

# The power of tax-equivalent yield

## What is tax-equivalent yield?

The pretax yield a taxable bond needs to possess for its yield to be equal to that of a tax-exempt bond is the tax-equivalent yield. The tax-equivalent yield helps to fairly compare the yield of a taxable and tax-exempt bond. When considering an investment in a tax-exempt security, such as a municipal bond, an investor may forget that the yield on this type of security is not directly comparable to the yield on a taxable security. Unlike the yield on a tax-exempt security, which is not subject to federal income tax<sup>1</sup> and, in some cases, state and local income taxes, the yield on a taxable security reflects its pre-tax yield—which can create an unfair comparison to the benefits of a tax-exempt security.

## Tax-Exempt Investments Appear Attractive, Particularly in Higher Tax Brackets<sup>2</sup>

An investor's tax rate has a significant impact on the results of a tax-equivalent yield. The chart below displays the amount of additional yield that is required from a "taxable" fixed-income investment to equal the "tax free" yield of a municipal bond.

## Calculating tax-equivalent yield

Tax-equivalent yield is determined by taking the yield of a tax-exempt bond and dividing it by one minus an investor's federal income tax bracket.

For instance, if an investor is in the 32.0% federal income tax bracket, and is looking to compare a taxable bond with a 4.0% yield to a tax-exempt bond with a 3.5% yield, the tax-equivalent yield would be calculated as follows:

$$3.5\% / (1 - 0.320) = 3.5\% / 0.680 = 5.15\%$$

In this instance, the tax-equivalent yield of the tax-exempt bond (5.15%) is greater than the 4.0% yield of the taxable bond by 1.15%.

		With a tax-free yield of:										
			1.00%	1.50%	2.00%	2.50%	3.00%	3.50%	4.00%	4.50%	5.00%	
Income (Single filers)	Income (Joint filers)	2024 Federal Income Tax Rate	You need to find a taxable investment yielding:									
\$0 to \$11,600	\$0 to \$23,200	10.0%	1.11%	1.67%	2.22%	2.78%	3.33%	3.89%	4.44%	5.00%	5.56%	
\$11,601 to \$47,150	\$23,201 to \$94,300	12.0%	1.14%	1.70%	2.27%	2.84%	3.41%	3.98%	4.55%	5.11%	5.68%	
\$47,151 to \$100,525	\$94,301 to \$201,050	22.0%	1.28%	1.92%	2.56%	3.21%	3.85%	4.49%	5.13%	5.77%	6.41%	
\$100,526 to \$191,950	\$201,051 to \$383,900	24.0%	1.32%	1.97%	2.63%	3.29%	3.95%	4.61%	5.26%	5.92%	6.58%	
\$191,951 to \$243,725	\$383,901 to \$487,450	32.0%	1.47%	2.21%	2.94%	3.68%	4.41%	5.15%	5.88%	6.62%	7.35%	
\$243,726 to \$609,350	\$487,451 to \$731,200	38.8%*	1.63%	2.45%	3.27%	4.08%	4.90%	5.72%	6.54%	7.35%	8.17%	
\$609,351 or more	\$731,201 or more	40.8%*	1.69%	2.53%	3.38%	4.22%	5.07%	5.91%	6.76%	7.60%	8.45%	

\* Includes 3.8% Medicare surtax.

