

# The Basics of Tax-Free Investing

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**T**ax-free securities, also called municipal (or muni) bonds because they are largely issued by local municipalities, provide income that generally is exempt from federal, and possibly state and local, taxes. They appeal strongly to investors who want tax-free income, especially those in the highest tax brackets. But the decision to invest in tax-free securities needs to be made in the larger context of building and maintaining an appropriate investment portfolio.

In general, your fixed-income portfolio allocation should be based on your time horizon, and your holdings should be diversified among domestic and international investment-grade and high-yield bonds. Once you have made those decisions, then you can determine if tax-free securities are appropriate for your portfolio.

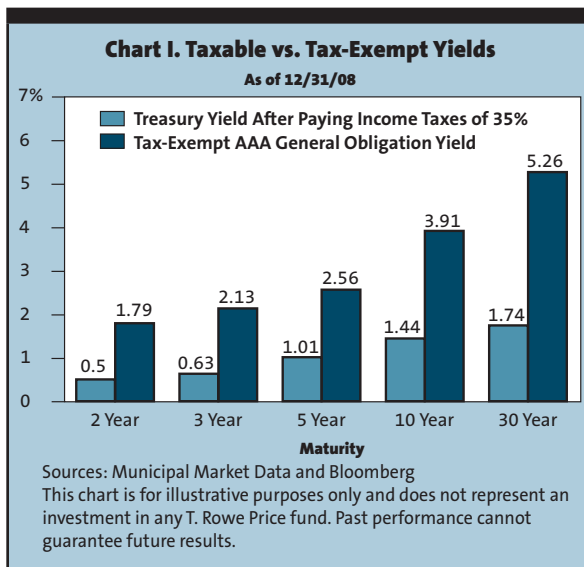
### After-tax income—the bottom line

While there are several factors that can go into the selection of tax-free securities for your portfolio, the most obvious and immediate is after-tax income. Because of their tax advantages, municipal bonds offer lower yields than those on taxable bonds. But once the taxes are paid on the income from taxable bonds, investors might find that municipals would have provided a higher income stream.

That is why municipal investors look closely at after-tax income. The Finding Taxable-Equivalent Yields worksheet below will tell you what taxable return you would have to earn to equal the tax-free return on a municipal security. For example, an investor in the 25% federal tax bracket would need a taxable security yielding at least 8.0% to equal or exceed a 6.0% yield on a municipal security.

Worksheet: Finding Taxable-Equivalent Yields			
		Example	Your Calculation
Line 1	Enter the tax-free yield	5.0%	_____ %
Line 2	Subtract your federal tax bracket, expressed as a decimal, from 1.00	1.00 – .25 = .75	_____
Line 3	Divide the tax-free yield (Line 1) by Line 2 to find the taxable equivalent yield	$\frac{5.0}{.75} = 6.67\%$	_____ = _____ %

In theory, the after-tax yields on comparable taxable and tax-free yields should be the same. But because there are several tax rates and numerous other factors influencing the bond markets, it is not unusual for either municipal or taxable bonds to offer a significant after-tax yield advantage. Bear in mind, however, that municipals are not appropriate investments for qualified retirement plans and other tax-advantaged accounts, where the higher income on taxable bonds will already be shielded from taxes.



### Don't forget state and local taxes

Municipal bond income also can be exempt from state and local taxes, which can enhance their after-tax value. If you want to know by how much, though, a few additional steps are required. Since state and local income taxes are a deduction on your federal Form 1040 (if you itemize), merely adding all the tax rates together exaggerates your effective tax bracket. Instead, the calculation must be modified as follows:

1. Multiply the number in Line 2 on the Finding Taxable-Equivalent Yields worksheet by your state (or combined state/local) tax rate
2. Add the result to your federal tax rate
3. Express the result as a decimal
4. Subtract this number from 1.00
5. Divide this result into the tax-free yield

For example, a California resident in the highest federal (35.0%) and state (9.3%) tax brackets would (1) subtract 0.35 from 1.00 to get 0.65; (2) multiply 0.65 by 9.3% to get 6.045%; and (3) add 6.045% to 35.0% to get a combined effective tax bracket of approximately 41.0%.

To determine the taxable security yield necessary to equal a 6.0% tax-free yield, the California investor would divide 6.0% by  $(1.00 - 0.41)$ , or 0.59. The answer is 10.17%.

