

Better conversations. Better outcomes.

Tax reform: What does this mean for your tax-free investors?

Changes in tax rates, tax reform, tax exemptions, etc. are ever-present conversations in the news these days. The consensus appears that some type of tax reform for both individuals and corporations is on the table. Municipal bonds are a big draw for investors looking for income exempt from federal taxes and your tax-free investor clients may be worried about the impact cuts may have on their tax-free income.

Many investors fear that muni bonds will lose value if income tax rates are reduced. The belief is that reduced tax rates will lower the attractiveness and thus the demand for tax-exempt bonds.

We've put together a list of reasons why your clients might want to keep calm and carry on with their tax-free allocations.



There is no correlation between municipal bond prices and changes in income tax rates. If tax rates for individuals drop by several percentage points, as proposed by the Trump administration, municipal bonds will not necessarily cheapen relative to corporate and treasury bonds.



Many municipal investors are not in the highest marginal tax bracket. The average tax rate of holders of municipal bonds is in the 25%-28% range - much lower than the highest tax bracket at 39.6%. The current proposal to lower the highest rate to 33% may cause some adjustment in muni pricing; however, many investors will continue to reap the after-tax benefit over taxable bonds.



Lowering the corporate tax rate could have an impact on demand for munis. However, corporations, like banks and insurance companies, only own about 20%-25% of municipal bonds.

To help your clients determine the impact of any reductions in income tax rates, calculate the tax equivalent yield to show the tax-adjusted returns on their muni bonds. The formula for the calculation is:

$$\text{Tax free yield} \div (1 - \text{tax rate}) = \text{Tax equivalent yield}$$

Here's an example of using the formula — for a client with a tax rate of 25%, we want to know the taxable equivalent yield of a municipal bond paying 3%:

$$0.03 \div (1 - 0.25) = 0.04$$

3%
tax free yield

25%
tax rate

4%
tax equivalent yield

With this example, your client would need a taxable bond with a yield of 4% to get the same return as a muni bond.

Here's a cheat sheet of the taxable equivalent yields based on each tax bracket. Please note that this is based on federal income tax only and does not include state income tax. While there is still a lot of uncertainty with regard to "if" and "when" any tax reform policies will be enacted, municipal bonds will continue to provide tax-exempt benefits.

Tax equivalent yield per marginal tax rate

Tax-free yield	10% tax bracket	15% tax bracket	25% tax bracket	28% tax bracket	33% tax bracket	35% tax bracket	39.6% tax bracket
2.00%	2.22%	2.35%	2.66%	2.77%	2.98%	3.08%	3.31%
2.50%	2.78%	2.94%	3.33%	3.47%	3.73%	3.85%	4.14%
3.00%	3.33%	3.53%	4.00%	4.17%	4.48%	4.62%	4.97%
3.50%	3.89%	4.18%	4.66%	4.86%	5.22%	5.38%	5.79%
4.00%	4.44%	4.71%	5.33%	5.55%	5.97%	6.15%	6.62%
4.50%	5.00%	5.29%	6.00%	6.25%	6.71%	6.92%	7.45%
5.00%	5.56%	5.88%	6.66%	6.94%	7.46%	7.69%	8.27%
5.50%	6.11%	6.47%	7.33%	7.63%	8.20%	8.46%	9.11%
6.00%	6.67%	7.06%	8.00%	8.33%	8.95%	9.23%	9.93%
6.50%	7.20%	7.65%	8.66%	9.02%	9.70%	10.00%	10.76%
7.00%	7.78%	8.24%	9.33%	9.72%	10.44%	10.77%	11.59%

Source: BMO Global Asset Management

Continue the conversation

BMO Global Asset Management Better Conversation Guides provide insights into some of the biggest challenges to your success.

Visit the Advisor Resources section on the BMO Global Asset Management Viewpoints website at bmogamviewpoints.com for additional resources and information to help make your next client conversation a better conversation.

Contact us

-  1-844-BMO-Fund (266-3863)
-  bmogamviewpoints.com
-  [bmo-global-asset-management](https://www.linkedin.com/company/bmo-global-asset-management)
-  bmogam.com/betterconversations

The opinions expressed here represent our judgment at this time and are subject to change. This is not intended to serve as a complete analysis of every material fact regarding any company, industry or security. Information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

BMO Global Asset Management is the brand name for various affiliated entities of BMO Financial Group that provide investment management and trust and custody services. Certain of the products and services offered under the brand name BMO Global Asset Management are designed specifically for various categories of investors in a number of different countries and regions and may not be available to all investors. Those products and services are only offered to such investors in those countries and regions in accordance with applicable laws and regulations. BMO Financial Group is a service mark of Bank of Montreal (BMO).

BMO Asset Management Corp. is the investment advisor to the BMO Funds. **BMO Investment Distributors, LLC is the distributor.** Member FINRA/SIPC.

Securities, investment advisory and insurance products are: **NOT FDIC INSURED — NOT BANK GUARANTEED — MAY LOSE VALUE.**

© 2017 BMO Financial Corp. (5762725, 5/17)