Is There Such a Thing as a Tax-Free Investment?

The simple answer to this question is “yes.” There are two main types: (1) municipal bonds and municipal bond mutual funds and (2) tax-free money market funds.

Municipal bonds are issued by state and local governments in order to finance capital expenditures; typically, municipal bond funds invest in municipal bonds. Municipal bonds are generally free of federal tax because the interest from bonds issued by a state, municipality, or other local entity is exempt from federal taxation.

As an added benefit, most states will allow a state tax exemption if the owner of the bond resides in the state of issue. However, if you purchase a bond outside your area of residency, it may be subject to both state and local taxes.

If you buy shares of a municipal bond fund that invests in bonds issued by other states, you will have to pay income tax. In addition, while some municipal bonds that are in the fund may not be subject to ordinary income tax, they may be subject to federal, state, or local alternative minimum tax. If you sell a tax-exempt bond fund at a profit, there are capital gains taxes to consider. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance.

Municipal bonds come in a variety of forms and should be selected by strict criteria based predominantly on the state’s or municipality’s ability to service the debt. It’s important to remember that the principal value of bonds may fluctuate with market conditions. Bonds redeemed prior to maturity may be worth more or less than their original cost. Investments seeking to achieve higher yields also involve a higher degree of risk.

Tax-free money market funds invest in short-term notes of state and local governments and can provide a high amount of liquidity. Money market funds can be invested in a wide range of securities, so it is important to analyze your options carefully before investing.

Money market funds are not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. Although money market funds attempt to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in such a fund.

If you decide to invest in either type of tax-exempt security, consider the different options carefully. You can purchase individual bonds, which come in denominations of $1,000. Or you might consider investing in a municipal bond mutual fund, a portfolio of bonds in which you can invest for as little as $500. Municipal bonds can also be purchased through a unit investment trust, a closed-end portfolio of bonds with minimums of $1,000.

Often tax-exempt securities are the most favorable for those in higher tax brackets, so it's important to determine whether buying them would be an advantageous move for you. To decide whether municipal bonds or money market funds would be an asset to your portfolio, calculate the taxable equivalent yield, which enables you to compare the expected yield of the tax-exempt investment with its taxable equivalent.

For instance, if you are in the 28% federal income tax bracket and invest in a municipal bond yielding 5%, this is equivalent to investing in a taxable investment yielding 6.94%. If you are in the 35% tax bracket and invest in the same bond, it would be the equivalent of investing in a taxable investment yielding 7.69%.

Also be aware that tax-exempt income is included in the formula for determining taxes on Social Security benefits. In some instances, it may be necessary to limit your tax-exempt income by shifting to other tax-advantaged investment areas.

If they're in line with your investment objectives, tax-exempt securities can be an excellent means of reducing taxable income. Check your options with your tax advisor.

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.