The right **ideas**.

The right **results**.

Achieved with the right **firm**.

Taxable versus Tax-exempt Investments

Michael Hermes, Tax Senior

For some high-income taxpayers, their tax liability due to the IRS was unusually high this past tax season, and not for the most obvious reason–the 2013 increase in the top income tax rates. Instead, some high-income taxpayers were subject to the new Net Investment Income Tax (NIIT), a complex additional 3.8% levy on certain investment income.

These higher tax rates may have taxpayers considering allocating a portion of their investments from taxable to tax-exempt investments. Primarily due to the fact that interest and dividends earned on tax-exempt investments not only escape ordinary income tax rates that can be as high as 39.6%, but also the Net Investment Income Tax. While those new, higher income tax rates apply only to taxable income exceeding $406,750 for single or $457,600 for a couple (2014), the NIIT affects a broader range of taxpayers, those with modified adjusted gross income (MAGI) above $200,000 for single or $250,000 for a couple. Also, the threshold for the NIIT is not adjusted for inflation.

Of course there are many factors to consider when making an investment, but, when comparing taxable investments to tax-exempt investments; one important aspect is the after-tax return of the investment. Depending on your tax bracket and state tax consequences, the difference on the return between taxable and tax-exempt investments can be significant.

Tax-exempt investments, such as municipal bonds, usually carry a lower stated interest rate than taxable bonds of similar quality and safety, for example. However, much of the appeal of investing in municipal bonds is that, depending on your tax rate, their after-tax yield can exceed the after-tax yield from a bond that pays a higher rate of taxable interest. While interest on tax-exempt bonds is not subject to federal income tax, gains and losses on the sale of a tax-exempt bond are recognized. Therefore, the tax effect of disposing of a tax-exempt bond prior to maturity should be considered. Controlling the timing of such gains or losses is easier when bonds are individually held versus through a mutual fund. Investors in tax-exempt bond mutual funds recognize gains passing through from the fund or, in some cases, when they dispose of their shares in the mutual fund.

The current higher tax rates for high-income taxpayers can make tax-exempt investments an attractive alternative to taxable investments. Taxpayers should make sure to consider the tax effects of their investments in deciding that type of investments would result in the greatest net benefit.

29125 Chagrin Blvd. Cleveland, Ohio 44122
Phone 216-831-0733 • Fax 216-765-7118 | www.zinnerco.com

Your Success is our Business.