Would a 4% Taxable Equivalent Return Make You A Bond Investor?

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by Stan Richelson and Hildy Richelson

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Among advisors, 4% is the magic number for retirement planning. We are told that the only way to achieve this return is to allocate a substantial amount to risky assets, such as stocks, real estate and alternative investments. It is possible, however, to earn a return of 4% from the lowly, misunderstood tax-exempt municipal bond.

To broaden your understanding of the meaning of *return*, focus on the distinction between a before-tax and after-tax investment. Investments that provide before-tax returns include stocks and stock-funds, corporate and Treasury bonds and bond funds, REITS and certificates of deposit.

An after-tax return is what an investor can spend in the stores or on-line – e.g. gifts and trips. The interest returned on tax-exempt municipal bonds ("muni bonds" hereafter) is an after-tax amount. The interest is paid twice a year and is swept into your money market account. It does not make a sound. It does not go ka-ching! There is no nightly news report or app alerting you to the increase in your wealth.

Interest payments are so quiet that some of our clients need reminding that the cash coming into their money market account is tax-exempt. How do you know it is actually tax-exempt? It will show up on page one of your federal Form 1040 on line 2a as tax-exempt interest. It is reported, but is not included as taxable income.

If you are in a high federal income tax bracket, you will benefit significantly from owning muni bonds. If you are subject to a high state-tax burden, muni bonds may further enhance your after-tax return.

To understand the true financial and tax value of muni bonds, you must dive into some technical concepts. The thought of saving taxes might spur you on. You will learn a new financial calculation and some tax rules. But, all you need to come away with is that muni bonds will lower your taxes and help you achieve your financial goals.

Investing for the highest after-tax return

You must view every investment through a tax lens: How will the return from this investment be reported on my tax return?

To make this calculation, you must first determine your highest federal income tax bracket. This is called your *marginal tax bracket*, the tax rate on your last dollar of taxable income. To find out your marginal tax bracket, type “marginal tax bracket calculator” into a search engine or ask your accountant.

Federal tax brackets range from 10% to 37%. Once you know your marginal tax bracket you can then compare the return you would get on an investment that is taxable with one that is not.

Muni bond interest is not subject to federal income tax (with some exceptions). Therefore, to appreciate the value of a tax-exempt investment to you and compare it to a taxable one, we use a calculation called the *taxable equivalent return*, which is based upon your marginal tax bracket.

The following formula makes the comparison and equates the return on a taxable investment and a muni bond:

Taxable investment rate x (1 – your top marginal tax bracket) = Tax-free bond rate

Federal tax example

Assume that the taxable investment rate is 6% and your marginal federal tax bracket is 37%. The computation would be as follows:

.06 x (1 - .37) = (.06 x .63) = .0378 or 3.78%

In this example, a taxable yield of 6% is equivalent to a tax-free yield on a muni bond of 3.78% if you are in the 37% federal tax bracket. Stated another way, if you can get 3.78% return on a muni bond, it is the equivalent to a return on a taxable investment of 6%.

State tax considerations

The above computation doesn’t take into account state or local income taxes. They also have a considerable impact on your investment returns. Here are the highest effective tax rates in selected states for 2018:[i]

Effective State Tax Rates

California	13.30%
New Jersey	10.75%
New York State	8.82%
New York City & New York State	12.76%
Connecticut	6.99%
Maryland	8.95%

If you live in a high-tax state and you buy bonds issued by your state of residence or municipality, in-state muni bonds provide an even greater benefit. Using the computation above, you would add your state (and possibly city) marginal tax bracket to your marginal federal tax bracket. You can understand how this might impact you in the following example.

A recent bond issue: New York State Housing Finance Agency Affordable Housing Revenue Bonds

The New York State Housing Finance Agency, Affordable Housing Revenue bonds were issued on March 12, 2019. They were rated Aa2 by the Moody's Rating Service. In calculating the benefits of owning these bonds, we are assuming that the investor is in the 37% marginal federal tax bracket.

New York State Housing issue sold two-year bonds coming due in 2021 and every year thereafter until 2031 – 12-years out. Those bonds are called *serial* bonds because they have sequential maturities, with bonds coming due in every year. In addition, there were *non-sequential bonds* offered in 2034, 2039, 2044, 2049 and 2052.

Here are some selected returns shown in the table below. In the 2021 maturity, the bonds paid a 1.65% tax-exempt return per year. In the 37% marginal federal tax bracket that is equivalent to an estimated taxable equivalent yield of 2.619%. The issue pays an estimated tax-equivalent return of 4.048% to holders of bonds maturing in 2027, 5.159% for bonds maturing in 2034, 6.032% for bonds maturing in 2049, with a whopping 6.11% in 2052.

Investing in a laddered bond portfolio takes long-range thinking. If pension funds and insurance companies purchase these bonds, don't you think they would help you as well?

New York State Housing Finance Agency,

Affordable Housing Revenue Bonds

Dated March 12, 2019

Year	Tax-exempt Rate	Federal taxable equivalent Return
2021	1.65	2.619
2027	2.55	4.048
2034	3.25	5.159
2049	3.82	6.032
2052	3.85	6.111

Since this is a New York State offering, a New York State resident not only receives a federal benefit, but a New York State tax exemption as well. A New York City resident receives an even bigger benefit because the bonds are free of New York State, New York City and federal taxes. For New York City residents, the bonds are triple tax-free.

Tax-wise high net worth individuals in the know have historically turned to high-quality muni bonds because they provide asset preservation as well as one of the last tax shelters. Though this might seem to be a loophole to close up, it is of great benefit to state and city governments as well. This New York State bond issue, for example, supports affordable housing.

Conclusion – Buy muni bonds

The benefit of a muni bond has increased under the new federal tax law.

This is particularly true for many individual taxpayers in high-tax states such as New York, California, New Jersey, Connecticut, Minnesota and Maryland who will now use the standard deduction. Residents in those state can no longer deduct more than $10,000 of their state and city taxes on their federal returns.

One way to preserve your principal and generate a good after-tax cash flow is to invest your money in high-quality muni bonds. These bonds compare favorably with other investments on an after-tax basis, particularly considering their value to preserve your principal when risk markets go into a downdraft.

Stan and Hildy Richelson are the principals of Scarsdale Investment Group, Ltd., a fee-based advisory firm based in Blue Bell, PA. They are co-authors of the book BONDS**:** The Unbeaten Path to Secure Investment Growth*, Bloomberg Press, 2011, second edition.*

[i] “Highest State Effective Tax Rate,” *Fidelity Tax Guide. 2018. p.13.*