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Reduce Your After-Tax Bite with "Munis"

Investing in municipal bonds will diversify your after-tax portfolio, provide you income and reduce your taxes. But first, do the math to see if investing in "munis" is better than investing in taxable bonds.

Normally, bond interest is taxed as high as 35% at the federal level. It's also subject to state and local income taxes, depending on where you live. This means that unless you invest in municipal bonds (munis), you can lose nearly half of the interest earned to taxes.[1]

Municipal bond interest income is free of federal tax, and it's free of state tax if you reside in the state where your bond is issued. That makes munis very attractive compared to U.S. Treasury and investment-grade corporate bonds, two types of taxable bonds with which munis are often compared.

State and local governments issue municipal bonds to finance public projects such as roads, schools and sewer systems. Some munis are "general obligation" bonds, backed by the full faith, credit and taxing power of the issuer. Others are "revenue" bonds, which finance bridges, tunnels, hospitals and other public works and are backed by income from the project.

When you invest in a municipal bond, you're lending money to the municipality, which promises to pay a certain amount of interest (typically every six months) and return your principal on a specified maturity date. You can hold the bond until maturity or sell it beforehand in the marketplace.

The tax-free yield on a municipal bond can be higher (or lower) than that of a taxable bond of comparable credit quality — after you pay income taxes. And the higher your tax bracket, the better your return when compared with taxable bonds.

But if you're in a very low tax bracket, say 10%, munis probably aren't for you. For example, a municipal bond that pays 5.5% won't be as good as an AAA-rated corporate bond paying 7%. To a person who pays 15% in federal taxes, the corporate bond would yield 5.95% after taxes (7% x 0.15 = 1.05% to the government; 7% - 1.05% = 5.95% to you).

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[1] This article presents an overview of municipal bonds and municipal bond funds. Before investing in either, learn the tax rules and confer with your tax and/or investment advisor. Whether in mutual funds or not, bonds are subject to the normal risks associated with investment securities. Past performance does not guarantee future results.

Unlike U.S. Treasury bonds, munis aren't considered totally risk-free from a credit standpoint, even though they are issued by a local governmental entity. Instead, municipal bonds with strong credit ratings can be comparable in risk to blue-chip corporate bonds.

Like corporate bonds, most municipal bonds have credit ratings published by independent national credit-rating agencies, such as Moody's Investors Service, Standard & Poor's (S&P) and Fitch. Some municipal bonds are insured, which means that in the event of a default, the insurance company pays the bondholder. Typically, an insured bond receives a AAA rating.

Market Risk, Call Risk

Like any fixed-income security, a municipal bond's value will fluctuate daily, depending on market conditions, particularly current interest rates. When rates rise, the bond's value declines because it pays a fixed rate of interest that is lower than what the market is offering. Conversely, the bond's value appreciates when interest rates decline. A bond's sensitivity to changes in interest rates will depend largely on its number of years until maturity ─ the longer the time frame, the more sensitive it will be. If you're concerned about market risk, consider investing in a bond with a short maturity, but you'll typically receive a lower yield from a shorter-term bond.

If you're not concerned about market risk because you intend to hold the bond until maturity, consider investing in long-term munis, which may offer a higher yield. Or you might decide to forgo the semiannual income and buy a zero-coupon municipal bond. Zero munis don't pay interest, but you can buy them at steep discounts, because the money you would have received in interest is reinvested for you.

Beyond credit risk and market risk, there's the risk that the issuer will "call" the bond, or retire it before maturity. Some bonds have a call provision that lets the issuer redeem them within, say, 10 years, if interest rates fall significantly. An issuer's ability to call a bond is similar to the homeowner's ability to refinance.

If you're a homeowner, you're no doubt aware that you can refinance your mortgage to take advantage of lower rates if mortgage rates fall. In the municipal bond arena, "callability" is a right that issuers value greatly and are usually willing to pay higher yields in exchange for it. Conversely, if you want protection against calls, you'll probably have to accept a lower yield.

