

Financial fitness

Not All Yields Are Created Equal

By Rocky Mills, North Ranch Resident

How to calculate the "Tax Equivalent Yield"

Some interest or dividend payments are fully taxable as ordinary income. Let's say you're a resident of California in the highest federal and state income tax brackets, you'll pay:

- 39.6% federal income tax
- 8.0% state income tax (net after the benefit for Federal itemized deduction)
- 3.8% health care tax
- 1.2% itemized deduction limitations
- 52.6% **Total**



This means that if you were paid a fully taxable interest payment of \$10,000, you would only put \$4,740 in your pocket, net after these taxes.

On the other hand, some interest payments are totally free of these taxes. If you received a \$4,740 tax-free interest payment, you'd get to keep it all. And this, of course, is exactly the same as getting \$10,000 in fully taxable interest.

This demonstrates the concept of "tax equivalence:" how a taxable and a tax-free payment stacked up against each other. We can do the same thing for any given percentage yield (i.e. the payment you receive divided by the amount you have invested).

Let's say, using the examples above, that the interest payments came from an investment of \$200,000. The \$10,000 of taxable interest would thus be a yield of $\$10,000 / \$200,000 = 5.00\%$. The \$4,740 of tax-free interest would represent a yield of $\$4,740 / \$200,000 = 2.37\%$. We know, from above, that these two yields put the same amount of money in your pocket, if you're a California resident in the highest federal and state income tax brackets. In investment circles, we would say:

This 2.37% tax-free yield has a tax equivalent yield (TEY) of 5.00%.

Is there an easy way to calculate this TEY? Yes.

1. Determine your total tax rate. In this example, it was 52.6%.
2. Subtract this from 100% to get your "keepable" rate: $100\% - 52.6\% = 47.4\%$.
3. Then take your tax-free yield and divide by your keepable rate: $2.37\% / .474 = 5.0\%$.

Or use an online TEY calculator (such as funds.eatonvance.com/tax-equivalent-yield-calculator.php). You simply enter your taxable income, your filing status and your state of residence to get your tax rate. Then enter your tax-free yield to get your TEY.

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