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Municipal bonds—frequently called “munis” for short—are often attractive to investors in the highest income tax brackets. Nevertheless, despite the obvious benefits, there are potential drawbacks to watch out for as well.

For starters, there are four main tax advantages to investments in munis.

1. Interest income generated by munis is exempt from federal income tax. The higher your tax bracket, the more important this is. For instance, if you're in the current top tax bracket of 37% and earn a 4% yield with a muni, the taxable equivalent yield is 6.92%.

2. The interest income is also exempt from any applicable state income tax as long as

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annual tax return.

Before you pull the trigger on munis, however, there are several disadvantages to consider, including the following:

- Interest income received from munis issued by an entity in another state is subject to state income tax. The state tax exemption, when available, only applies to muni income in the state where you reside state.
- The income from “private activity” bonds is an adjustment item for the alternative minimum tax (AMT) calculation. This could result in you paying the AMT instead of regular income tax or increasing AMT liability.
- There's no tax benefit if you sell a muni purchased at a premium. For instance, if you buy a muni for \$11,000 that will be worth \$10,000 if you hold it until maturity, you can't subsequently claim a \$1,000 loss on your tax return. The premium must be amortized over time.
- If you sell a muni at a profit, you owe pay capital gains tax on the sale. Example: Suppose you acquire a muni with a face value of \$10,000 and sell it for \$11,000. The \$1,000 gain is taxable as a capital gain.
- The calculation of the tax on Social Security benefits includes tax-free municipal bond income. Depending on your situation, up to 85% of the Social Security benefits received may be subject to tax. This could be significant.

Lastly, take note of a savvy year-end tax strategy involving munis. If you “swap” a muni showing a current loss with another bond with somewhat different investment characteristics, you may be able to claim the loss on your 2022 return, even if the new bond carries a higher interest rate than the old one.

The upshot: Munis can be a good deal for savvy investors, but they aren't usually recommended for novices. Weigh all the pros and cons before you invest.

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