

The Preferential Tax Treatment of Municipal Bonds

From an investor's perspective, one valuable benefit of municipal bonds is their preferential tax treatment. Below is a summary of the tax benefits associated with the interest income generated from this type of bond.

Exempt From Federal Taxes

Interest earned on most municipal bonds is exempt from federal taxes. For this reason, the higher an investor's tax bracket, the more beneficial a municipal bond investment will be. Interest from certain municipal bonds can be taxable for alternative minimum tax (AMT) purposes, if you are subject to AMT in the year you receive the interest. Generally, AMT bonds have a higher yield than non-AMT bonds. Your financial advisor can help you determine which bonds may be AMT bonds. You can work with your tax advisor to determine whether or not you will be subject to AMT in any given tax year.

Potentially Exempt From State and Local Taxes

Generally, interest earned on municipal bonds issued within an investor's home state is exempt from state and local taxes. An investor who purchases an out-of-state municipal bond, however, is subject to state and local taxes on the interest earned.

Exempt From the 3.8% Net Investment Income Tax

The net investment income tax (NIIT) is an additional 3.8% tax that may be imposed on the unearned income of individuals, estates, and trusts. Net investment income includes interest, dividends, capital gains, nonqualified annuities, royalties, rents, and income from passive activities. Interest earned on municipal bonds, however, is exempt from the NIIT.

For additional information on the NIIT and when it may apply, see Section 1411 of the Internal Revenue Code.

Not Includable in Adjusted Gross Income

As a taxpayer's adjusted gross income (AGI) increases, certain tax benefits begin to phase out. Because interest earned on municipal bonds is not includable in a taxpayer's AGI, some of these tax benefits may be preserved. However, some calculations will use a modified AGI (MAGI) to determine the treatment of a particular item, deduction, or credit. In some of these cases, tax-exempt interest is added back in to determine your MAGI. You should consult with your tax advisor to help you navigate the impact of tax-exempt interest on your MAGI.

Not Impacted by the \$10,000 Cap on State and Local Tax Deductions

Under the current law, taxpayers who itemize their deductions may only deduct up to \$10,000 of state and local taxes. Many, if not most, investors who are suitable candidates for municipal bonds will be limited by this \$10,000 ceiling and, therefore, will no longer benefit from a deduction of state taxes paid on taxable investment income, such as interest earned on corporate bonds. The temporary cap on this deduction may make the benefits of a tax-free municipal bond even more valuable compared to a taxable bond.

Although municipal bonds typically yield lower returns than taxable investments, they can be a great fit for investors in the highest tax brackets. By performing a simple tax-equivalent yield calculation, investors can compare the after-tax return of taxable investments to the tax-free return of municipal bonds. Consider discussing the potential benefits of adding municipal bonds to your investment portfolio with your financial advisor and tax professional.

Bonds may be subject to state and alternative minimum taxes, and capital gains tax may apply if bonds are sold prior to maturity. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. Do not rely on this information when making decisions with tax consequences. Stifel does not provide legal or tax advice and will not be held liable for any actions or suits based upon the information provided above. Consult your legal or tax professional if expert assistance is required.

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