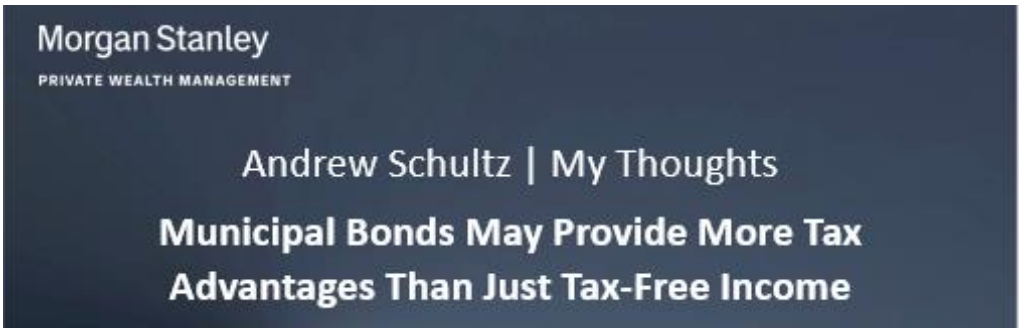

In the excitement of a bull market, who wants to talk about boring municipal bonds? I do, for many reasons. When it comes to highly appreciated stocks with a large embedded capital gains tax liability, municipal bonds may be very helpful in reducing that tax burden. In this article, I will provide a basic explanation of how this is possible and explain how municipal bonds work.

Most municipal bonds are issued at a $1,000 face value, pay a fixed amount of interest, and have a set maturity. For example, a $1,000 municipal bond with a 4.5% interest rate (coupon) and a 10-year maturity will pay $45 of federally tax-free income every year and return $1,000 when the bond matures. During the life of the bond, its market value can fluctuate up or down, usually based on prevailing interest rates and other factors. So, no matter the value of the bond, as long as it does not default, it will pay $45 interest annually and $1,000 will be returned to the investor at maturity.

Another useful feature of municipal bonds is municipal tax loss swapping, which can help reduce current capital gains liability.

Let me explain. I will use two fictitious bonds and a hypothetical story for this example.

Two years ago, when rates on long-term municipal bonds were lower, an A+ rated bond for the Gotham City sewer system was purchased at $1,000 (par) with a 4% coupon. Today, new long-term municipal bonds rated A+ are being offered at $1,000 with a 4.5% coupon. As a result, the Gotham City sewer bond is now trading at $940. Its value decreased as interest rates rose. Meanwhile, an AA-rated Emerald City school district bond with a 4% coupon is trading at $940 and has a similar maturity to the Gotham bond. If the Gotham bond is sold at $940 and the Emerald bond is simultaneously purchased at $940, a $60 tax loss will be realized, the $40 annual income will be maintained, and $1,000 will be returned at maturity. This strategy allows for a $60 capital loss now that could be used against a current or future realized capital gain.

Again, please remember this is a fictitious example.

There are additional nuances and considerations when attempting this strategy, such as avoiding de minimis tax issues and understanding bond calls. This is why it is important to work with a team that has experience and knowledge in municipal bonds. This is an area I have been working in for over 34 years.

I have a saying: "It is not what you make when investing; it is what you keep after taxes." This is why, at The Schultz Group at Morgan Stanley, we aim to minimize taxes without sacrificing returns.

Municipal tax loss swapping is one of our valuable tools. With over 37,000 municipal bond issuers in the U.S., opportunities for tax-loss municipal swaps are abundant.

If you would like to discuss this further, please do not hesitate to reach out to me.

Thank you,

Andrew Schultz
Private Wealth Advisor

Disclaimers:

This illustration is hypothetical and shown for illustrative purposes only. The illustration is not intended to predict the returns of any particular investment, which will fluctuate with market conditions. Actual results may differ from those depicted in the illustration.

Interest on municipal bonds is generally exempt from federal income tax. However, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, local tax-exemption typically applies if securities are issued within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made. NOTE: High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

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Tax-loss harvesting. IRS rules stipulate that if a security is sold by an investor at a tax loss, the tax loss will not be currently usable if the investor has acquired (or has entered into a contract or option on) the same or substantially identical securities 30 days before or after the sale that generated the loss. This so-called “wash sale” rule is applied with respect to all of the investor's transactions across all accounts.

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