

Taxable Equivalent Yield

What is Taxable Equivalent Yield?

Taxable Equivalent Yield (TEY) is a way of comparing the yields of tax-exempt bonds and taxable bonds on a pre-tax basis. Taxable Equivalent Yield is the yield you would need to receive on a taxable bond in order to equal the yield of a tax-free bond after taxes (state & local income taxes) are accounted for.

TEY is calculated by dividing the tax-free yield by the reciprocal of investor's tax bracket. *See example 1.*

Why is Taxable Equivalent Yield Important?

It demonstrates how a tax-free bond, although offering a lower yield than a taxable bond, can leave you with a higher return after your tax liability is factored in.

Does the TEY Consider State Taxes?

It can. To factor this impact we assume that state taxes paid are deducted on the federal tax return. The effective state (and local) tax rate is added to the federal bracket. The tax-free yield is then divided by the reciprocal of the investor's total tax rate.

For example, Pennsylvania levies a 3.07% tax rate on most interest income, but exempts Pennsylvania municipal bonds. After deducting this tax on the federal return the effective state tax rate is only 2.00%. *See example 2.*

The Impact of State Taxes on TEY

The following table is an example of Taxable Equivalent Yield on a bond yielding 4.50%. Rates assume an investor, who is in the 35% federal tax bracket, married, filing a joint tax return, earning \$320,000 per year.

State	State Tax Rate	State Tax x (1-.35) = Effective State Tax Rate	Eff. State Tax + 35% = Total Tax Rate	TEY
Connecticut	5.00%	3.25%	38.25%	7.28%
Delaware	5.95%	3.86%	38.86%	7.36%
D.C.	9.00%	5.85%	40.85%	7.60%
Florida	NA ¹	NA	35.00%	6.92%
Georgia	6.00%	3.90%	38.90%	7.36%
Maryland	7.31% ²	4.75%	39.75%	7.46%
Massachusetts	5.30%	3.44%	38.44%	7.31%
New Jersey	8.97%	5.83%	40.83%	7.60%
New York	6.85%	4.45%	39.45%	7.43%
New York City	10.49% ³	6.81%	41.81%	7.73%
Pennsylvania	3.07%	2.00%	37.00%	7.14%
Rhode Island	8.75% ⁴	5.69%	40.69%	7.58%
Virginia	5.75%	3.73%	38.73%	7.34%

Data reflects 2006 tax information

¹ Florida does not have a state income tax and no longer levies an intangible tax as of January 1, 2007.

² Assumes 4.75% state income tax + 2.56% county tax (Anne Arundel) – rate for other MD counties may vary

³ Assumes 7.375% state income tax + 3.648% city income tax

⁴ Assumes 25% of Federal tax (25% * 35% = 8.75%) for state tax rate

Example 1:

An investor is considering a municipal security yielding 4.50%. She is in the 35% federal tax bracket.

The calculation of her Taxable Equivalent Yield is

$$4.50\% / (1 - .35) = 6.92\%$$

She would need to receive a 6.92% yield on a taxable security in order to match a 4.50% municipal bond.

Example 2:

A Pennsylvania investor, in the 35% federal tax bracket, considering a 4.50% municipal security

$$3.07\% * (1 - .35) = 2.00\% \text{ Effective State Tax}$$

$$2.00\% + 35\% = 37.00\% \text{ Total Tax Rate}$$

$$4.50\% / (1 - .37) = 7.14\% \text{ TEY}$$

Taxable Equivalent Yield On Line

The Janney Montgomery Scott website

www.jmsonline.com

features an online TEY calculator. Visit the site, enter your state and the yield you are checking.

<http://www.jmsonline.com/jms/bonds/calculator.html>

The interest on certain taxable securities such as U S Treasury issues and U S agency issues is exempt from state taxation so state specific TEY calculations would not apply. This information is obtained from reliable sources but is not guaranteed as to accuracy or completeness. Investors should consult their accountant or tax advisor to ascertain specifics of their individual tax situation.

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