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An Under-the-Radar Tax Benefit in Muni-Bond Funds.

Funds treated differently from individual munis, allowing investors to claim a tax loss

It's common knowledge among many investors that interest from municipal-bond funds are generally free of income taxes. What is not such common knowledge is that, if used right, muni-bond funds may have a negative tax rate.

That is to say, in addition to tax-free income, investors may be able to take a tax loss without actually incurring an economic loss. Because muni investors are typically in a high tax bracket, this strategy may have broad appeal.

The idea revolves around the fact that interest rates have declined and muni-bond coupon payments are higher than the so-called SEC yield. The SEC yield, created by the Securities and Exchange Commission to help comparisons among bond funds, represents the fund's true income and carves out any return of capital that is included in the distribution yield. This creates a potential opportunity, according to Joel Dickson, global head of investment research and development at Vanguard Group.

How the Strategy Works

Muni bonds are typically issued at a premium in excess of the face amount of the bond. Because rates have declined, the premiums are now even greater. For example, if you bought a muni bond (not a fund) at $110 that would mature at $100 in five years, roughly $2 a year is just return of your own principal, though the regulator, the Municipal Securities Rulemaking Board, allows it to be called income. After a year, your $110 cost basis would be adjusted to about $108, and you would see that adjusted cost basis on your brokerage statement. Because the cost basis is adjusted down—something known as amortization of premium—you can't sell it a year later at a loss because you were paid back that principal and have no economic loss.

Bond funds, however, are treated differently than owning the bond directly. The amortization of premium doesn't impact the cost basis and thus losses can be claimed even though none were incurred.

Here's how it can work for you or your client, using the example of a muni fund from Mr. Dickson's firm:

Say the Vanguard Intermediate-Term Tax-Exempt Admiral fund has an SEC yield of 1.35%. Though this is the true income, the total distribution yield is 2.79%, meaning 1.44 percentage points is return of principal from an economic perspective. If this continued for a year, an estimated loss of the net asset value of 1.44 percentage points could occur.

The Tax Benefits

For a $100,000 investment over a year under this scenario, the investor would have been paid

$2,790 in cash, with $1,350 of that in income and $1,440 in return of principal. You could then sell the fund to recognize the $1,440 tax loss and buy a different low-cost muni-bond fund. This capital loss can be used up to the Internal Revenue Service limit of $3,000 a year or an unlimited amount to the extent you have capital gains this loss could offset.

If you have short-term capital gains , you save at an ordinary income-tax rate. Yet even if a long-term capital gain, you may save 25% or more after taking into account the alternative minimum tax and the Medicare tax that affect so many of the higher-taxed investors who typically own munis.

So the tax loss of 1.44 percentage points on a $100,000 investment at a 25% marginal tax rate translates to a 0.36% tax benefit, or a $360 savings. This may not seem like much, but frame the extra 0.36% with the 1.35% SEC yield to give you a 1.71% tax-free benefit.

Pitfalls to Ponder

Tax laws are complex and Mike Piper, author of "Taxes Made Simple," points out that the fund must be held for six months or the losses could be disallowed according to IRS rules. 852(b)(4)(B).

Also, the actual loss is going to vary based on other factors, such as the direction of interest rates, what investor perceptions are of muni-bond risks, and the muni-bond fund used to execute the strategy.

While these factors will result in the loss being either more or less than estimated, the same factors are also likely to be present if an investor owned the muni bonds directly rather than through a fund. And, of course, muni bonds also have risks of real losses whether owned directly or through a fund. But if you decide munis are right for part of a portfolio, the low-cost muni-bond fund can be superior to bonds from a tax perspective.

And beyond a tax perspective, there are 5 other reasons bond funds are superior to owning the bonds directly. When it comes to muni bonds, there are now 6 reasons funds are superior.

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