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Bonds

Before Selling, Consider Maturity Dates and Potential After-Tax Income

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Bonds are traditionally long-term investments that guarantee a steady stream of income plus the return of principal if held to maturity.

But investors may find themselves considering whether to sell sooner for two reasons: As interest rates have risen, the value of older bonds that pay lower interest rates has dropped, and some investors who hold tax-free municipal bonds might do better with taxable high-grade corporate or agency bonds that pay higher interest and vice versa.

In the tax-free versus taxable option, the crucial variable is the investor's personal income tax rate. Bond dividends are taxable as ordinary income, so investors in a high federal tax bracket who live in a high-income tax jurisdiction often end up with more after-tax income if they buy a tax-free bond.

Consider this example: A Maryland resident in the 28 percent federal tax bracket also pays up to 7 percent in state income taxes. That means she would take home only 65 percent of the income on a taxable bond. For her, a tax-free municipal bond issued in Maryland that pays 3.5 percent interest would bring in substantially more after-tax money than a taxable corporate bond paying 5 percent. But the calculation is quite different for an investor in a low income tax state, such as Virginia, who is in a relatively low federal tax bracket. For him, a high-grade taxable bond brings in more money. (High-yield, or "junk," bonds will bring in still more money, but they are far riskier and not recommended for most retail investors.)

Even if an investor has the wrong kind of bond, he may not want to rush out and sell. That's because selling a bond before its maturity date brings in less than the face value.

"What you have to do is determine what would you net from the sale of the bond, and when you reinvest that, what kind of after-tax income would you generate," said J. Patrick Collins, a Towson financial adviser. For a short-term bond, it may more sense to wait until maturity and then reinvest the proceeds in a more appropriate bond. There are also tax considerations -- selling a bond early generates a capital loss, which can be used to balance other gains.

Unlike stock brokers, bond dealers generally do not charge a commission. Their cut is included in the price they give the customer, so it may pay to shop around, said Michael Decker, senior vice president of the Bond Market Association. The association's Web site, <http://www.bondmarkets.com>, has a variety of information about investing in bonds, including pricing information. The NASD Web site has an easy tool for checking recent prices on specific bonds at <http://www.nasdbondinfo.com>.

Investors stuck with a low-interest-paying bond can make a similar calculation to see if it is worth selling and buying one that carries a higher interest rate. But usually the loss on the sale will just about balance out the gains from a higher interest rate on the new bond, Decker said. The tax loss may make

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the switch worthwhile, depending on the rest of the investor's portfolio.

Investment professionals warned investors to be wary of repeating their mistakes -- long-term bonds currently do not pay more interest than short-term ones, so investors should be extremely cautious about tying up their money for a long period when the Fed is still considering raising interest rates, Collins said.

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