

Tax-exempt municipal bonds

Fixed-income securities generally exempt from taxes

Attractive benefits

Tax-exempt municipal bonds are among the most popular types of investments available today. They offer a wide range of potential benefits, including:

- Current income generally free from federal and, in some cases, state and local taxes.¹
- A degree of safety with regard to payment of interest and repayment of principal.
- Wide range of choices for bond rating, maturity, type of bond and geographic location to fit your investment objectives and risk tolerance.
- Marketability in case you must sell before maturity.

¹ Income is generally free from federal and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, are subject to taxes. Income may be subject to federal Alternative Minimum Tax (AMT).

Municipal bonds are debt obligations issued by states, cities, counties and other governmental entities to raise money to build schools, highways, hospitals and other projects for the public good. Tax-exempt municipal bond issuers promise to pay investors a specified amount of interest (usually paid twice a year, which is generally exempt from taxes, plus the principal returned on a specific maturity date. Often, individuals serve as investor, voter and taxpayer reaping the benefits of the same project.

What are the types of municipal bonds?

Municipal securities include both long- and short-term issues. Short-term securities (notes) typically mature in a year or less. Long-term securities (bonds) usually mature after a year or more from issue. Notes are issued to raise money in advance of future revenues such as tax income, state or federal aid payments, and bond proceeds. Notes are also used to meet irregular cash flows and unanticipated deficits, as well as raise immediate capital for projects until long-term financing can be arranged. Bonds are usually sold to finance longer-term capital projects.

The two basic types of municipal securities are general obligation bonds and revenue bonds:

- **General obligation bonds.** Principal and interest are secured by the full faith and credit of the issuer and are supported by the issuer's taxing power. The issuance of general obligation bonds is subject to voter approval.
- **Revenue bonds.** Principal and interest are secured by revenues derived from tolls, charges or rents paid by users of the facility built with the proceeds of the bond issue. Public projects financed by revenue bonds include highways, bridges, airports, water and sewage treatment facilities, hospitals, and low-income housing. Many of these bonds are issued by special authorities created for the purpose.

Bonds with special investment features include:

- **Insured municipals.** Many municipal bonds are backed by municipal bond insurance specifically designed to reduce investment risk. Insurance coverage applies to the timely payment of principal and interest only; it does not eliminate market risk.
- **Floating-rate and variable-rate bonds.** These securities are attractive when interest rates are rising. Generally, interest is periodically recalculated based on a percentage of prevailing rates for Treasury bills or other interest rates.

Additional considerations

- **Calls.** Many municipal issuers reserve the right to call, or retire, all or a portion of the bonds at a premium or at par before they are due. Municipals will be quoted at either the yield to call or the yield to maturity, whichever is lower. Be sure to ask about calls before buying municipal bonds.
- **Interest payments.** Bond interest is usually paid twice a year. On notes, interest is typically paid only at maturity.
- **Reporting requirements.** All tax-exempt interest, including original-issue discount accretion, must be reported on tax returns. This rule does not affect the tax-exempt status of the security.
- **Minimum investment.** Most tax-exempt municipal bonds and notes are issued in denominations or multiples of \$5,000.
- **Settlement dates.** Dealers are required by the Securities and Exchange Commission (SEC) to have payment for a securities purchase, or to make payment for a securities sale, no later than the third business day following the date of the trade.
- **Listings.** Financial newspapers and business pages of major daily newspapers usually list prices of widely traded municipal securities. Because the prices are typically based on \$1 million lots and reflect a volume discount, purchases and sales of smaller amounts may differ according to the size of the order. Municipal securities broker-dealers also offer quotes.
- **Marketability.** Holders of municipal securities can sell their notes or bonds in the secondary market through one of the thousands of banks and securities firms registered to buy and sell municipal securities. Municipal bonds are sold in the over-the-counter (OTC) market. If you sell your bonds before their maturity date, you will receive the current market price, which may be more or less than what you paid for the bonds.

- **Zero-coupon, compound-interest and multiplier bonds.** These bonds are issued at a deep discount from their maturity value and have no periodic interest payments. Investors receive one payment at maturity equal to the principal invested, plus interest compounded twice a year at the original interest rate. Because they do not pay interest until maturity, their prices tend to be volatile. These bonds may be attractive to investors seeking capital for a long-term financial goal like retirement or college.
- **Put bonds.** Some bonds have a “put” feature, which allows investors to redeem the bond at par value on a specified date, at some point before its maturity date. If interest rates increase, you can generally redeem the bonds at any put date, recover the principal and purchase higher-yielding bonds.

