



# MAXIMIZE AFTER-TAX RETURNS

## Q&A

- Why think about maximizing after-tax returns?
- How can municipal bonds and municipal bond funds help me maximize after-tax returns?
- Are there additional benefits associated with investing in municipal bonds?
- How can asset location help to maximize after tax returns?

## Q: Why think about maximizing after-tax returns?

With taxes on investment income, bond prices under pressure from an uncertain interest rate environment and a low-rate backdrop, you may be concerned about your fixed-income investments' ability to deliver the income you need to reach your financial goals. One strategy to help you keep more of what your investments earn is to examine the tax efficiency of your portfolio.

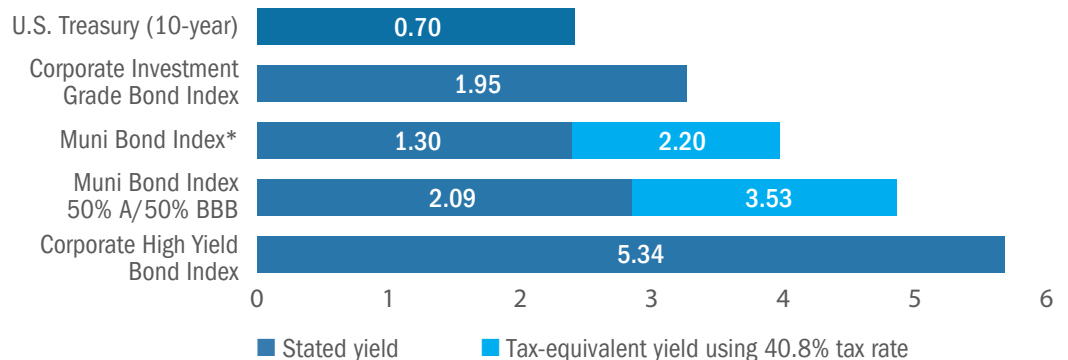
You may think of tax-efficient investing as a strategy geared toward high-net-worth investors, but let's face it — taxes add up for everyone. But keep in mind, as tax rates increase, the value of tax-exempt municipal bond income also increases. The goal of tax-efficient investing is not to avoid taxes. It is to maximize the after-tax return of an investment portfolio.

## Q: How can municipal bonds and municipal bond funds help maximize after-tax returns?

Many investors don't realize the negative effect taxes can have on long-term portfolio performance. Although tax-exempt investments may be more advantageous to investors in higher tax brackets, the potential benefits of investing in municipal bonds are significant, regardless of your income level. While interest earned on taxable fixed-income investments, such as corporate bonds and Treasuries, is taxed at the investor's ordinary income tax rate, interest earned on municipal bonds and exempt-interest dividends from municipal bond funds are generally exempt from federal taxes — which means you keep more of what you earn. State taxes may apply to your municipal bond income, depending on your state of residence.

For the two municipal investment categories in the chart below, the added yield afforded by their tax-exempt status is indicated in the light blue portion of the bar. Although taxable bond yields may appear higher in some cases, once you factor in the taxes on that income, the tax-exempt options begin to look better.

### MUNICIPAL BONDS OFFER COMPETITIVE YIELD: Taxable-equivalent yields (%)



\*Assumes a 2020 federal income tax rate of 40.8% (37% income tax rate + 3.8% net investment income tax rate). Other taxes are possible. State income taxes may be applicable and can further reduce the after-tax returns of some municipal bond investments (depending on the state of residence). Income from certain tax-exempt securities may be subject to the federal and/or state alternative minimum tax for some investors. In addition, federal and state income tax rules will apply to any capital gain distributions and capital gains or losses on sales. When investing in municipal securities, investors in higher tax brackets can receive a greater tax benefit than those in lower tax brackets. Municipal bonds provide income exempt from federal and, in some cases, state income taxes. Past performance does not guarantee future results. Sources: Columbia Threadneedle Investments as of 08/31/20. Asset classes represented with following indices: Bloomberg Barclays Treasury Index (U.S. Treasury), Bloomberg Barclays Corporate Investment Grade Index (Corporate investment grade bond), Bloomberg Barclays Municipal Bond Index (Muni bond index), Bloomberg Barclays U.S. Corporate High Yield Index (Corporate high yield). The Muni Bond Index 50% A/50% BBB represents a 50/50 allocation to the Bloomberg Barclays Muni Bond Single-A and BBB indices, which are noninvestable indices of tax-exempt bonds rated A or BBB.

The tax-exempt interest income municipal bonds and municipal bond funds distribute can be very attractive in an environment where investors are constantly looking for higher yielding options.

As an investor, you cannot control interest rates or changes in tax law. However, depending on your overall investment picture, investing in municipal bonds is an option that may provide income, diversification and tax advantages.

### **Q** : Are there additional benefits associated with investing in municipal bonds?

Financial planning often presents a dilemma for socially conscious investors. You care deeply about your community, the environment and the welfare of others, but you also want to reach your financial goals. You need an investment option that prioritizes both doing well (financially) and doing good (for the community).

