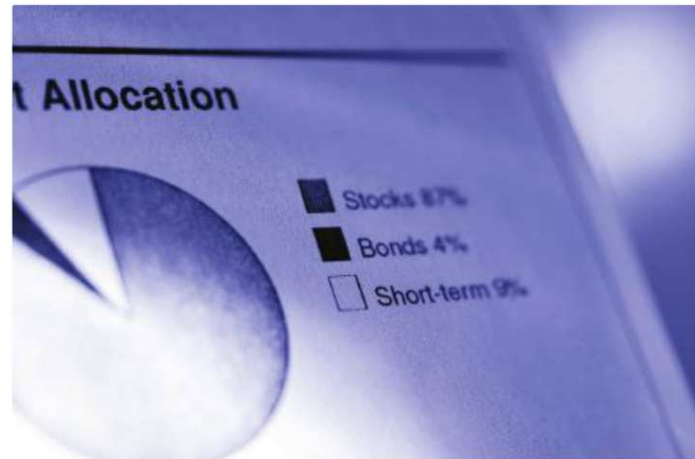
Municipal Bonds: Tax-Friendly Investing

BY AMIT PATEL, CPA/PFS, CFP®

Municipal bonds have long been the staple investment choice for many investors who are looking for tax-free income. These types of bonds are issued by state and local governments to fund various infrastructure projects, finance capital improvements and support other general public purposes. Similar to corporate and U.S. government bonds, interest is paid to the bond holder as compensation for investing in the bonds. The key difference with municipal bonds is that the interest paid to the bond holder is tax-free for federal income tax purposes. In most cases, the interest received may also be tax-free for state income tax purposes. The favorable tax treatment of these bonds can create valuable tax planning opportunities for many taxpayers.

Individuals in higher-income tax brackets tend to benefit more from investing in municipal bonds than individuals in lower-income tax brackets. A person in the 25 percent tax bracket would not receive the same tax benefit that a person in the 39.6 percent tax bracket would receive. Another important component to analyze is the taxable equivalent yield on a particular municipal bond. This is critical when comparing different bond investments, especially when evaluating non-taxable bonds, like municipal bonds, to taxable bonds, like corporate bonds. Suppose a local government municipal bond yields 3 percent and the investor is in the 35 percent tax bracket. The investor is comparing the local government municipal bond to a corporate bond yielding 4 percent. On the surface, the corporate bond's yield looks more favorable than the municipal bond's yield; however, the taxable equivalent yield on the municipal bond is actually 4.62 percent. In this example, the municipal bond is a more attractive investment to the investor in comparison to the corporate bond. Other factors such as state income taxation may increase the taxable equivalent yield and make municipal bonds even more attractive to the investor.



There are other non-tax related factors to evaluate before investing in municipal bonds. Understanding the default risk of the bond issuer is a vital component in the investment decision process. Although defaults of local and state governments are rare, the credit ratings of the municipal bond issuer help to determine the yield derived from the bond. For instance, a bond with a lower credit rating will generally provide a higher yield to account for the higher inherent risk in the bond. On the other hand, bonds with higher credit ratings will generally provide lower yields to the investor. Interest rate risk is another factor that should be considered carefully when investing in all types of bonds. Bonds are generally fixed-rate investments and changes in overall market interest rates can potentially affect the total overall return on the bond investment. If you are holding a fixed 4 percent yielding bond and market interest rates rise to 5 percent, your bond becomes less desirable in the market and eventually loses market value. This can be detrimental if you do not hold the bond to its stated maturity date. Other factors such as inflation risk, liquidity risk, call risk and regulatory risk should be considered in all bond investment decisions.

Municipal bonds can be an effective tax planning tool, specifically for those in the higher-income tax brackets. It is important to consult with your CPA and financial advisor to discuss the tax and financial planning merits of investing in municipal bonds.

AMIT PATEL

Amit Patel is a licensed Certified Public Accountant and CERTIFIED FINANCIAL PLANNER™ practitioner with A.P. Accounting & Tax Services in Sanford. Mr. Patel has also been awarded the Personal Financial Specialist designation by the American Institute of Certified Public Accountants (AICPA) for demonstrating a high degree of expertise in the practice of financial planning. His practice areas include tax planning, financial planning and business consulting. To learn more about A.P. Accounting & Tax Services, visit www.apflcpa.com.

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