



Investment Insights

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Reduce Your Taxes Today!

As tax season mercifully draws to a close, many of us once again feel like too much of our earnings are going to pay taxes, and not enough is staying in our pockets. This feeling is largely justified, as recent studies by The Tax Foundation have shown that the average American taxpayer works 86 days each year to pay Federal taxes, and an additional 37 days to pay state taxes. The same study indicates that a larger portion of the average American taxpayer's income goes to paying for government than food, clothing, and shelter *combined!*

When it comes to reducing your taxes on investment income, there is a perfectly legal and simple way to keep the tax man out of your wallet: municipal bonds. Municipal bonds are generally bonds issued by state and local governments to raise money for projects such as schools, transportation systems, and hospitals. These bonds have stated maturities ranging from as little as six months to as long as 30 years. Most bonds are rated according to quality, and many are insured for payment of interest and principal. The beauty of municipal bonds is that the interest they pay is free of Federal taxes! Additionally, bonds issued within an investor's state of residence can be free of state taxes, as well!

There are two ways to invest in municipal bonds: individually, and through mutual funds. For an investor looking to diversify in individual bonds, it is generally preferable to have at least \$100,000 to invest so that the money can be spread out over four or five different bonds of varying quality and maturities. Although individual bonds can be purchased in increments as small as \$5,000, this is much like buying 10 shares of a stock—it can be more expensive to buy in small amounts, and hurt your returns on your investment. Individual bonds pay interest semi-annually, and the principal amount of the bond is returned to you upon maturity, much like a CD.

For an investor looking to invest less than \$100,000 in municipal bonds, or an investor who is concerned about properly diversifying their investment, mutual funds can be an excellent way to invest in tax-free municipal bonds. Many of the larger municipal bond funds own hundreds of individual bonds, giving shareholders broad diversification of their investment. Most tax-free mutual bond funds also provide tax-free *monthly* income to shareholders. The initial investment required in many of these funds can be as little as \$1000, and subsequent investments can be as little as \$50 at a time. In addition to

accessibility, these funds employ professional managers to manage the portfolio through uncertain times such as those we've experienced in California in the past few years.

How should you determine whether to invest in tax-free bonds? Here is a useful exercise: take the yield currently available on tax-free bonds (for example, a five-year AAA-rated California tax-free bond currently yields approximately 3.30% as of 4/2/02), and divide this number by {100%-your tax bracket}. This gives you the yield you would need to earn on a taxable investment to have the same money *after taxes* in your pocket.

$$\frac{\text{Available tax-free yield}}{100\% - \text{your tax bracket}} = \text{Taxable equivalent yield}$$

In this example, if you are a taxpayer in the 35% combined state and Federal tax bracket, you would need a 5-year CD or other taxable investment to yield just over 5% to be equivalent to a 3.30% tax-free bond. If CD yields are lower, you will be better off with the tax-free bond.

With taxes fresh in our minds, now is a great time to review your investment income and determine if tax-free bonds might fit into your portfolio. Remember: *it's not what you earn, but what you keep!*

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