

Bond Case Briefs

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Muni Bond Math: A Tax Time Refresher

Summary

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Municipal bonds, which are issued by state and local governments, occupy a special place in the investing landscape.

For most investors, the choice of a muni bond fund is primarily driven by the need for tax-efficient income. The income from these bonds is exempt from federal income tax and sometimes state income taxes as well.

Tax preparers everywhere are explaining to clients what they can expect with this year's tax filing. Going forward, investors will be seeking ways to minimize that future tax burden, especially for those in states with high state and local taxes (SALT).

Municipal bonds, which are issued by state and local governments, occupy a special place in the investing landscape. The income from these bonds is exempt from federal income tax and sometimes state income taxes as well. This treatment can make them especially attractive for investors looking for ways to minimize their tax burden.

It's all in the math

To account for their tax benefit, municipal bonds tend to have lower yields than comparable taxable securities, such as corporate bonds or U.S. Treasuries. Calculating a tax-equivalent yield lets you fairly compare these two types of bonds.

The formula is straightforward:

$$\text{Tax-equivalent yield} = \text{Muni bond yield} / (1 - \text{tax rate})$$

In 2019, the highest marginal tax bracket is 37% and the 3.8% Health Care Act tax also applies to investment income, giving us a maximum marginal tax rate of 40.8%.¹ Thus, if you had a muni bond that was yielding 2%, then it had a tax equivalent yield of 3.4% ($2\% / (1 - 40.8\%)$). In other words, a taxable bond would need to yield at least 3.4% to provide a comparable return.

Ramping up tax efficiency with ETFs

For most investors, the choice of a muni bond fund is primarily driven by the need for tax-efficient income. But the income is only part of the story. Here is a checklist you can use to help determine the tax efficiency of a muni bond investment:

Consider state-specific options if you live in a high-SALT state

For many investors in high-tax states, such as California or New York, only \$10,000 of state income taxes can be deducted.¹ State-specific funds let investors deduct bond income from their federal and state tax returns.

Minimize capital gains payouts

Both mutual funds and exchange-traded funds (ETFs) must pay out any realized capital gains. According to data from Morningstar, 33% of intermediate-term municipal bond mutual funds paid out capital gains in 2018. These distributions may be taxable events, increasing an investor's tax burden.

Look out for AMT-eligible securities

Income from bonds issued by non-governmental entities, such as a development project for a municipal airport, might be subject to the alternative minimum tax. These bonds might yield more to make up for this tax treatment, but the bond holder will have to report this income and potentially pay tax on the interest. When evaluating an individual bond, mutual fund or ETF, make sure to check for the AMT exposure. (This can typically be found in the annual report or a fund company's website.)

iShares muni bond ETFs check all three tax efficiency boxes. They have:

- Monthly income that is exempt from federal income taxes.
- A history of no capital gains payouts. Since 2007, no iShares municipal bond ETFs have distributed capital gains.
- No AMT exposure. The iShares Municipal Bond ETFs seek to track S&P Municipal Bond indexes that screen out any bonds with income subject to AMT.

Over time, tax savings can have a big impact on your bottom line. April 15 is a good reminder that tax awareness isn't a seasonal activity, but one that's good practice all year around.

¹ Source: Forbes, March 7, 2018; irs.gov.

BlackRock

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