*When comparing yields in this manner, make sure that you are comparing securities or mutual funds of similar maturity and credit quality or the comparison will not be valid.*

### Basics of municipal securities

Once you've determined that municipals can offer you a better after-tax yield, you'll next need to understand a bit more about them and how they behave.

- *Types*—General obligation municipals (GOs) are backed by the issuer's full taxing and revenue-raising powers. Revenue bonds depend on the income earned by a specific project or authority, such as road or bridge tolls, user fees for water, or revenues from a publicly financed business (perhaps a hospital or utility).

- *The meaning of "tax-free"*—The interest income you receive is exempt from federal income taxes. In addition, most states do not tax income earned on their own obligations. Thus, a New York City bond owned by a New York City resident is exempt from New York state, city, and federal income taxes—triple-tax-free. The same bond owned by a resident of another state would be exempt from federal income taxes but subject to their own state's income tax.

### Risks associated with municipal securities

Municipal bonds are subject to both interest rate and credit risk.

- *Interest rate risk*—The potential for price fluctuation due to changes in interest rates. The longer a bond's maturity (i.e., the length of time until the bond's maturity date), the higher its potential interest rate risk.

- *Credit risk*—The possibility that a borrower will not make timely interest and principal payments (that is, it will default). Municipal bonds are rated for their viability just as most corporate bonds are. Credit risk increases with lower-quality bonds. Because states have significant control over their financial resources, very few municipals receive "junk bond" ratings, and defaults are exceedingly rare. Still, prices on munis can move significantly when ratings change, for better or worse.



**Table I: How Interest Rates May Affect Bond Prices**

Price per \$1,000 of a Municipal Bond if Interest Rates:		
Bond maturity in years	Rates fall 1% and the bond's value rises to:	Rates rise 1% and the bond's value drops to:
1	\$1,009.62	\$990.57
3	\$1,027.75	\$973.27
5	\$1,044.52	\$957.88
10	\$1,081.11	\$926.40
30	\$1,172.92	\$862.35

Chart assumes a 5% coupon and \$1,000 par value for each bond and shows value changes apart from fluctuations caused by other market conditions or factors.

### Including tax-free bonds in your portfolio

Tax-free securities may be an appropriate fit for the fixed-income portion of a diversified investment portfolio. Once you've determined how much of your fixed-income portfolio should be invested in short-, intermediate-, and long-term U.S. investment-grade and high-yield securities, you could consider substituting taxable bonds with tax-free securities with similar attributes, such as a comparable maturity date and credit quality.

Rather than purchasing individual bonds, many investors may find it easier to invest a portion of their fixed-income assets in tax-free bond funds. Such funds usually focus on short-, intermediate-, or long-term municipals or on investment-grade or high-yield securities. There are numerous advantages to investing via mutual funds.

■ *Diversification*—Without investing a very large sum of money, it is difficult to assemble a portfolio representing enough different bond issuers to significantly reduce interest rate and credit risks. Of course, diversification cannot assure a profit or protect against loss in a declining market.

■ *Credit research*—Because the market is large but fragmented and inefficient, obtaining up-to-date credit information for decision-making and monitoring requires considerable time and resources. Many mutual fund managers can draw on proprietary research by professional analysts for selecting and tracking portfolio holdings.

■ *Liquidity*—Anytime you wish, you can sell some or all of your mutual fund shares at their current net asset value, often with no transaction costs. Individual bonds are less liquid, and small sales can incur steep transaction costs.

■ *Services*—These might include monthly interest reinvestment or checkwriting.

There are a few disadvantages as well.

■ *Lack of a maturity date*—An investor holding an individual bond knows it will pay off at face value upon maturity if there are no early redemption features and it does not default. A bond fund has no maturity date—and thus no certainty regarding how much the investment will be worth at any future date.

■ *Expenses*—Mutual fund fees and charges are often smaller than the transaction costs of buying a specific bond, but they are charged annually and can add up. It is necessary to examine these fees, listed in the fund's prospectus, carefully to make sure they are not excessive.

■ *Capital gain distributions*—These distributions are taxable whether you take them in cash or reinvest in additional shares.

Many investors overlook municipal bonds in their portfolios. But munis often offer investors excellent value, regular income, and a lower tax bill. All investors can benefit from examining whether munis suit the fixed-income portion of their portfolios.

Insights reports provide background information on many aspects of investing. *Call 1-800-638-5660 to request a prospectus, which includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.*

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