

Municipal bonds for tax-free retirement income

Tax-exempt municipal securities pay interest to U.S. taxpayers that is exempt from income tax. In order to attract investors in high tax brackets, these bonds usually do not need to approach the yields that U.S. Treasury notes or bonds do.

Generally, tax-free “munis” only pay about 75%-90% of the interest that you’d earn on a taxable bond of comparable maturity and credit quality. So, depending on your tax bracket, munis actually may give you higher after-tax income. As the table below shows, upper-income taxpayers may want to take a close look at municipal bonds.

Taxable Equivalent Yields*								
Taxable Income 2008			Tax-Free Yield					
			3.0%	3.5%	4.0%	4.5%	5.0%	
Single Return	Joint Return	Bracket						
\$0 to \$8,025	\$0 to \$16,050	10%	3.33%	3.89%	4.44%	5.00%	5.56%	
Over \$8,025, to \$32,550	Over \$16,050 to \$65,100	15%	3.53%	4.12%	4.71%	5.29%	5.88%	
Over \$32,550 to \$78,850	Over \$65,100 to \$131,450	25%	4.00%	4.67%	5.33%	6.03%	6.67%	
Over \$78,850 to \$164,550	Over \$131,450 to \$200,300	28%	4.17%	4.86%	5.56%	6.25%	6.94%	
Over \$164,550 to \$357,700	Over \$200,300 to \$357,700	33%	4.48%	5.22%	5.97%	6.72%	7.46%	
Over \$357,700	Over \$357,700	35%	4.62%	5.38%	6.15%	6.92%	7.69%	

*Federal tax only. If an investor is subject to state and local income taxes, equivalent yields would be higher.

A fly in the ointment?

While tax-free income is a lure, there is some question whether the attraction is the same for people of retirement age. Concern centers around the effect that municipal bond coupon payments have on Social Security. Although not taxed itself, income from municipal bonds is included in the “provisional income” used to determine how much of each retiree’s Social Security benefit is subject to income tax.

Here's how it works. Your provisional income is one-half of your Social Security benefit plus all your other income for the year, including tax-free income. If this total is more than \$32,000 and less than \$44,000 on a joint return, or between \$25,000 and \$34,000 on a single return, you pay tax on up to 50% of your benefit. Above those limits the taxable amount increases to a maximum of 85%.

The calculation may be complex, but if your provisional income exceeds those upper limits, it makes no difference whether it comes from taxable or nontaxable sources, Uncle Sam will tax 85% of your benefit. Nonetheless, if your income does not reach those limits, municipal bonds actually can reduce the tax exposure of your Social Security benefit.

How would that work? Because the interest yield from munis is lower than that of taxable government or corporate bonds of comparable maturity and credit quality, you have less bond interest to include in provisional income.

For those with too much income to qualify for lesser taxation of their Social Security benefit, the switch to tax-free income won't provide the same double kick. However tax-free bonds still may be valuable, especially for those in the top marginal tax brackets.

Time for a tax break?

If you think that municipal bonds or a municipal bond fund is right for you, you most likely will want to seek out investment-grade issues, or those that carry insurance. In our low-inflation environment, you won't get very much yield advantage by subjecting yourself to greater risk, and you don't want to spend your retirement years losing sleep over your income sources.

Also, you probably will want to stick with plain vanilla "general obligation" bonds to ensure continued tax exemption and freedom from possible exposure to the dreaded alternative minimum tax. Of course, we would be happy to consult with you on the role that tax-free municipal bonds appropriately might play in your retirement portfolio.

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Any developments occurring after January 1, 2008, are not reflected in this article.