Pros and Cons of Muni Bond Funds

Municipal bond mutual funds are a good way to diversify and minimize call and market risks. If you have $10,000 to invest, you could buy two municipal bonds (minimum denominations are $5,000). Or you could buy shares in a mutual fund portfolio of perhaps 100 different municipal bond issues, understanding that diversification doesn't guarantee

against loss, however. Bond funds also reduce credit risk potential, the risk that a bond you buy will sour.

The chief advantage of a bond fund is convenience: You're actively paying for the services of an experienced portfolio management team to evaluate the bond risks. *Note that both bonds and bond funds are subject to many types of risk, including credit, call, default, inflation, current income and interest rate (or market) risks*.

The disadvantage of a bond mutual fund is that it has neither a fixed yield nor a contractual obligation to pay back the principal at some maturity date, the two main characteristics of individual bonds. Naturally, like other types of funds, bond mutual funds charge fees that can erode returns. (Of course, owners of individual bonds incur transaction fees.) And because bond mutual fund managers constantly trade their positions, a bond mutual fund risk-return profile may continually change. Thus, unlike an actual bond, whose risk level tends to decline the longer it's held, a bond mutual fund can increase or decrease its risk exposure as the fund manager makes portfolio moves.

The one significant tax drawback of mutual funds is that they typically generate capital gains distributions every year. These distributions represent the net profits the portfolio realizes when the mutual fund portfolio manager sells some of the bonds. (Investors in muni bond funds are often surprised to discover capital gains distributions on what they thought was a tax-free investment.) The sale of an individual municipal bond can also generate a capital gain or loss. If you hold the muni for more than one year, you'll pay a long-term capital gains tax that can be as high as 28% or as low as 5%, depending on your tax bracket. If you hold it for less than one year, the federal income tax can be as high as 35%.

Some municipal bonds may be subject to the alternative minimum tax (AMT), a taxation alternative that does away with most write-offs in exchange for a lower tax rate. Typically, you would calculate your taxes using both the regular income tax system *and* the AMT and then pay the higher amount.

Before you invest in an individual municipal bond, check to see if it is subject to the AMT. With a municipal bond fund, you'll need to see if it invests in "private activity" bonds, which are subject to the AMT. These are municipal bonds that are issued to finance projects that involve private enterprises, such as constructing a professional sports stadium.

If you invest in a mutual fund, the prospectus will indicate whether the fund may purchase private activity bonds. For a municipal bond fund to be called tax-exempt or tax-free, it can invest only up to 20% of its assets in private activity bonds. Otherwise, it can only be called a municipal bond fund. At the end of each year, your mutual fund's tax report will tell you the percentage of the fund that is subject to the AMT.

Typically, private activity bonds pay higher yields because they are counted as income for AMT purposes. Under certain circumstances, that can create a favorable

investment opportunity. For example, if you aren't subject to the AMT, you might buy private activity bonds for the higher yield they pay.

Because of the tax-free status of municipal bonds and municipal bond funds, don't put them in a retirement plan, which already shelters investments from taxation. Instead, keep them outside, where you, not Uncle Sam, can enjoy the income.

Comparing After-Tax Yields of Municipal and Corporate Bonds

This table is for illustrative purposes only. Past performance does not guarantee future results.

	5.5% Municipal	**7% Corporate**
Investment	$10,000	$10,000
Interest	$550	$700
Federal Taxes (35% Bracket)	$0	$245
Net Return	$550	$455
After-tax Return	5.5%	4.55%

The Muni Tax-Free Advantage: Let's say you're in the 35% tax bracket and you have a choice between a 10-year AAA-rated municipal bond paying 5.5% interest and a comparable corporate bond paying 7%. In this example, you would prefer the municipal bond, because the tax-free rate of 5.5% is greater than the after-tax yield of 4.55% on the corporate bond.

To learn more about retirement planning and other TIAA-CREF financial services, visit us at **www.tiaa-cref.org**, **schedule an appointment online**, or call a consultant at **800 842-2776.**

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