How do yields affect municipal bonds?

There are basically two types of bond yields you should know about. “Current yield” is the annual return on the dollar amount paid for a bond. “Yield to maturity” is the rate of return to the investor earned from payments of principal and interest, with interest compounded semiannually at the stated yield, until the maturity date. Yield to maturity takes into account the amount of the premium or discount, if any, and the time value of the investment.

Tax-exempt yields are usually stated in terms of yield to maturity, with yield expressed at an annual rate. For example, if you buy a bond with a 5% coupon at par, its yield to maturity is 5%.² If you pay more than par, the yield to maturity will be lower than the coupon rate. If you pay less than par, the yield to maturity will be higher than the coupon rate.

When the price of a tax-exempt bond increases above its par value, it is said to be selling at a premium. When the price of the bond is below par value, it is said to be selling at a discount.

How are municipal bonds issued?

- **Registered.** Beginning in July 1983, as a result of federal tax-law changes, municipal bonds were issued in registered form only. With a registered security, your name is registered on the issuer’s books and appears on the bond, and interest payments will come directly to you. A bond can be registered as to principal and interest or only as to principal.
- **Book entry.** An increasing number of municipal bonds today are issued in “book-entry” form, the same way U.S. government securities are issued. Ownership is recorded through data entry at a central clearing house. Confirmation of purchase from a bank or brokerage firm provides a written record of the transaction. With book-entry securities, physical transfer of certificates is not necessary.

Registered and book-entry bonds offer protection from loss or theft, automatic payment of interest, notification of calls, and ease of transfer among other protections and conveniences.

Before July 1983, municipals were issued mostly in certificate form with coupons attached. Some of these so-called “bearer bonds” are still available in the marketplace. The issuer has no record of who owns these bonds. The owner clips the coupons and collects the interest from the issuer’s paying agent. Transferring the bonds requires physical delivery and payment. However, the supply of bearer bonds in the marketplace is very limited. If you buy bearer bonds, there is no guarantee that you will receive your bonds in that form.

²This information is hypothetical and is provided for informational purposes only. It is not intended to represent any specific return, yield, nor is it indicative of future results.

Comparing bonds

Effect of federal income taxes on yields of tax-exempt and taxable bonds

	5.00% tax-exempt bond	7.00% taxable bond
Cash investment	\$30,000	\$30,000
Interest	\$1,500	\$2,100
Federal income tax at 35%	\$0	\$735
Net return	\$1,500	\$1,365
After-tax yield	5.00%	4.55%

³The solutions discussed may not be suitable for your personal situation, even if it is similar to the example presented. Investors should make their own decisions based on their specific investment objectives and financial circumstances. It should not be assumed that the recommendations made in this situation achieved any of the goals mentioned. This example is hypothetical and does not represent any specific investments or strategies.

What does “tax exemption” mean?

Under current federal income-tax law, the interest income from investing in municipal bonds is free from federal income taxes unless you are subject to the alternative minimum tax (AMT). In that case, a portion of your income may be subject to taxation. Please consult your tax advisor for more information. In most states, interest income received from securities issued by governmental units within the state is also exempt from state and local taxes. In addition, interest income from securities issued by U.S. territories and possessions is exempt from federal, state and local income taxes.

One way to appreciate the tax-exemption of a municipal security is to compare it to a similar, taxable investment. For example, assume that you and your spouse are in the 35% federal tax bracket, file a joint return, and claim \$180,000 in taxable income. Now assume that you have \$30,000 to invest and you are considering two investment alternatives: a tax-exempt municipal bond yielding 5% and a taxable corporate bond yielding 7%. Which investment will prove most advantageous (assuming that it is held to maturity)?

As you can see in the chart to the left, if you invested your money in the tax-exempt municipal bond, you’d earn \$1,500 in interest (a 5.00% yield) and pay no federal income taxes.³ The taxable investment, however, would provide you only \$1,365 in income (a 4.55% yield) after federal income taxes have been deducted. The tax-exempt municipal bond would provide the better yield after taxes are taken into account. The tax-exempt security would be an even better investment if you accounted for state and local income taxes when calculating returns on the taxable investment. To determine the yield you would need to earn from a taxable investment to equal the yield on a tax-exempt security, refer to the chart on page 6.

