

Municipal bonds for tax-free retirement income

Tax-exempt municipal securities pay interest to U.S. taxpayers that is exempt from federal income tax. Because of that fact, traditionally, munis have not had to pay interest rates as high as those of U.S. Treasury bonds. So investors in high brackets could do better with munis because their after-tax return turned out to be higher than with taxable bonds. But recently, many investors have been reluctant to lend money to cities and states that could be facing financial crises. The concern has kept many investors out of the muni market, driving yields up and prices down. In 2008 some yields topped 6% on long-term issues, significantly higher than what taxable Treasuries have been offering.

A fly in the ointment? Although 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?

At a time when many states and cities are facing their own financial crises, it's not unrealistic for someone considering an investment in a municipal bond or bond fund to be concerned about the potential default on interest or principal payments. To help keep that risk to a minimum, consider seeking out investment-grade issues, or those for which you can purchase insurance.

Also, you probably will want to stick with plain vanilla "general obligation" bonds that are considered less risky than revenue bonds and, in addition, won't face possible exposure to the 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, 2009, are not reflected in this article.