HOW TO DETERMINE IF MUNICIPAL BONDS ARE RIGHT FOR YOU


After 2018 tax reforms, are tax exempt bonds less attractive?

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The changes from an extensive tax reform package went into effect in 2018, and most taxpayers are assessing how they are personally impacted by the modified tax code. The top federal tax rate for single and married filers dropped from 39.6% to 37% (these rates ultimately become 43.4% and 40.8% when accounting for the 3.8% net investment income tax). What does this mean for tax exempt bonds and why? Have lower rates made tax exempt bonds less attractive? Most importantly: How can you determine if municipal bonds are appropriate for you? This brief article provides answers to these questions and more.

WHAT IS A MUNICIPAL BOND?

A municipal bond (also frequently called a muni) is debt issued by a state or municipality. Investors are attracted to municipal bonds because they are generally exempt from Federal taxes, and potentially exempt from state and local taxes for residents located in the same state as the issuer. Simply put: investors have the ability to reduce their tax burden by allocating from taxable bonds to municipal bonds.

WHY DOES THE FEDERAL GOVERNMENT PERMIT TAX-FREE BONDS WHEN THEY ARE LOOKING FOR WAYS TO INCREASE REVENUE?

Municipal debt serves as a low-cost way for cities and states to fund infrastructure and finance capital improvements. The interest rate, or more specifically the interest payments, on the bond represent the true cost to the state or municipality. Investors are willing to accept a lower rate on tax-exempt debt, wisely recognizing that the after-tax return is more important than a nominal return. Financially stable states with full employment and growing economies are positives for the Federal Government because sound infrastructure typically attracts corporations that pay healthy salaries to employees, who happen to pay federal taxes.

SHOULD I SELL MY CURRENT MUNICIPAL BOND HOLDINGS NOW THAT TAX RATES HAVE DECLINED?

The simple answer is no. Financial markets are forward looking, and lower taxes rates have already been priced into the municipal bond market. The modest decline in individual tax rates had a negligible impact on bond prices, and a strong argument could be made that the change in tax rate had no impact.

Had individual tax rates declined substantially, expecting the price of existing municipal bonds to lose value would have been reasonable. Why? When tax rates decline, tax-exempt interest payments become less valuable. Ultimately bond market pricing will adjust. New municipal bonds would be required to increase the rate of interest paid, and existing municipal bonds would decline in price to reflect the new tax equivalent yield.

Bond pricing is very complicated, an extensive explanation of influencing factors is beyond the scope of this article. Owners of individual bonds should not lose sight of the fact their initial investment will be returned once the bond matures, regardless of what happens with tax rates. If you purchased a $50,000 ten-year municipal bond when top federal tax rates were 50 percent, you will receive $50,000 at the end of ten years even if the top rate is 30 percent at maturity.

SHOULD I BUY NEW MUNICIPAL BONDS? UNDERSTAND YOUR TAX EQUIVALENT YIELD

Determining whether you should invest in municipal bonds is quite simple, however it is an exercise very few take the time to understand. Corporate bonds (and most other bonds) are taxed as ordinary income. On the other hand, most municipal bonds are exempt from federal taxation; for the purpose of this calculation we will ignore the benefit of a state tax deduction.

Whether you find yourself in the highest marginal tax bracket, (today's top federal rate is 40.8 percent when including the investment income tax) or in one of the lower brackets, you can calculate your tax equivalent yield by subtracting your tax rate (in decimal form) from one. Example: (1-0.408=0.592). The next step is to divide the yield of your municipal bond by the reciprocal of your tax rate (0.592). An equation for the problem reads {Municipal bond yield}/(1-your marginal tax rate). Illustrations may help with understanding tax equivalent yield. Two scenarios are explained below, one using today's tax rates, and a second assuming a hypothetical decline in interest rates.

EXAMPLE 1:

An investor in today's highest tax bracket is considering allocating $100,000 to a corporate bond or to a municipal bond:

- A fully taxable corporate bond is yielding five percent
- A municipal bond is yielding three percent. The investor's tax equivalent yield is
  - 3.0%/(1-0.408)=5.07%

The taxable bond would pay $5,000 in interest annually, however the investor would owe $2,040 in taxes for a net return of $2,960. An investment in the municipal bond would generate $3,000 annually tax free. In this instance, three percent is more than five percent!

EXAMPLE 2:

Let's assess a hypothetical example where the highest tax bracket drops to 33 percent. Bond market pricing would adjust accordingly, meaning the spread in yield between municipal bonds and taxable bonds would narrow. An investor in this hypothetical tax bracket is deciding between:

- A fully taxable corporate bond yielding four percent
- A municipal bond yielding three percent. The investor's tax equivalent yield is
  - 3.0%/(1-.33)=4.48%

Once again, the municipal bond is more attractive to this particular investor. In fact, the municipal bond yield could drop to 2.70% and remain the superior investment option. While the difference in net return was negligible in the first example, the spread is generally much wider for investors in the highest tax bracket. What does this statement mean in simple terms? For investors in the top tax bracket, municipal bonds typically offer a significantly higher tax equivalent yield relative to taxable bonds.

ARE MUNICIPAL BONDS ONLY SUITABLE FOR INVESTORS IN THE TOP TAX BRACKET?

While we would prefer to provide a definitive response to this question, the answer is "it depends on a variety of factors." Generally, the answer to this question is "no;" however, bond pricing dynamics often change based on a host of variables which are beyond the scope of this article. Market pricing often creates an environment where tax free bonds are favorable for investors in the top three or four tax brackets. A quick tax equivalent yield calculation will typically provide an answer to this question.

A variety of additional factors should be considered prior to allocating funds to municipal bonds or any other investment. Credit quality, maturity, inflation expectations, and regional demographics may influence bond pricing. You should consult with a professional to determine if municipal bonds are an appropriate component of your larger investment strategy. The authors welcome your questions. ■

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