Are Municipal Bonds Right for You?

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With Republicans now in control of both houses of Congress and President Trump indicating a desire to simplify the tax code, it's fair to expect that a tax cut may be on the horizon. But what would lower taxes mean for tax exempt bonds? Will lower rates make tax exempt bonds less attractive? Most importantly: How can you determine if municipal bonds are appropriate for you? Ahead, we will examine and offer guidance on 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 bonds, represent the trust cost to the state or municipality. Investors will demand a lower rate on tax exempt debt. Financially stable states with full employment and growing economies are positives for the federal government. Sound infrastructure typically attracts corporations paying healthy salaries to employees, who happen to be paying federal taxes.

Should I sell my current municipal bond holdings?

If individual tax rates decline substantially, expecting the price of existing municipal bonds to lose value is certainly reasonable. Why? If tax rates decline, the value of the tax-exempt interest payment is reduced (note the example calculation on page 33 to help articulate the point). Owners of individual bonds should not lose sight of the fact that their initial investment will be returned once the bond matures. If you purchased a $50,000 10-year municipal bond when top federal tax rates were 43.4 percent, you will receive $50,000 at the end of 10 years even if the top rate is 30 percent at maturity.

Individual investors should typically avoid trading bonds for a variety of reasons beyond the scope of this article. An argument could certainly be made that the action an investor should follow is thrown out the window if a municipal bond market crash is inevitable. We are of the opinion the price decline would be marginal. Fortunately, we do have a historical point of reference to support our position. Former President Regan dropped the top marginal tax rate from 50 percent to 28 percent in the 1980s and the municipal bond market survived.

A decline in the top rate over the next few years is highly likely to be less severe. President Trump has proposed reducing the top rate to 33 percent. Congress must find a way to complete tax reform without forcing the deficit to soar. Reaching an agreement could take an extended period of time. President Reagan pledged to simplify the tax code at his inauguration in January 1984; his tax reform act did not become law until October 1986. We would advise against reacting based on legislation that may take years to pass.

Should you buy new municipal bonds? Understand your tax equivalent yield

Determining whether or not you should invest in municipal bonds is actually 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. Most municipal bonds are exempt from federal taxation. For the purpose of this calculation we will ignore the benefit of a state tax deduction.

If you happen to find yourself in the highest marginal tax bracket, today's top federal rate is 43.4 percent. Calculate your tax equivalent yield by subtracting your tax rate (in decimal form) from one. Ex: (1-0.434 = 0.566).

The next step is to divide the yield of your municipal bond by the reciprocal of your tax rate (0.566). An equation for the problem reads {Municipal bond yield} / (1-your marginal tax rate).

Example 1: Consider an example for an investor in the highest tax bracket who is considering allocating $100,000 to a corporate bond or 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 percent / (1-0.434) = 5.30 percent

The taxable bond would pay $5,000 in interest annually, however the investor would owe $2,170 in taxes for a net return of $2,830. 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: The highest tax bracket drops to 33 percent; consequently, the spread between municipal bonds and taxable bonds has narrowed. An investor 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 percent / (1-0.33) = 4.48 percent

Once again the municipal bond is more attractive to this particular investor. In fact, the municipal bond yield could drop to 2.75 percent and continue to offer a more attractive tax equivalent yield.

Conclusion

A variety of additional factors beyond the scope of this article should be considered prior to allocating funds to municipal bonds or any other investment. You should consult with a professional to determine if municipal bonds are an appropriate component of your larger investment strategy. ■

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