Tax-Equivalent Yield:

Leveraging the Power of Tax-Free Income

Key takeaways

- Taxes can have a significant impact on investor net income and total return.
- Calculating tax-equivalent yield for taxable versus tax-exempt investments is a prudent exercise with potentially material results.
- Investing in tax-exempt securities, such as municipal bonds, may offer investors significant benefits including enhanced net income, total return, portfolio diversification, and risk-adjusted performance.

Earning income tax-free can be extremely attractive and beneficial for all investors, particularly those in higher tax brackets. Tax-free bonds allow investors to keep more of what they earn while potentially enhancing overall portfolio alpha and risk/return profiles. One way for investors to compare a taxable and tax-free alternative is through calculating tax-equivalent yield.

What is tax-equivalent yield?

Tax-equivalent yield is the nominal (pretax) yield that a taxable bond would need to equal the yield on a comparable tax-exempt bond, such as a municipal bond. The calculation can be used to compare yields between a taxable investment and a tax-free alternative.

Tax-equivalent yield = nominal yield/(1 – marginal tax rate)

EXAMPLE

An investor in the 24% federal income tax bracket is seeking a bond with a pre-tax yield of 4%. If, for instance, the investor decides to invest in a taxable corporate bond, the annual income received from that bond would be taxable at the 24% federal tax rate (plus applicable state/local tax). However, if the investor decides to invest in a municipal bond, their federal tax would be exempt on interest income earned (as well as state/local tax if the investor resides in the state of issuance). A simple example of the federal tax-equivalent yield is as follows:

Tax-equivalent yield = 4.0%/(1 – 0.24) or 5.26%

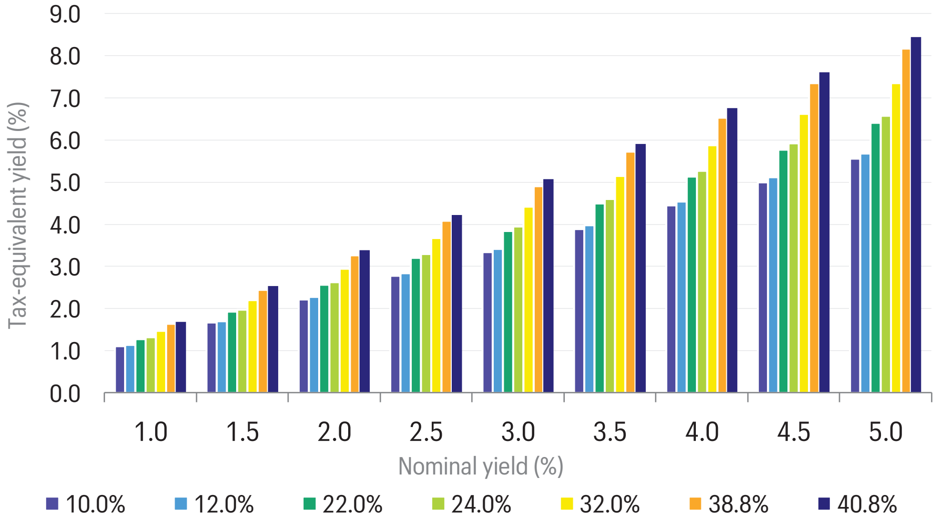
That is a significant increase in yield of 1.26% or 126 basis points (bps; 100 bps equal 1.00%) for the municipal bond.

Tax-equivalent yields across the federal tax rate spectrum

Depending on your annual income, federal tax rates ranged from 10.0% ($0 to $10,275) to 40.8%* ($539,900+) in 2022. For municipal bond investors, this means the greater the yield and higher the tax bracket, the greater the tax-equivalent yield and, subsequently, the greater the tax savings and net income. For example, an investor in the 10% tax bracket would earn a 1.1% tax-equivalent yield on a 1% nominal yield. However, an investor in the 40.8%* tax bracket would earn an 8.4% tax-equivalent yield on a 5% nominal yield (an increase of 3.4% or 340 bps).

