



SIEBERT

INTRODUCTION TO:
Municipal Bonds

Municipal BONDS

Definition:

State and Municipal Bonds (hereafter referred to as Municipal Bonds) are debt obligations of state and local governments. The bond issues can support general needs of the issuer or specific projects. Many (although not all) Municipal Bonds are federally tax exempt and many residents have state and local tax exemptions as well.

TYPES OF MUNICIPAL BONDS

Municipal Bonds fall into two general categories:

- **General Obligation Bonds:** Backed by the full faith and credit of the municipality. Repaid from general revenue of the municipality. Considered to have a lower risk than revenue bonds.
- **Revenue Bonds:** Used to fund specific projects – bridges, tunnels, highways, etc. Repaid from the revenue of the project (i.e. tolls). Generally, the investor has no recourse should the project turn out to be unprofitable.

REASONS TO INVEST

- ✓ **Safety:** Many municipal bonds are backed by strong municipalities and states that have sufficient revenue to cover their debt.
- ✓ **Taxation:** Many municipal bonds are tax-free on the federal level. Residents may be completely tax exempt from Federal and State taxes if their home state issues the debt.
- ✓ **Yield:** Total yield on municipal bonds may be higher than corporate bonds given the reduced or exempt tax treatment.

DEFINITION:

When comparing Municipal Bonds to other investments, it is important to calculate the Taxable Equivalent Yield. This is the interest rate one would need to receive if the issue was fully taxable to be equivalent to the municipal issue. The taxable equivalent yield is as follows:

$$\frac{\text{Interest Rate (municipal bond)}}{(1 - \text{Tax Rate})} = \text{Interest Rate (taxable bond)}$$

EXAMPLE:

An investor is trying to decide between a federally tax free municipal bond paying 5% and a 6% corporate bond. Both are taxable at the state level but only the corporate bond is subject to the 25% federal income tax. The investor considers all other factors, such as risk, to be the same.

The taxable equivalent yield is:

$$\frac{5\%}{(1 - 0.25)} = 6.67\%$$

Therefore, the investor has determined that the municipal bond provides a higher yield when including tax implications.

MUNICIPAL BOND FUNDS

Municipal Bond Funds are often an attractive alternative to municipal bonds for investors. The funds often have lower minimum investment levels. Municipal bond funds can diversify risk by investing in a variety of revenue and general obligation bonds in a single state. Investors need to be aware of tax implications and carefully review which assets the funds invest in to ensure they are not subject to taxation.

Fun Facts

- Prior to the Tax Reform Act of 1986, almost all Municipal Bonds, including private purpose bonds, were entirely tax free at the Federal level.
- Certain Municipal Bonds are actually triple-tax exempt from Federal, State, and Local Taxes. These include certain issues from U.S. Territories such as Puerto Rico and Guam.

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800.872.0444

**www.SiebertNet.com
15 Exchange Place | Suite 615
Jersey City, NJ 07302**

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