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Tax-Free Income: Should You Consider Municipal Bonds?

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Municipal bonds can offer investors an enticing advantage: tax-free income. This means the interest earned is often exempt from federal taxes and, in many cases, state taxes as well. This can be an appealing feature for investors in higher income tax brackets who are looking for ways to keep more of what they earn.

WHAT ARE MUNICIPAL BONDS?

Municipal bonds, often referred to as "munis," are issued by state and local governments to fund public projects like schools, roads, bridges, and other infrastructure. Think of them as a loan that investors make to local governments to help finance community improvements.

There are two main types of municipal bonds:

- General Obligation Bonds (GO) – These bonds are backed by the full faith and credit of the issuing municipality. They are considered lower-risk because they are secured by the taxing power of the municipality.
- Revenue Bonds – These bonds are backed by the revenue generated from a specific project being funded. They tend to carry a higher risk since repayment depends on that project's income. However, they usually offer a higher yield to compensate for this additional risk.

In addition to steady, tax-advantaged income, municipal bonds also serve a broader public good by financing projects that benefit local communities.

However, while munis are often viewed as "safe," investors should also keep in mind:

- Credit risk – Though defaults are rare, municipalities can face financial distress.
- Call risk – Many bonds can be called (paid back early), which may impact long-term income.

Balancing tax benefits with these risks is key to making the right decision.

FEDERAL AND STATE TAX BENEFITS

Municipal bonds are exempt from federal income taxes to encourage investment in public works. In many cases, they are also exempt from state and local taxes if you live in the state where the bond is issued.

Example: If a Massachusetts resident buys a bond issued by the Commonwealth of Massachusetts, they may avoid both federal and state taxes on the interest earned. However, if that same person buys a bond from Florida, they would still owe Massachusetts state income tax on the interest.

Important Planning Note: Not all bonds issued within your state are automatically exempt from state taxes. Some bonds, even if issued locally, may still be taxable depending on how they are structured. In addition, while municipal bond income is generally excluded from taxable income, it is still included in your Adjusted Gross Income (AGI) for purposes of calculating Medicare's Income-Related Monthly Adjustment Amount (IRMAA). This means tax-exempt interest could push certain retirees into a higher IRMAA bracket, resulting in higher Medicare premiums. For example, $40,000 of muni bond income could raise a couple's AGI enough to increase their annual Medicare Part B and D premiums by more than $2,000 (you can refer to the 2025 Important Numbers PDF to view the various tax brackets).

AMT CONSIDERATIONS

Alternative Minimum Tax (AMT) is designed to ensure high-income earners pay at least a minimum amount of tax. While most municipal bonds remain exempt, certain private activity bonds (used for projects like hospitals, sports arenas, or housing developments) may be taxable under AMT rules.

This makes it critical to review the characteristics of each bond carefully before investing. Coordination with your financial and tax professional is highly recommended.

UNDERSTANDING TAX-EQUIVALENT YIELD

Tax-equivalent yield (TEY) is a tool used to compare the value of a tax-free bond to a taxable investment. It shows what a taxable bond would need to yield to match the after-tax return of a municipal bond.

$$\text{Tax-Equivalent Yield} = \frac{\text{Tax Free Yield}}{1 - \text{Tax Rate}}$$

Example: If you are in the 35% tax bracket and a municipal bond offers a yield of 3%, the tax-equivalent yield would be:

$$\text{Tax-Equivalent Yield} = \frac{3\%}{1-0.35} = \frac{.03}{.65} = 4.62\%$$

This shows us that a taxable bond would need to yield 4.62% to match the after-tax income of the 3% municipal bond. This comparison helps investors evaluate whether a muni bond or a taxable bond provides better net value.

Important Planning Note: It is especially important to review your tax bracket annually to determine if investing in Municipal Bond funds are the right fit for your portfolio. There is a significant Tax-Equivalent Yield difference when someone is in the 35% bracket vs. 12% bracket.

THE GRIMES PERSPECTIVE

Municipal bonds can be a valuable addition to a diversified portfolio. With their combination of tax advantages, community impact, and steady income, they can be especially appealing to high-income investors in high-tax states. However, because of nuances like AMT exposure, state-specific rules, credit risk, and call features, municipal bonds aren't a one-size-fits-all solution. If you're wondering whether muni bonds fit into your tax strategy, ask your Grimes Advisor to run a personalized tax-equivalent yield analysis and evaluate how they complement your broader financial plan.

Related: What Are Treasuries, Municipals, and Corporates? Bond Types Explained

This article is part of an ongoing series aimed to help build overall financial literacy, and was co-authored by Grimes & Company's Financial Planning Associate Matthew Licata*, as well as summer intern Gavin Walsh. While not a comprehensive deep dive into every single topic, it is designed to provide a helpful overview to key topics within the world of investing and financial planning. Please* reach out to connect *with an advisor or expert on the subject to learn more and start planning for your financial future.*