

Tax aspects of investing in municipal bonds

This section details the federal income tax consequences of investing in tax-free municipal bonds. While I cannot advise you with respect to the purchase of any particular bond, I can explain how the tax rules in this area work, in order to help you make informed comparisons between various alternative investment opportunities.

- **Purchase of bond.** If you buy a tax-exempt bond for its face amount, either on the initial offering or in the market, there are no immediate tax consequences. If you buy such a bond between interest payment dates, you will have to pay the seller any interest accrued since the last interest payment date. This amount is treated as a capital investment and is deducted from the next interest payment as a return of capital.
- **Amortization of bond premium.** If you buy a tax-exempt bond at a premium, you must amortize the premium over the term of the bond, or in some cases to an earlier call date. While no deduction is permitted for the amount of premium amortized in each year, the effect of this is to reduce your basis in the bond by a corresponding amount. Thus, if you buy such a bond at a premium and hold it to maturity, you won't recognize a loss when the bond is paid off.

If you buy a tax-exempt bond at a discount, see below.

- **Exclusion of interest from taxable income.** In general, interest you receive on a tax-free municipal bond isn't includible in gross income (although, as discussed below, it may be includible for alternative minimum tax purposes). While this is an attractive feature, keep in mind that a municipal bond is likely to pay a somewhat lower rate of interest than an otherwise equivalent taxable investment. What is really significant isn't whether the interest is included in income, but rather what the after-tax yield is.

In the case of a tax-free bond, the after-tax yield is generally equal to the pre-tax yield (although alternative minimum tax consequences may also have to be taken into account). In the case of a taxable bond, the after-tax yield will be based on the amount of interest you have left over after taking into account the increase in your tax liability on account of each year's interest payments. This will depend on your effective tax bracket. In general, tax-free bonds are likely to be more attractive for taxpayers in higher brackets, since they receive a greater benefit from excluding interest from income. For lower-bracket taxpayers, on the other hand, the tax benefit from excluding interest from income may not be enough to make up for the lower interest rate generally paid on this type of bond.

I can help you with the effective yield calculations necessary to make a meaningful comparison of different investments.

Even though municipal bond interest isn't taxable, it must be shown on the return. This is because tax-exempt interest is taken into account when determining the amount of social security benefits that's taxable, and may affect the alternative minimum tax computation as well as the earned income credit and investment interest deduction, see below. (Requiring municipal bond interest to be shown on the return also alerts IRS to the potential disallowance of any interest *expense* incurred to carry the bonds, see below.)

- **Tax-deferred retirement accounts.** It generally doesn't make sense to buy and hold municipal bonds in your regular IRA, Keogh, or 401(k) plan account. The income in these accounts isn't taxed currently, but once you start making withdrawals, the entire amount withdrawn is likely to be taxed. Thus, if you want to invest your retirement funds in fixed income obligations, it's advisable to invest in higher-yielding taxable securities.
- **Alternative minimum tax consequences.** Even though interest on municipal bonds is generally excluded from income for purposes of the regular federal income tax, interest on certain "private activity bonds" is included in income for purposes of the alternative minimum tax. Your broker can tell you whether the particular bond you are considering is a private activity bond subject to this rule.

The alternative minimum tax is a separate tax system that applies if the tax determined under that system exceeds your regular income tax. Whether or not the alternative minimum tax applies will depend on your overall tax picture; however, in general, the effect of the alternative minimum tax would be to prevent you from achieving too low an effective tax rate by means of tax-favored techniques such as investing in municipal bonds. I can help you determine how the alternative minimum tax would apply to your situation, and how it would affect the after-tax yield if you were to invest in municipal bonds.

- **Effect of exempt interest on taxation of social security benefits.** In general, a portion of social security benefits is taxable if your adjusted gross income, subject to certain modifications, exceeds specified amounts. For this purpose, the modifications to adjusted gross income include adding in tax-exempt interest. The effect of this rule is that, if you receive social security benefits, investing in municipal bonds could increase the amount of tax you have to pay with respect to the social security benefit. While technically the municipal bond interest remains exempt from tax, the effect is the same as though a portion of that interest were taxable.

I can help you with the calculations necessary to determine whether and how you would be affected by these rules.

- **Effect of exempt interest on earned income credit.** If you are otherwise eligible to take an earned income credit, you will lose the credit completely if you have more than \$2,900 in 2007 (\$2,800 in 2006) of "disqualified income," generally, interest, dividend, nonbusiness rental, passive, and capital gain net income. Disqualified income includes tax-exempt income. Thus, municipal bond income could cause loss of the credit. However, in most cases, an individual who's eligible for the earned income credit will be in a low tax bracket, thus making municipal bonds an unattractive investment in view of their lower yield, as discussed above.
- **No deduction for interest on obligations incurred in connection with tax-exempt investments.** If you borrow money for the purpose of investing in municipal bonds, you can't deduct the interest expense with respect to that borrowing. Moreover, even if the proceeds of borrowing aren't directly traceable to tax-exempt investments, interest deductions could be disallowed if IRS could establish that you continued the borrowing in effect (that is, you didn't pay it off) for the purpose of acquiring or carrying the municipal bonds. If you have otherwise deductible interest and invest in municipal bonds, the effect of this rule, by denying a deduction for interest paid, could be effectively to tax the municipal bond interest.
- **Sale, call or redemption of bond.** Normally, the sale, call before maturity, or redemption of a municipal bond is treated the same as a taxable bond. If you held

the bond long enough, any gain is taxed at favorable rates. Capital losses can be used to offset other capital gains. Up to \$3,000 of any remaining losses can generally be applied against other income, with a carryover of any excess to later years.

- **Market discount on disposition.** Ordinarily, when you sell a bond which you bought in the market, any gain you realize is taxed at favorable capital gains rates (if you held the bond long enough). However, where you buy a bond with "market discount," gain not exceeding the portion of the discount that accrues during the period you hold the bond is instead treated, when you sell it, as ordinary income. This rule applies to tax-exempt municipal bonds bought after April 30, 1993. Since, depending on your tax bracket, ordinary income may be taxed at a higher rate, the effect of this is to reduce the benefit of tax-exempt bonds relative to taxable bonds, in the case of bonds trading at a discount.
- **Municipal bond funds.** If you are looking for diversity and professional management for your municipal bond holdings, you may want to consider buying shares of a mutual fund that invests in tax-exempt municipal bonds. These funds may be broadly based or targeted to the bonds of a particular state. Some "high yield" (junk-bond) municipal bond funds are also available. A fund that's invested at least 50% in tax-exempt obligations may distribute exempt-interest dividends to its investors. These dividends are treated essentially the same as municipal bond interest. To preclude a potential tax loophole, if an investor buys mutual fund shares, receives an exempt-interest dividend, and then sells the shares at a loss within six months after the purchase, the loss is disallowed to the extent of the exempt-interest dividend.