*Includes additional 3.8% net investment income tax that may be imposed on single filers with modified adjusted gross income exceeding $200,000.

EXHIBIT 1: FEDERAL TAX-EQUIVALENT YIELDS



What is your federal tax rate?

ANNUAL INCOME	FEDERAL TAX RATE
$0 to $10,275	10.0%
$10,275 to $41,775	12.0%
$41,775 to $89,075	22.0%
$89,075 to $170,050	24.0%
$170,050 to $215,950	32.0%
$215,950 to $539,900	38.8%*
$539,900 +	40.8%*

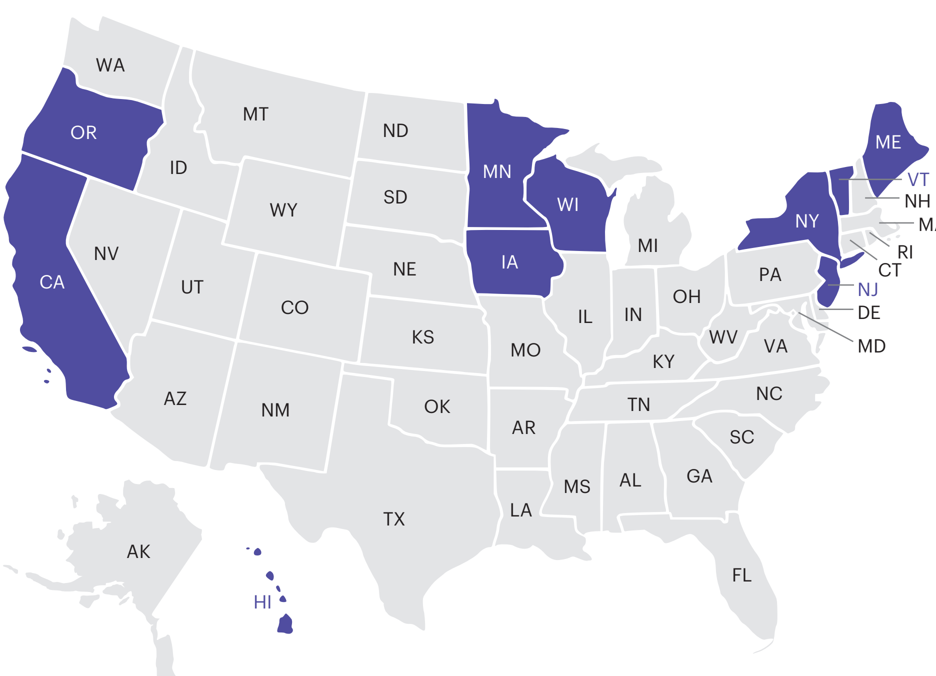
Sources: Tax Foundation and Allspring.
*Includes additional 3.8% net investment income tax that may be imposed on single filers with modified adjusted gross income exceeding $200,000.

Additional savings and income with state and local tax exemptions

In addition to federal tax exemptions, net interest income on municipal bonds is exempt from state and local taxes if you reside in the state in which the bond is issued. This means that net interest income may be further enhanced through state and local exemptions. The state in which you reside can have a significant impact on tax savings.

When it comes to taxes, state residence matters.

