

Tax-exempt wealth building with zero coupon municipal bonds



Wealth Management

Introduction

Retirement can bring about feelings of both excitement and concern. Concern because we hope we have planned and invested wisely enough to enjoy retirement.

More and more often, investors have maxed-out their 401(k)s, IRAs and other retirement accounts, and are looking for other tax-advantaged ways to save for retirement. There are many alternatives to consider, but few offer the security and value found with zero coupon municipal bonds.

Zero coupon municipal bonds (“zeros”) are tax-exempt, intermediate- to long-term bonds purchased at a deep discount. They do not make periodic coupon interest payments. Instead, interest compounds semi-annually at a rate specified at purchase. The difference between purchase price and face amount equals this interest.

With zero coupon municipal bonds, the compounded interest is exempt from federal income taxes and, in some states, is also free from state income taxes to residents in the state of issuance.

Why buy zeros?

For investors who do not need current income, municipal zeros are an excellent way to accumulate funds for retirement. Some of the benefits are:

Small initial investment —

Zeros are typically sold in denominations of \$5,000 face amounts. However, they are sold at a substantial discount from the face amount, which means they can be bought for a lower initial investment.

Protection from reinvestment risk —

Because interest income on zeros is accrued over the life of the bond rather than paid out, there are no concerns about reinvesting periodic payments at potentially lower interest rates.

Tax-exempt compounding —

The accrual of interest income over the life of the bond also means that you are earning “interest on interest,” also known as compounding. Interest income is compounded semi-annually at the original yield over the life of the bond.

Factors to consider

There are a few factors to consider before deciding if zeros are the right investment vehicle for you:

Price volatility — Bonds selling at a deep discount are more affected by changes in market interest rates, all other factors being equal, compared with bonds selling at or above par. Thus, if an investor liquidated a zero prior to maturity, their principal amount could be less or more than the original price, based on the

current market. As a bond nears maturity (and therefore its par value), price volatility decreases.

Issuer quality — Since investors do not receive a return until maturity, sale or early redemption, they should carefully consider the quality of the issuer. For added protection, investors might consider a bond that is insured by one of the municipal bond insurers such as BAM (Build America Mutual Assurance Co.) or Assured Guaranty Corp.

Call features — Although the majority of zero coupon municipal bonds are non-callable, some issues are callable (redeemable by the issuer at specified dates before maturity).

Tax considerations — There are no federal income tax consequences for individuals who purchase a tax-exempt zero at issuance and hold to maturity. However, a few investors may be subject to an alternate minimum tax (AMT). If bonds are purchased at a discount to the issuance price, you should consult your tax advisor.

Investment scenario

The following example shows how a zero coupon municipal bond strategy can work for a retiring couple interested in tax-free income to supplement their retirement.

Client situation

- Husband and wife both age 50
- Plan to retire in 15 years
- Want to invest approximately \$11,000 annually until retirement

Their RBC Wealth Management financial advisor suggests they invest their annual savings of approximately \$11,000 in 15-year zero coupon municipal bonds each year for the next 15 years. Assuming a 4.00% average annual yield, the client would receive \$20,000 each year (upon maturity).

In this example, the couple would receive \$20,000 every year for 15 years—federally tax-free—during their retirement. Total investment dollars have more than doubled over the 15-year time frame.

Age at time of investment	Investment	Value at maturity	Age at time of maturity
50	\$10,869	\$20,000	65
51	\$10,869	\$20,000	66
Age progresses, and investment and maturity values stay constant.			
63	\$10,869	\$20,000	79
64	\$10,869	\$20,000	80
Totals	\$163,035	\$300,000	

For illustrative purposes only

Summary

Zero coupon municipal bonds can provide important benefits to investors who are seeking tax-advantaged ways to save for retirement. Contact your RBC Wealth Management financial advisor to learn how you can put this investment strategy to work for you.

Investing in municipal bonds involves risks, such as interest rate risk, credit risk and market risk, including the possible loss of principal. Clients should contact their tax advisor regarding the suitability of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on state of residence. Income from municipal bonds could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer.

RBC Wealth Management does not provide tax advice. All decisions regarding the tax implications of your investments should be made in consultation with your independent tax advisor.