Where are municipal bonds available for sale?

In the municipal market, two methods of issuance constitute the primary market. Additionally, municipals are traded from dealer to dealer in the secondary market (after being issued). Municipal new issues are sold in the primary market, much like an initial public offering of stock. Municipal new issues come to market by either the competitive or the negotiated method. A competitive underwriting works as a sealed-bid auction that takes place on a specific date at a specific time. A number of dealers, or groups of dealers (called “syndicates”), submit their bids to buy the bond issue. The syndicate willing to provide the issuer with the lowest net interest cost will buy the deal. In a negotiated underwriting, an issuer chooses a dealer or group of dealers and negotiates the terms that will satisfy both parties’ needs. Once a new bond issue has been initially sold in the primary market, it is then traded in the secondary market. The secondary market provides a place for investors to buy and sell their bonds.

Who buys municipal bonds, and what are the roles of the investor?

In recent years, individual participation in tax-exempt municipal bonds has expanded significantly. Investors in municipal bonds play a variety of roles. In order to bring a new municipal issue to market, voter approval is often required. Once the voters approve financing for a new municipal project, often those voters will become beneficiaries of that project. In addition, those same voters may be the investors buying the municipal bond issue. The taxes paid by these same investors and voters provide for the payment of principal and interest on the bonds. So the individual could serve as investor, voter and taxpayer reaping the benefits of the project.

Are municipal bonds considered safe?

Issuers of municipal bonds have an outstanding record of meeting principal and interest payments in a timely manner. When you invest in any bond, one of your primary concerns should be the issuer's ability to meet its financial obligations.

Issuers initially disclose details of their financial condition through "official statements" or "offering circulars," which are available from your Financial Advisor, your bank or a library of official statements. Issuers must also provide financial information on an ongoing basis to a nationally recognized depository. This information is made available to dealers trading these issues in the secondary market.

Another way to evaluate an issuer is to examine its credit rating. Many bonds are graded by rating agencies such as Moody's Investors Service, Standard & Poor's Corporation and Fitch Investors Service, Inc. A number of banks and brokerage firms have their own research departments, which also analyze municipal securities. Bond ratings are important benchmarks because they reflect a professional and independent assessment of the issuer's ability to make interest payments and repay the bond's face value at maturity. Bonds rated Baa (by Moody's) or BBB (by S&P or Fitch) or better are considered "investment grade," which means suitable for preservation of investment capital. However, credit ratings should not be the sole basis for any investment decision.

Credit ratings

Credit quality	Rating Service		
	Moody's	Standard & Poor's	Fitch
Prime	Aaa	AAA	AAA
Excellent	Aa	AA	AA
Upper medium	A	A	A
Lower medium	Baa	BBB	BBB
Speculative	Ba	BB	BB
Very speculative	B, Caa	B, CCC, CC	B, CCC, CC, C
Default	Ca, C	D	DDD, DD, D

Tax-exempt municipal bonds may enhance your after-tax return, consistent with the amount of risk you are willing to accept. But in general, as with any investment, the higher the return you seek, the higher the risk.

Market risk factors

The interest payment, also known as the coupon rate, cannot be changed during the life of the bond (unless, of course, it is a variable-rate or convertible security). However, the market price of a security changes with market conditions. If you sell your municipal bonds before maturity, you will receive the current market price, which may be more or less than their original price. So it's important to understand how the direction of interest rates might affect the value of your holdings.

As with other fixed-income securities, municipal bond prices fluctuate in response to changing interest rates. Prices increase when interest rates decline and decline when interest rates rise. Here's why:

- When interest rates fall, new issues come to market with lower yields than older securities, making the older securities worth **more**; hence the increase in price.
- When interest rates rise, new issues come to market with higher yields than older securities, making the older ones worth **less**; hence the decline in price.

Tax issues*

Tax-exempt municipal bonds are free from federal, and in some cases from state and local, taxes – but they are not free from all tax implications. As a reminder, Wells Fargo Advisors does not provide tax or legal advice. Please be sure to consult your tax advisor concerning the tax implications of the investment you are thinking about purchasing.

