Taxable vs. Tax-Exempt: What's the Difference?

If you have recently thought about where you can best invest your discretionary savings, you may have come up against the age-old question of whether you will do better in a *taxable* or *tax-exempt* investment. While the answer is far from clear-cut, here is one thing to keep in mind when making your decision.

To determine the equivalent that a taxable investment would have to pay for you to net the same amount after tax, plug your tax bracket into the following formula: E = B/(1-T) where B is the tax-exempt bond yield, T is your personal income tax bracket, and E is the taxable equivalent yield. For example, Ms. Johnson, who is in the 36 percent tax bracket (T), is considering buying a tax-exempt bond fund yielding 5 percent (B).

However, she is also considering a taxable investment. How much would the taxable investment need to yield in order to produce after-tax results equal to the bond fund? The answer is 7.81 percent (0.05 divided by (1 minus 0.36) = 7.81%).

Example: Determining the Taxable Equivalent of a Tax-Exempt Yield

$$\frac{\text{Tax-Exempt Yield of 5\%}}{\text{(1 Minus Personal Income Tax Bracket of 36\%)}} = \text{Taxable Equivalent of 7.81\%}$$

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