EXHIBIT 2: COMBINED STATE TAX RATES

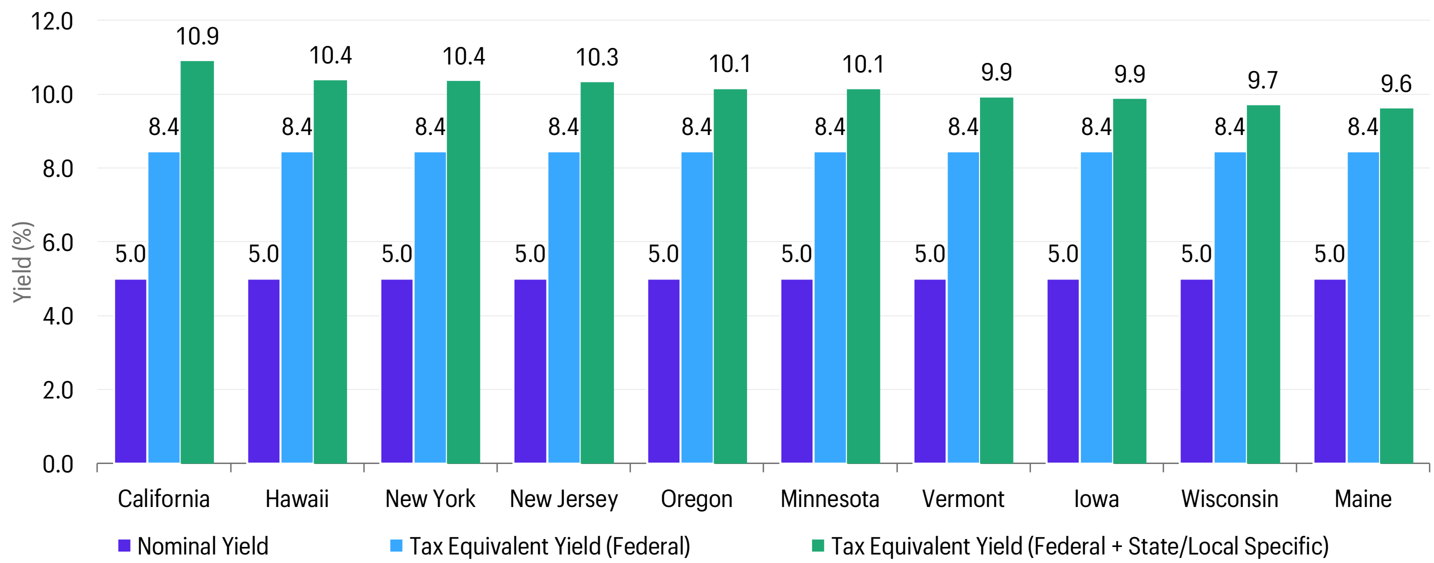


HIGHEST-TAXED STATES (%)	
California	54.10
Hawaii	51.80
New York	51.70
New Jersey	51.55
Oregon	50.70
Minnesota	50.65
Vermont	49.55
Iowa	49.33
Wisconsin	48.45
Maine	47.95

Source: Tax Foundation, Allspring. Based on the highest federal (37%) and state tax bracket and assuming the investor is also subject to the additional 3.8% Medicare surtax on net investment income. Assumes non-deductibility of state income tax at federal level.

This is especially true for residents in the highest-taxed states. Below is an example of how a bond with a 5% nominal yield for top earners translates into materially higher tax-equivalent yields when accounting for federal, state, and local taxes. Residents in California, Hawaii, New York, New Jersey, Oregon, and Minnesota would effectively double their yield and income on a tax-equivalent basis.

EXHIBIT 3: COMBINED STATE TAX-EQUIVALENT YIELD



Sources: Tax Foundation and Allspring. Based on the highest federal (37%) and state tax bracket and assuming the investor is also subject to the additional 3.8% Medicare surtax on net investment income. Assumes non-deductibility of state income tax at the federal level.

Summary

The impact of taxes on an investor's net income and total return can be significant. Due to their tax-exempt status, municipal bonds may offer investors significant benefits, including enhanced income, total return, portfolio diversification, and risk-adjusted performance.

Why invest in municipal bonds now?

+ Tax burdens on top earners remain high.
+ Increased yields offer greater tax-free income opportunities.
+ Strong diversification and risk/return benefits may help dampen volatility and increase risk-adjusted performance.

Why Allspring for municipal bonds investing?

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+ Multiple offerings in both mutual funds and separately managed accounts

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For municipal income funds: A portion of the fund's income may be subject to federal, state, and/or local income taxes or the alternative minimum tax. Any capital gains distributions may be taxable.

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