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# LEARN | Understanding Tax-Equivalent Yield

3 minutes

Understand how taxes can impact your clients' returns on bonds and how a simple calculation can help maximize outcomes.

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## Did You Know?

Tax equivalent yield is equal to:

$$\text{Tax-free bond yield} \div (1 - \text{marginal tax rate})$$



## Key Takeaway

When considering potential investments in different types of bonds, clients should evaluate yields on a tax-equivalent basis, taking into account the taxes they would owe on the interest earned from each.





## Compare a 3.6% In-State Bond to Other Investments

### Hypothetical Example: Pretax Yield Needed for Equivalent After-Tax Income

Compare the pretax yield and total tax rate for four investment types. In this example, the taxpayers make \$280,000/year and are married, filing jointly. Their combined top tax rate is 32.8% (this includes a federal marginal tax rate of 24%, net investment income surtax of 3.8% and state tax rate of 5%). For purposes of this example, we will assume in-state municipal bonds yield 3.6%.

Total Tax Rate

Break-Even Yield

 <b>In-State Bond<sup>1</sup></b>	0%	3.6%
 <b>Out-of-State Municipals<sup>2</sup></b>	5.00%	3.79%
 <b>U.S. Treasury Bonds<sup>3</sup></b>	27.80%	4.99%
 <b>Other Debt Instruments<sup>4</sup></b>	32.80%	5.36%

## Next Step

By understanding the tax treatment of different bond categories, you can help guide clients toward more tax-efficient investment strategies.

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## Tax-Equivalent Yield Calculator

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#### Disclosure



<sup>1</sup> In most states, interest on in-state municipals is not subject to state or local income tax.

<sup>2</sup> In most states, interest on out-of-state municipals is subject to state income tax and applicable local income tax.

<sup>3</sup> Interest received on U.S. Treasuries is exempt from state and local income taxes.

<sup>4</sup> Other debt instruments include corporate bonds and loans, debt issued or guaranteed by Ginnie Mae, Fannie Mae, Freddie Mac and other federal agencies that are not backed by the full faith and credit of the U.S. government, and the sovereign debt of other countries, among others. Interest on other debt instruments is taxable as ordinary investment income.

This hypothetical illustration is provided solely to demonstrate the long-term effect of applying mathematical principles to an assumed set of facts. Actual results will differ and could be substantially different.

The Firm does not provide tax advice. The tax information contained herein is general and is not exhaustive by nature. Tax laws are complex and subject to change. Investors should always consult their own legal or tax professional for information concerning their individual situation.



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