

Using Municipal Bonds for After-Tax Returns

Municipal bonds may be attractive investments for high-net-worth individuals because their income returns are usually exempt from federal income taxes and, in some cases, state and local income taxes. In contrast, interest income from U.S. government bonds is subject to federal income taxes, while corporate bonds are generally fully taxable. The taxable-equivalent yield compares the municipal bond yield with that of a taxable bond. If you live in a state that collects a state income tax, the calculation of the taxable-equivalent yield should be adjusted to reflect the fact that interest income on government bonds is exempt from state income taxes. Your state and local income tax rates may also be factored in if you are investing in locally issued tax-exempt bonds.

Individuals may invest in municipal bonds by purchasing individual bonds, by investing in a mutual fund, or through a privately managed account. A mutual fund provides the advantages of professional management and greater diversification. However, an actively managed mutual fund may report realized short- and long-term capital gains, which are taxable. In addition, interest income from municipal issues known as private-activity bonds is taxable if you are subject to the alternative minimum tax. Privately managed accounts offer professional management and the opportunity to coordinate the recognition of capital gains or losses on municipal bond investments with other investments you may have. Municipal bond investments are subject to interest rate risk and credit risks.

Municipal bonds have long been considered a haven for high-net-worth investors because their income returns are generally free from federal income taxes and, in some cases, state

and local income taxes. In choosing whether and how to invest in municipal issues, you will want to consider your tax situation, the after-tax returns of municipal bonds compared to taxable issues, and the tax efficiency of managed municipal bond investments.

Consider Your Tax Situation

The maximum tax on long-term capital gains remains at 15% for most Americans but rises to 20% for those with taxable incomes of over \$425,800 (\$479,000 for joint filers). In addition, a surtax on net investment income, which includes capital gains, results in an overall top long-term capital gains tax rate of 23.8% for high-income taxpayers. What's more, municipal bonds' pretax yields historically have averaged approximately 31% below those available on Baa-rated corporate and 10% below government issues of comparable maturities, making them a potentially attractive investment for investors in higher tax brackets.¹

Your financial advisor can assist you in comparing the after-tax yield on tax-exempt municipals to that of taxable issues. The accompanying table shows the taxable-equivalent yield for different yields and federal income tax brackets. These figures provide a general reference but may not be applicable to your situation. While income from corporate bonds is generally fully taxable, income from U.S. government bonds is exempt from state income taxes. If you are in a high-tax state or locality that also exempts interest income from locally issued municipal bonds (known as double or triple tax-exempt bonds), the calculation of taxable-equivalent yield for those issues must be adjusted to reflect the state and local income tax savings.

Other tax considerations you should be aware of before investing in municipal bonds include:

- Capital gains on municipal bond investments are taxable as short- or long-term capital gains, depending on how long you have held the investment.
- Income from certain bonds, known as private-activity bonds, must be reported as taxable income if you are subject to the alternative minimum tax. These bonds, which are used to finance projects such as sports stadiums or airport terminals that provide some benefits to private companies, are identified as private-activity bonds in their prospectuses.
- Municipal bonds generally are not held in tax-deferred retirement accounts since the investment returns in these accounts are taxed as ordinary income upon withdrawal.

The Tax Efficiency of Managed Municipal Bond Investments

Individuals may invest directly in individual bonds, in municipal bond mutual funds, or through a privately managed account. Managed investments offer the advantages of professional management and, in the case of mutual funds, greater diversification. However, actively managed mutual funds may generate taxable short- and long-term capital gains, offsetting some of the potential tax advantages of municipal bond investing.

Some funds may have accrued capital losses in previous years that can be carried forward and applied against future capital gains. A privately managed account combines the benefits of professional management and direct ownership of the underlying securities. One advantage of

investing in municipal bonds through a privately managed account is the potential tax savings that can result from coordinating the recognition of losses in the bond portfolio to offset taxable gains on other investments that you may have.

If you have large, unrealized gains in stock positions, for example, short-term losses on your municipal bond investments may offer opportunities to realize some of the gains on your stock holdings. Using a technique known as "tax loss harvesting," a private account manager may sell some bonds when prices are depressed, resulting in realized capital losses. The proceeds of the sale are then reinvested in different bond issues, and the losses may be used to offset realized gains on an equal amount of appreciated stock. Because longer term bonds tend to be more volatile than shorter term issues, an investor using this strategy may prefer a portfolio that includes long-term bond issues.

