



What Every Muni Investor Should Know About Tax-Equivalent Yields

Once you've identified your income-tax bracket, a simple math formula can help you decide if tax-exempt municipal bonds may be right for you.

It's easy to spot the difference between apples and oranges at your local market. For investors attempting to discern the advantages of tax-free municipal bonds over taxable corporate bonds, it's more like apples to apples. And it takes more than a simple eye test to ensure a fair and accurate comparison.

After all, municipal bonds ("munis" for short) and investment-grade corporate bonds share many common attributes. Both fixed-income types can offer attractive yields, boast relatively high credit quality, and can help diversify equity-heavy portfolios. But since the income earned on munis is generally exempt from federal income taxes, a careful investor needs a reliable tool for sizing up the tax advantages of munis, especially when, at first glance, it might appear that taxable bond yields are superior.

That's why learning how a municipal bond's tax-equivalent yield is calculated could be a useful thing to know.

A tax-equivalent yield is the return calculation that puts a taxable bond and tax-exempt muni on equal footing. Computing the tax-equivalent yield helps investors understand how much a tax-exempt bond may save them in taxes. This provides a fairer way to compare the potential tax-free benefits a muni investor could receive vs. taxable alternatives whose yields are quoted pre-tax.

Calculating Your Tax-Equivalent Yield Is Easy

By identifying your current tax bracket, you can quickly calculate whether a municipal bond offers a yield that's competitive with its taxable equivalent. The formula looks like this:

$$\text{Tax-Equivalent Yield} = \frac{\text{Tax-Free Municipal Bond Yield}}{100 - \text{Tax Bracket}}$$

Key Points

- While municipal bonds and corporate bonds have many similarities, the income earned on munis is generally exempt from federal income taxes.
- To truly discern the potential advantages of a tax-free muni vs. a taxable equivalent, it's helpful to know how a municipal bond's tax-equivalent yield is calculated.
- By identifying your current tax bracket, you can quickly figure out whether a municipal bond's yield is competitive with the quoted pre-tax yield of a taxable bond.

Client Conversations

Here's an example: Consider a married couple that files joint taxes and earns somewhere between \$89,450 and \$190,750. Of the seven current federal tax brackets, this couple would fall into the 22.00% bracket (see **FIGURE 1**). Now, say the couple has found a municipal-bond issue with a quoted yield of 4.50% and a competing 5.15% corporate bond. Which yield would make the taxable corporate bond a clearly preferable choice over the municipal alternative?

After plugging the numbers into the tax-equivalent yield formula, it's easy to see that the muni actually offers a more attractive yield:

$$\text{Tax-Equivalent Yield} = \frac{\text{Tax-Free Municipal Bond Yield}}{100 - \text{Tax Bracket}}$$

$$\text{Or: } 4.50\% \div (100 - 22\%) = 5.77\%$$

The formula reveals that, for investors whose adjusted gross income (AGI) falls into the 22.00% tax bracket, a pre-tax corporate bond would have to yield at least 5.77% to be competitive against the municipal bond earning 4.50% with its built-in tax savings. As **FIGURE 1** also shows, the tax-equivalent yields for tax filers in the two highest tax brackets offer the greatest potential to exceed the yields of comparable taxable bonds.

FIGURE 1

Single and Married Filers: Finding the Tax-Equivalent Yield That Matches Your Tax Bracket

		Municipal Bond Yields:				
		1.50%	2.50%	3.50%	4.50%	5.50%
Income falls between...	2023 federal tax bracket	A taxable investment would have to yield...				
\$0 to \$11,000 (Single)	10.00%	1.67%	2.78%	3.89%	5.00%	6.11%
\$0 to \$22,000 (Married)						
> \$11,000 to \$44,725 (Single)	12.00%	1.70%	2.84%	3.98%	5.11%	6.25%
> \$22,000 to \$89,450 (Married)						
> \$44,725 to \$95,375 (Single)	22.00%	1.92%	3.21%	4.49%	5.77%	7.05%
> \$89,450 to \$190,750 (Married)						
> \$95,375 to \$182,100 (Single)	24.00%	1.97%	3.29%	4.61%	5.92%	7.24%
> \$190,750 to \$250,000 (Married)						
> \$250,750 to \$364,200 (Married)	27.80%*	2.08%	3.46%	4.85%	6.23%	7.62%
> \$182,100 to \$200,000 (Single)	32.00%	2.21%	3.68%	5.15%	6.62%	8.09%
> \$200,000 to \$231,250 (Single)						
> \$364,200 to \$462,500 (Married)	35.80%*	2.34%	3.89%	5.45%	7.01%	8.57%
> \$231,250 to \$578,125 (Single)	38.80%*	2.45%	4.08%	5.72%	7.35%	8.99%
> \$462,500 to \$693,750 (Married)						
> \$578,125 (Single)	40.80%*	2.53%	4.22%	5.91%	7.60%	9.29%
> \$693,750 (Married)						

* Includes additional 3.80% net investment income tax surcharge that may be imposed on single filers with modified AGI in excess of \$200,000 or married joint filers with AGI in excess of \$250,000. Single = tax brackets shown for single tax filers; Married = tax brackets shown for couples who are married and filing jointly. For illustrative purposes only. Source: IRS.gov.

And Don't Forget the 3.80% Net Investment Income Surcharge

As for those higher tax brackets, they're worth a closer look. Officially, the four highest brackets, as determined by the Internal Revenue Service (IRS) for 2023, stand at 24.00%, 32.00%, 35.00%, and 37.00%. But because of an additional 3.80% federal tax surcharge that's used to finance Medicare and other subsidies paid through the Affordable Care Act, the highest brackets actually end up being 27.80%, 35.80%, 38.80%, and 40.80%. The surcharge is officially known as the Net Investment Income Tax, and it nearly always applies to high-income earners who have either excess amounts of net investment income¹ or excess AGI (as determined by an IRS threshold). The surcharge is applied to whichever category of excess income is less.

If you're wondering whether interest income from munis could be considered net investment income subject to the 3.80% surtax, the good news is that they're not.² This is a potential positive to consider when weighing the potential advantages of muni bonds. But, as in most matters concerning taxes, your financial professional or tax professional can help you compare yields on tax-exempt municipals vs. taxable alternatives so that you'll be less likely to confuse the apples from the oranges at tax time.

Talk to your financial or tax professional to help you assess the potential advantages of municipal bonds.

¹In general, investment income includes, but is not limited to: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments, or commodities and businesses that are passive activities to the taxpayer (within the meaning of section 469 of the Internal Revenue Code). To calculate net investment income, a taxpayer's investment income is reduced by certain expenses properly allocable to the income. Source: IRS.gov.

²Although municipal-bond interest generally isn't subject to federal taxes, the IRS does include income from such bonds in your modified AGI when determining how much of your Social Security benefit is taxable. Source: schwab.com.

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