



Taxing Matters

Understanding Municipal Bonds

April 2010

Now that the IRS' annual April 15th feast day has passed, taxpayers are left to contemplate their tax (in)efficiencies. Certainly, the expertise of a qualified tax professionalⁱ can help identify legal tax saving strategies which include maximizing deductions & minimizing taxable income. While I won't comment on the former, I can provide some insight on the latter – specifically, municipals bonds. Specifically, we'll examine what exactly municipal bonds are; the different types, how to evaluate, calculating tax equivalent yields and who should consider them.

What are Municipal Bonds?

Municipal bonds are issued by city and state governments to fund public projects such as schools, highways, hospitals, housing, sewer systems and other vital projects. The interest paid by the bond is usually tax free on the local, state and federal level ('triple tax exemption') if purchased by a citizen of the respective state. Residents of certain states such as Indiana, Utah, Nevada, Texas, South Dakota, Washington and Wyoming are granted this triple tax exemption for all states. In effect, an Indiana resident can buy any state's municipal bond and enjoy all its tax benefits. Obviously, since the bond's interest is tax free, it pays a lower rate of interest than corresponding taxable bonds.

Types of Municipal Bonds

There are basically 3 different types of municipal bonds: general obligation, revenue and private activity. General obligation (GO for short), and are backed by the issuer's ability to tax. General obligation bonds are issued to pay for projects such schools and sewer systems. GO's are usually considered pretty safe because they are backed by the tax base. If something goes wrong, just hike taxes to cover the revenue shortfall. Revenue bonds, on the other hand, are serviced by the actual project's revenues. Airports, utility, toll roads and bridges are common examples. Lastly, private activity muni bonds are used to fund projects such as sports stadiums and housing projects.

How to evaluate

The first thing we consider is the bond's rating (i.e. the ability the pay back your money). Just because it's called a municipal bond doesn't mean it's a risk free investment – just ask my dad about the Washington Public Power Supply System bond debacleⁱⁱ (WHOOOPS) – he'll provide a lively earful. But one must consider not only the rating, but the financial backing of the bond, term, calls dates and if it's subject to AMT (alternative minimum tax). A quick note on AMT – for some taxpayers, a portion of the seemingly tax-free income becomes taxable - so be aware. This is especially prevalent on private activity bonds.

Calculating Taxable Equivalent Yields

The purpose for this calculation is to determine if the tax free yield of a muni is more attractive than a similar taxable bond. The tax free yield obviously becomes more appealing for those earners subject to high income taxes. For example: Rich pays 31% federal and 9% state and local taxes. What would a taxable bond have to yield to equal a 5% tax free bond? Simply divide 5 (tax free yield) by .60 (1-tax rate paid) which equals 8.33%. Conversely, you can multiply 8.33 (taxable yield) by .60 to get the tax-free yield of 5%. Fun with math!

Final Thoughts

Municipal bonds are most attractive for higher income earners. With the expiration of the Bush tax cuts & gapping federal deficits, tax rates have only one direction to go – up. Higher taxes will inevitably broaden the appeal of tax free investments like municipal bonds. Sure there is plenty of talk about states like California and Michigan defaulting on their debts – we consider that just political rhetoric. If you are unsure about individual state bonds, consider a well run, low expensed municipal bond fund. Bottom line: municipal bonds make sense for the yield starved and tax adverse investor.

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ⁱⁱ [WHOOOPS](#)