By investing in municipal bonds — bonds created to serve the public good by improving infrastructure, building schools and hospitals, and providing affordable housing, for example — you may be able to contribute meaningfully to local communities without compromising your investment goals. However, like all investments, municipal bonds are subject to risks including interest rate risk and credit risk, and you can lose money.

### **Q** : How can asset location help to maximize after tax returns?

Choosing tax-efficient investments is only the first step. The potential to realize tax advantages increases when asset location is part of your overall strategy. Asset location is all about how you divide investments between your taxable and tax-deferred accounts. Generally, tax-efficient investments like municipal bonds and municipal bond funds are best placed in taxable accounts, while less tax-efficient holdings like taxable bond funds are typically held in tax-deferred accounts such as an IRA or 401(k). Your financial advisor can help you create an asset location strategy that's right for you.

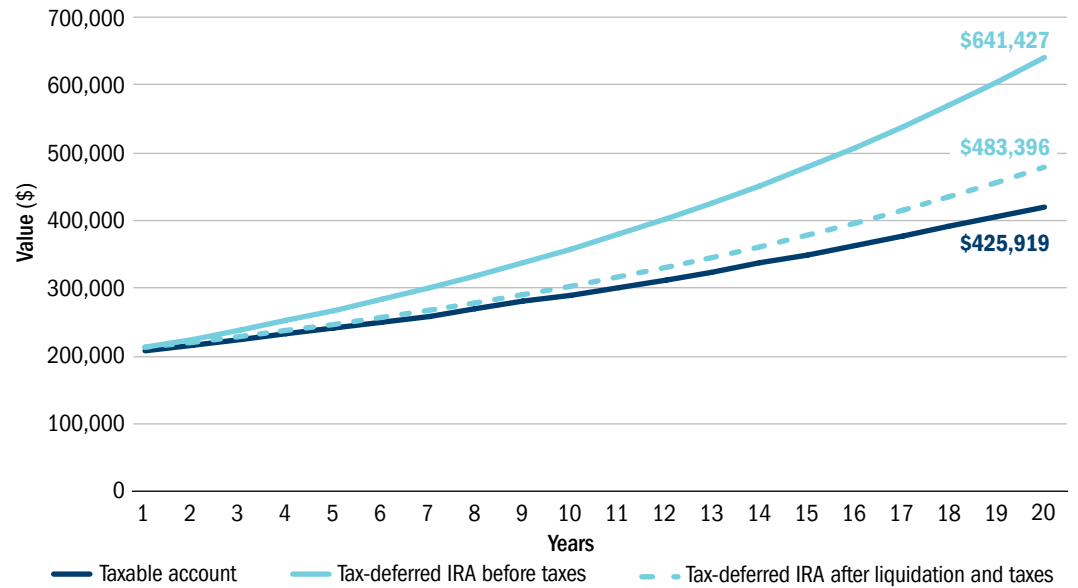
The chart on the following page illustrates the importance of choosing the appropriate asset location for your investments. Suppose an investor, John Dough, would like to put \$200,000 in a taxable bond fund for a period of 20 years, after which he will have reached retirement age. Let's assume his federal tax rate is 35.8% and he will be earning an annual rate of 6% before taxes on the investment. Which type of account should John choose for his investment? If he chooses a tax-deferred IRA, the amount he gets at the end of the 20-year period after liquidating the investment and paying applicable taxes could be over \$57,000 more than the liquidation value from a taxable account.

Some important things to keep in mind:

- Tax-deferred accounts are still subject to taxes upon withdrawal. The \$57,477 difference between the dotted and dark blue lines in the graph below represents the advantage of 20 years of compounded accruals in the tax-deferred account, even after taxes are deducted. The illustration also assumes John remains in the same tax bracket throughout the period, although if his tax rate decreases, the tax advantage will be lessened.
- Since municipal bonds and funds that invest in them are already tax-advantaged, placing them in a tax-deferred account would generally not create any additional tax benefits and could be unfavorable because municipal bond earnings would be taxable when distributed from a traditional IRA or retirement plan.

- Investors should not make investment decisions solely on the basis of tax treatment. You should consider other account and investment features including but not limited to available investment options, return potential, risks, fees and expenses, services, liquidity, potential penalties (such as for early withdrawals from a retirement account), required minimum distributions and creditor protection. Your financial advisor can help you evaluate these factors and choose an appropriate asset location.

**20-year returns in taxable account vs. tax-deferred IRA**



Source: Columbia Management Investment Advisers, LLC

Diversification strategies are becoming increasingly complex. But by evaluating the potential tax impacts of your investments and structuring your portfolio accordingly, you can help minimize the erosive effects of taxes on your portfolio. Keep more of your hard-earned savings. You deserve it!

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\* In U.S. dollars as of June 30, 2020. Source: Ameriprise Q2 Earning Release. Contact us for more current data.

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