax-free nature. The ratio is calculated by dividing the yield of a municipal bond by the yield of a Treasury bond with the same maturity.

Separately Managed Account (SMA) type of investment portfolio owned by an individual investor but managed by a professional investment manager.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually ex-pressed annually as a percentage based on the investment's cost, its current market value or its face value. Yields and distribute rates are historical and subject to change.

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

Yield to worst (YTW) refers to the lowest possible yield an investor can expect to receive on a bond, assuming the issuer does not default.

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