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Ken Berry • Oct. 12, 2022



Unless you’ve been marooned on a desert island like Robinson Caruso, you’re probably well aware of the main tax benefits of municipal bonds—often called often called “munis” for short. But let’s briefly recap them anyway.

1. Munis are exempt from federal income tax.
2. Munis may be exempt from state income tax if they’re issued by the state where you reside.
3. Muni income doesn’t count toward the net investment income (NIIT). This may help you to avoid or reduce the 3.8% NIIT.

However, there's another tax-saving aspect of munis that often flies under the radar.

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To be precise, a muni swap is actually a simultaneous sale and acquisition of bonds.. Thus, this technique isn't affected by the recent tax law crackdown on like-kind exchanges of property other than real estate. Muni swaps are still good-to-go.

How it works in a nutshell: You sell a muni showing a loss while you're buying another muni with similar investment characteristics (e.g., the same face value). When both ends of the exchange are complete, you're essentially in the same investment position as you were before, but now you have a current tax loss on the books.

Even better, you may be able to acquire a muni with a higher interest rate than the one you're swapping. Let's look at a hypothetical—

Example: You bought a Mountain State muni years ago for \$10,000. The bond's current value is \$7,500, it will mature in 15 years and it has a 4% interest rate. Currently, you're showing a \$2,500 short-term capital gain for the year. As a result, you decide to swap the Mountain State muni for a Valley State muni with a face value of \$10,000. The Valley State bond is also currently valued at \$7,500, but it matures in 20 years and it has a coupon rate of 4.5%.

When the swap is completed, the \$2,500 capital loss offsets your net short-term capital gain for the year. In your 37% tax bracket, you save \$925 in tax (37% of \$2,500). Plus, you're now in line to pocket more annual income. Instead of earning \$400 in tax-free interest each year, you'll get \$4,500. When the Valley State bond matures 20 years down the road, you'll owe tax on the \$2,500 gain, but that's in the distant future. Or you might swap munis again.

Caveat: This is a complex tax planning technique. Rely on your professional advisors for assistance.

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