Tax Free Municipal Bonds

Tax free municipal bonds are obligations of state & local government entities. The income from municipal bonds is tax free on your individual federal income tax return. Most states exempt municipal bonds originating in their own state from their state income tax. However, states generally tax bonds issued by other states and their municipalities.

The income from some municipal bonds are subject to the Alternative Minimum Tax (AMT) but are not subject to regular income tax.

There are two basic kinds of municipal bonds. General obligation bonds are backed by the taxing authority of the state or local government that issued them. They include states, counties, cities, special taxing districts, and school districts. Revenue bonds are backed by a particular revenue source. Revenue bonds include projects in areas as diverse as electric, water, sewer, hospital, housing, industrial developments, airports, and student loans.

The bonds are sold in increments of $5,000. Interest is paid semi-annually. While the income is tax free, when the bonds mature or are sold there is generally a small capital gain or loss. Bonds have a fixed maturity date when the principal of the bond is repaid. Additionally, many bonds have a “call” provision. This allows the issuer of the bond to pay the bond off early at predetermined times and often at a small premium.

Municipal bonds are sold by the issuing municipality and are also bought & sold in the secondary markets. Bonds are priced with 100 being “par.” When buying a bond you will also need to find out the “yield” and “yield to worst call.” This is the interest rate you will likely earn on your investment.

To compare the return from a tax free municipal bond to a taxable bond you need to convert the tax free income to your taxable equivalent return. You need your combined federal & state marginal income tax bracket. The formula is:

“Taxable Equivalent Return” = Municipal Bond Rate divided by the total of (100% minus your marginal tax bracket)

For example, you are looking to purchase a tax free bond yielding 5.0% and you are in a 35% combined federal & state marginal income tax bracket. First, take subtract your tax bracket from 100%. In this instance we arrive at 65%. Next divide the answer (65%) into the tax free bond rate (5.0%) to get 7.69%. What this means is that if you invested in a taxable investment yielding 7.69% and paying 35% federal and state taxes leaves you with an after tax yield of 5.0%. So in terms of net cash in your pocket, a taxable investment yielding 7.69% in a 35% tax bracket is equivalent to your 5.0% tax free investment.