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## Feeling blue at tax time? Consider municipal bonds

### IT'S YOUR BUSINESS

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**Q: I live in New Jersey and seem to be getting clobbered on taxes. How can I earn additional income without losing it all to taxes? Are there tax-advantaged investments?**

The problem: Taxes, taxes, taxes. While we are all proud to be taxpayers, few of us would volunteer to pay more taxes than are necessary. Yet, everyday we subject our savings to additional unnecessary taxes. The 1099 statements we are receiving around this time of year by our financial institutions can be viewed as a punishment for trying to earn additional income.

The solution: Tax-advantaged investments. No, we are not talking about risky, unregistered investments in the Cayman Islands. To the contrary, we are talking about some of the most secure, lowest risk investments available in the financial markets — municipal bonds.

In simple terms, municipal bonds are debt securities offered by states, local governments or non-profit organizations. Interest from municipal bonds is generally federal and state tax-free.

Like a bank, investors loan money to the municipality for an agreed upon period of time and interest rate. Unlike a bank, where deposits are federally insured, municipalities must compensate investors for accepting a higher level of risk because the bonds are not federally insured.

Many municipal bonds carry the highest credit rating available, AAA. This compares to many of the world's most profitable companies, which carry only an A rating. Many municipal bonds are backed by the municipality's taxing power and are called general obligation bonds. Additionally, commercial insurance companies insure some municipal bonds. This private insurance provides timely payment to bondholders if the issuer defaults on payments.

Like all bonds, municipal bonds carry traditional risks. Interest rate risk, the most prevalent risk, says the value of a bond will decline if interest rates increase. This is logical. As interest rates increase, investors demand higher rates on new bonds and will only purchase lower-yielding bonds at a lower price. Although credit risk is a key risk with most fixed income investments, it is a relatively small risk with municipal bonds.

- Double tax-free municipal bonds.

Can a 5 percent bond be more attractive than a 7 percent bond? Yes.

Imagine a New Jersey resident purchases a West Windsor 5 percent municipal bond that is federal and state tax-free. The bondholder would avoid paying 35 percent federal and 8 percent state income taxes — or a total of 43 percent. The New Jersey resident who purchases a 7 percent taxable bond would wind-up earning a mere 4 percent after taxes.

The investor who does their homework quickly realizes that the 5 percent tax-free bond is more attractive than the 4 percent after tax bond.

- Taxable municipal bonds.

Is there such a thing? Yes.

Some municipal bonds are actually taxable because the federal government will not allow the offering to have tax-free status if the financing is for activities that do not provide a significant benefit to the public. A good example would be the funding of a sports arena. So, if you see a Trenton sports arena municipal bond offering providing a 6 percent yield when similar municipal bonds are yielding 5 percent, pay close attention. The investor who does their homework may realize that the 5 percent tax-free municipal bond is more attractive than the 3.4 percent after-tax municipal bond.

- Individual bonds vs. bond funds.

Investors can purchase individual municipal bonds or municipal bond mutual funds. Individual municipal bonds entail the risk of default by an individual issuer. For example, if Newark were to default on a power plant municipal bond, investors could see only a part or none of their investment returned. If a municipal bond mutual fund, which owned 100 individual bonds, owned the same bond in its portfolio the damage would be significantly mitigated. Like a stock mutual fund, a bond mutual fund provides diversification and professional management.

Action step — consider municipal bonds. Tax-free municipal bonds can provide a healthy addition to an investment portfolio. The combination of safety and recurring income can make them an ideal investment in any market environment.

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