- **Gains and losses.** You may generate capital gains on a tax-exempt security if you sell it at a profit in the secondary market before maturity. Of course, if you sell your security for less than you paid for it, you could incur a capital loss. Sometimes, the gain or loss may be affected by required cost-basis adjustments. Under current law, up to \$3,000 of net capital losses can be used annually to reduce “ordinary income” on your tax return. Capital losses can be used without limit to reduce capital gains.
- **Tax treatment on discount bonds.** Special rules apply to tax-exempt bonds bought at a discount. A market discount generally exists when a bond is bought at a price below par. The discount is the difference between the purchase price of a bond and its maturity value or redemption price. Under tax law, discounts will be taxed at the time a bond is sold or redeemed. However, they could now be taxed as ordinary income, as opposed to a capital gain. A special provision for original issue discount (OID) bonds exempts their discount from tax. The special *de minimis* rule provides that if a bond is purchased with only a small discount (less than 0.25% of the face value of a bond for each complete year between the bond's purchase date and maturity date), the discount is considered to be zero. A discount on a municipal will therefore be taxed as ordinary income if the discount is more than this amount and as capital gains if it is less than this amount. It's important that you understand the tax implications of your purchase.
- **Alternative minimum tax (AMT).** Under the Tax Reform Act of 1986, interest on most tax-exempt private-activity bonds will be a “tax preference item” for individuals subject to the AMT. A preference item is an income source that is not included in the normal tax calculation. One of the benefits to investors in private-activity bonds (or AMT bonds) is that the range of yields will tend to be higher than for non-AMT bonds. This extra yield is an advantage for individuals who are not subject to the AMT. Keep in mind that as tax laws change, you may be subject to the AMT at some point in the future.
- **Taxable-equivalent yields.** The table on the next page will help you determine the yield you would need to earn on a taxable investment to equal the yield on a similar tax-exempt municipal bond. The table is for illustrative purposes only and is not intended to be representative of any specific security. The table considers federal tax only.

*Wells Fargo Advisors does not provide tax or legal advice.

Summary

Tax-exempt municipal bonds can be a valuable part of your fixed-income portfolio. They are considered safe and liquid and provide attractive tax benefits. Your Financial Advisor with Wells Fargo Advisors can help you determine whether these securities will fit your investment objectives and risk tolerance and which types or structures may best suit your investment needs. For more information on tax-exempt municipal bonds, consult your Financial Advisor today.

Tax-exempt/taxable-equivalent yields — Tax-year 2009

(Considers federal exemption only)

Tax-exempt yield %	Tax bracket					
	10%	15%	25%	28%	33%	35%
2.0	2.22	2.35	2.67	2.78	2.99	3.08
2.5	2.78	2.94	3.33	3.47	3.73	3.85
3.0	3.33	3.53	4.00	4.17	4.48	4.62
3.5	3.89	4.12	4.67	4.86	5.22	5.38
4.0	4.44	4.71	5.33	5.56	5.97	6.15
4.5	5.00	5.29	6.00	6.25	6.72	6.92
5.0	5.56	5.88	6.67	6.94	7.46	7.69
5.5	6.11	6.47	7.33	7.64	8.21	8.46
6.0	6.67	7.06	8.00	8.33	8.96	9.23
6.5	7.22	7.65	8.67	9.03	9.70	10.00
7.0	7.78	8.24	9.33	9.72	10.45	10.77
7.5	8.33	8.82	10.00	10.42	11.19	11.54
8.0	8.89	9.41	10.67	11.11	11.94	12.31

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Glossary

Advance refunding. A financing structure under which new bonds are issued to repay an outstanding bond issue before its first call date. Generally, the proceeds of the new issue are invested in government securities, which are placed in escrow. The interest and principal repayments on these securities are then used to repay the old issue, usually on the first call date.

Alternative minimum tax (AMT). A federal tax, established by the Tax Reform Act of 1986, which requires wealthy individuals and corporations with substantial income to pay a minimum tax amount, even if their income would not normally be taxable.

Bid. The price at which a buyer offers to buy a security.

Bearer bond. A security that has no identification as to owner. It is presumed to be owned, therefore, by the bearer (the person who holds it).

Callable bonds. Bonds that are redeemable by the issuer, before the specified maturity date, at or above par.

Call premium. A dollar amount, usually stated as a percentage of the principal amount called, paid as a premium for the exercise of a call provision.

Coupon. The part of a bond that denotes the amount of interest due, on what date, and where the payment is to be made. Bearer coupons are presented to the issuer's designated paying agent or deposited in a commercial bank for collection. In the case of registered coupons, the interest payment is mailed directly to the registered holder. Coupons are generally paid semiannually.

