

Tax Free Interest vs. Taxable Interest. Which is better?

Here's how to compare the yield on a tax-free bond with the yield on a taxable investment. For example, what taxable yield would you have to get to exceed a 7% tax-free return? A fairly straight-forward formula can be applied to come up with comparative yields if you know your tax bracket. Here's how it works:

Say you're in the 28% federal income tax bracket, so an additional dollar of taxable income would cost you 28 cents in additional tax. You have learned of an investment opportunity which offers a 7% tax-exempt yield. You want to know how this compares effectively with your taxable investment opportunities.

(1) Subtract your tax bracket from 1. This equals 0.72 (1 minus 0.28).

(2) Divide the tax-exempt yield (7%) by the figure arrived at above (.72).

The result is 9.72%. This means that you would need to earn 9.72% on your taxable investment to equal the 7% you would earn on the tax-exempt one.

If you know the taxable yield but seek a comparable tax-free yield, the computation is even easier. Simply subtract the taxable percentage from the taxable yield. That is, if you're in the 28% bracket, you'll keep 72% of your income. Thus, a taxable 8% yield translates into an after-tax yield of 5.76% (8 times 0.72).

Note that the above computations only take the federal income tax into consideration. If your income is subject to state or local taxation which the tax-exempt income avoids as well, you would have to use your total effective tax rate in your calculations to arrive at a more precise result.

Be careful in coming up with your effective state income tax rate. Remember that your state income tax is deductible for federal tax purposes. Thus, for a taxpayer in the 28% federal bracket, a 3.07% PA income tax is effectively only 2.21% (3.07×0.72) because each dollar taxed by the state saves 28 cents in federal taxes.

There may be other adjustments to make as well, so if you seek greater precision, please contact us.