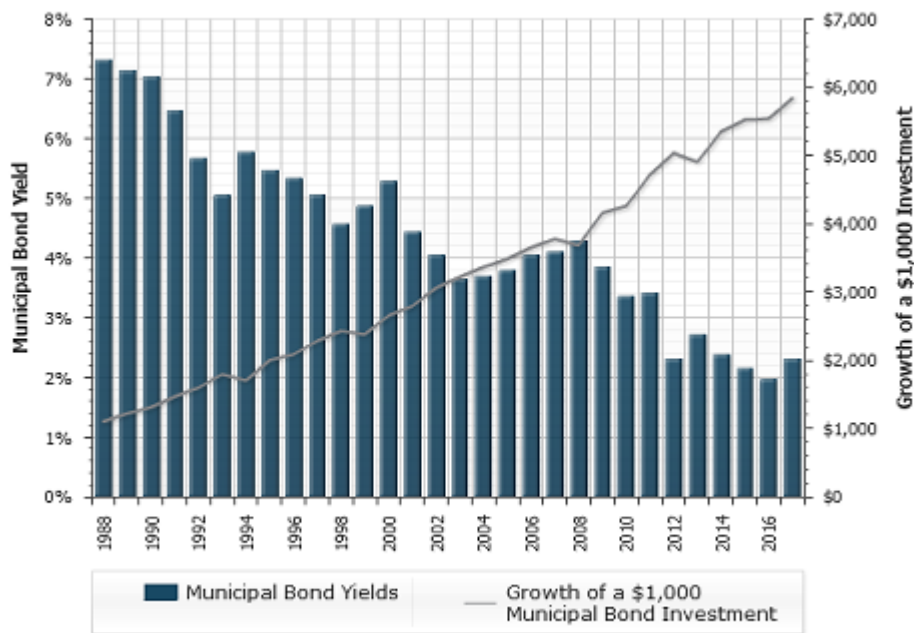
Portfolio Management Strategies

| Taxable vs. Tax-Free Yield | | | | | | | |
|----------------------------|---------------------------|------|------|------|------|------|------|
| Tax Bracket | 10% | 12% | 22% | 24% | 32% | 35% | 37% |
| | | | | | | | |
| Tax-Exempt Yield | Taxable-Equivalent Yields | | | | | | |
| 2% | 2.2% | 2.3% | 2.6% | 2.6% | 2.9% | 3.1% | 3.2% |
| 3% | 3.3% | 3.4% | 3.8% | 3.9% | 4.4% | 4.6% | 4.8% |
| 4% | 4.4% | 4.5% | 5.1% | 5.3% | 5.9% | 6.2% | 6.3% |
| 5% | 5.6% | 5.7% | 6.4% | 6.6% | 7.4% | 7.7% | 7.9% |
| 6% | 6.7% | 6.8% | 7.7% | 8.9% | 8.8% | 9.2% | 9.5% |

Municipal bond prices are sensitive to changes in interest rates and to demand and supply factors. The low interest rate climate of recent years made borrowing especially attractive, both for new projects and for refinancing older debt.

rate. The bond's call provisions will specify the earliest date that the bond may be called, which may be as soon as 10 years after the issue date. If you purchase individual bonds for more than their face value, it's important to consider whether the bond offers an attractive yield to

Value of \$1,000 Municipal Bond Investment: 1987-2016



Source: ChartSource®, DST Systems, Inc. Municipal bond yields based on the 12-month trailing yield of the Bloomberg Barclays Municipal Bond index. Growth of a bond investment based on a \$1,000 initial investment tied to the returns of the Bloomberg Barclays Municipal Bond index, and assumes reinvestment of all income received. Does not consider the effects of taxes. For most taxpayers, municipal bond interest is not subject to federal taxation. Your situation may be different; contact a tax or legal professional for further information. It is not possible to invest directly in an index. Past performance is not a guarantee of future results. © 2018, DST Systems, Inc. Reproduction in whole or in part prohibited, except by permission. All rights reserved. Not responsible for any errors or omissions. (CS000147)

Bond investors are generally hurt by higher interest rates, as bond prices fall when interest rates rise, and benefit when interest rates fall. However, most long-term municipal bonds are callable by the issuer prior to their maturity date at face value. An issuer is likely to call bonds that carry interest rates above the current market

the call date, rather than maturity. Like other types of bonds, municipal bonds carry credit risks. For example, a slowing economy generally creates wider price spreads between high- and medium-quality municipal bonds, offering professional managers opportunities to potentially add incremental returns through

careful security selection. High-yield and variable-rate municipal issues offer higher yields than general obligation or revenue bonds but also pose greater risk of default. Combining investments from several states and investing in insured bonds are two strategies that can help reduce the credit risk of a municipal bond portfolio.

Source/Disclaimer:

¹Source: The Federal Reserve. Based on 20-year Treasury constant maturity yields, yields of Baa-rated corporate bonds and general obligation municipal yields over the 50-year period ended December 31, 2015.

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