Current yield. The annual return on the dollar amount paid for a bond.

CUSIP. The Committee on Uniform Securities Identification Procedures, which was established under the auspices of the American Bankers Association to develop a uniform method of identifying municipal, U.S. government and corporate securities.

Dated date. The date of a bond issue from which the bondholder is entitled to receive interest (even though the bonds may actually be delivered at some other date).

Default. Failure of the issuer to pay principal or interest promptly when due.

De minimis. The point at which a discount municipal bond becomes taxable at an investor's ordinary-income tax rate as opposed to the capital-gains tax rate.

Discount. The amount by which the purchase price of a security is less than the principal or par value.

Double exemption. Securities that are exempt from state as well as federal income taxes are said to have a double exemption.

Extraordinary redemption. This is different from the optional redemption or mandatory redemption in that it occurs under an unusual circumstance, such as the destruction of the facility financed.

Face amount. The par value (principal or maturity value) of a security, appearing on the face of the bond certificate.

Floating-rate bond. A long-term bond for which the interest rate is adjusted periodically according to a predetermined formula, based on specific market indicators.

Interest. Compensation paid for the use of money. Interest is generally expressed as an annual percentage rate.

Issuer. A state, political subdivision, agency or authority that borrows money through the sale of bonds or notes.

Legal opinion. An opinion concerning the validity of a securities issue with respect to statutory authority, constitutionality, procedural conformity and usually the exemption of interest from federal income taxes. The legal opinion is usually rendered by a law firm recognized as specializing in public borrowings, often referred to as “bond counsel.”

Limited-tax bond. A bond secured by a pledge of a tax or category of taxes limited as to rate or amount.

Marketability. The ease with which a security can be sold in the secondary market.

Maturity. The date when the principal amount of a security becomes due and payable.

Moral obligation bond. A revenue bond which, in addition to its primary source of security, has a structure whereby a state pledges to make up shortfalls in the debt service reserve fund, subject to legislative appropriation. There is no legal obligation for the state to make such a payment, but market participants recognize that failure to honor the “moral” pledge would damage the state’s own creditworthiness.

Non-callable bond. A bond that cannot be called either for redemption by or at the option of the issuer before its specified maturity date.

Notes. Short-term promises to pay specified amounts of money, secured by specified sources of future revenues, such as taxes, federal and state aid payments, and bond proceeds.

Offering price. The price at which members of an underwriting syndicate for a new issue will offer securities to investors.

Official statement. A document prepared for or by the issuer that gives, in detail, security and financial information about the issue.

Optional redemption. A right to retire all or part of an issue before the stated maturity during a specified period of years, often at a premium. The right can be exercised at the option of the issuer.

Original-issue discount (OID). A bond, issued at a dollar price less than par, that qualifies for special treatment under federal tax law. If the bond is held to maturity, the difference between the issue price and par is treated as tax-exempt income rather than as a capital gain.

Par value. The principal amount of a bond or note due at maturity, usually \$1,000.

Paying agent. The place where principal and interest are payable. Usually a designated bank or the office of the treasurer of the issuer.

Premium. The amount by which the price of a security exceeds its principal amount.

Principal. The face amount of a bond, exclusive of accrued interest and payable at maturity.

Ratings. Designations used by investor services to indicate credit quality.

Registered bond. A bond whose owner is registered with the issuer or its agent, either as to both principal and interest or as to principal only. Transfer of ownership can only be accomplished when the securities are properly endorsed by the registered owner.

Special tax bond. A bond secured by a special tax, such as a gasoline tax.

Swap. Simply, the sale of a block of bonds and the purchase of another block of similar market value. Swaps may be made to establish a tax loss, upgrade credit quality or extend or shorten maturity, etc.

Trade date. The date when a bond transaction is executed.

Trustee. A bank designated by the issuer as the custodian of funds and official representative of the bondholders. Trustees are appointed to ensure compliance with the contract and represent bondholders to enforce their contract with the issuers.

Unlimited-tax bond. A bond secured by the pledge of taxes that are not limited by rate or amount.

Yield to maturity. The average annual yield on the security, assuming that the security is held to maturity and that the interest is reinvested at the yield to maturity.

Zero-coupon bond. A bond that is sold at a discount to par and makes no periodic interest payments. At maturity, the investor receives one payment equal to the principal invested plus interest earned, compounded semiannually at the original interest rate.

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