De minimis tax rule considerations

Wealth Management

Municipal bonds are well known to provide interest income that is tax-free at the federal level—and in many cases, at the state and local levels too. However, what many investors may not know is that the price appreciation of a municipal bond purchased at a discount in the secondary market is subject to taxation at either the investor's capital gains rate or their ordinary income tax rate, depending on the magnitude of the discount. Therefore, investors should be mindful of the de minimis tax rule when purchasing secondary-market discounted bonds in order to avoid potentially surprising tax consequences from their "tax-free" investment.

What is the de minimis tax rule?

The de minimis rule states that if a bond is purchased in the secondary market at a discount greater than the de minimis threshold of one-quarter point multiplied by the number of full years to maturity (partial years are not counted), then the gain is taxed as ordinary income. Conversely, if the discount is less than the de minimis threshold, the windfall is taxed as capital gains. For investors in the highest tax bracket, the difference between the tax rate applied to capital gains (23.8%) and ordinary income (40.8%) can have a significant impact on the total return of the investment.

To illustrate the de minimis rule, consider a bond maturing in seven years that has a de minimis cutoff at 1.75 points (or a price of $98.25). If the bond were trading at $98.00, it would be trading at a discount in excess of the de minimis threshold, and therefore the gain would be taxed as ordinary income. Investors should be aware that if the discount exceeds the de minimis threshold, the full amount of the gain—not just the amount that exceeds the threshold—is taxed as ordinary income at maturity. On a positive note, the price appreciation is not subject to taxation annually, but instead is taxable in the year the bond is sold or redeemed.

While market-discounted municipal bonds are subject to taxation, their premium bond counterparts (bonds with prices in excess of par) do not receive a comparable tax offset. This one-sided tax treatment differs from most other fixed income investments because of the distinguishing tax-exempt features of municipal bonds.

Rising interest rate environments

A market discount is created when a bond's price falls below par after being issued at par or above in the primary market. Market discounts on secondary-market municipal bonds typically occur in rising interest rate environments, but also may occur when an issuer's risk profile deteriorates. And while all bonds are subject to potential de minimis tax consequences in a rising interest rate environment, lower-coupon bonds are more susceptible. Furthermore, when a bond approaches the de minimis threshold, its price tends to decline more rapidly because of the greater likelihood of undesirable tax implications and the resulting fall-off in investor demand.

Bond issued at par examples

	Exceeds de minimis threshold	Below de minimis threshold
Maturity date	Dec. 1, 2025	Dec. 1, 2025
Purchase date	Aug. 1, 2017	Aug. 1, 2017
Purchase price	$98.00	$98.50
De minimis threshold	$98.25	$98.25
Tax repercussions	Ordinary income	Capital gains
Taxed amount	$2.00	$1.50

Source - RBC Wealth Management

Original issue discount bonds are not the same as market-discounted bonds

An original issue discount (OID) is the difference between a bond's issuance price and its redemption value (typically par). The OID represents interest paid by the issuer in the form of capital appreciation, and is therefore treated as tax-exempt interest. The de minimis rule still applies to OID bonds; however, instead of the market discount being calculated from par, it is calculated from the “revised issue price”: the OID price plus accrued OID to the purchase date, using the constant interest rate method of accrual. As an example, consider an OID bond that originally sold at $98.00 with 25 years to maturity, and after five years has a revised issue price of $98.50. Because the bond has 20 years to maturity, its de minimis threshold is 5.00 points, or a price of $93.50 ($98.50 – $5.00 = $93.50). As a hypothetical, if the bond were purchased for $92, the de minimis rule would be triggered, but only the difference between the revised issue price (rather than par) and the purchase price would be treated as ordinary income. Returning to the example above, $6.50 ($98.50 – $92.00) would be taxed as ordinary income, and $1.50 would be tax-free.

OID bond examples

	Exceeds de minimis threshold	Below de minimis threshold
OID issue price	$98.00	$98.00
Issue date	Sept. 1, 2015	Sept. 1, 2015
Maturity date	Sept. 1, 2040	Sept. 1, 2040
Purchase date	July 1, 2020	July 1, 2020
Purchase price	$92.00	$95.00
Revised issue price	$98.50	$98.50
De minimis threshold	$93.50	$93.50
Tax Repercussions	Ordinary income	Capital gains
Taxed amount	$6.50	$3.50
Tax exempt amount	$1.50	$1.50

Source - RBC Wealth Management

Taxable bonds are subject to the de minimis rule too

Not to be left out in the cold, all taxable bonds are subject to the same de minimis tax consequences as tax-free bonds. If a taxable bond is purchased in the secondary market below the de minimis threshold, then the entire price appreciation on the bond is taxed as ordinary income. Conversely, if the gain is less than the de minimis threshold, the windfall is taxed as capital gains.

The devil is in the details

Municipal bonds may provide relatively low-risk tax-free returns for investors; however, buyers must be aware of the latent tax repercussions created by exceeding the de minimis rule on discounted bonds in the secondary market. When purchasing discounted bonds, investors must factor in both the yield to maturity and the potential negative tax implications to arrive at their effective yield. While the basic de minimis tax concept is easy to calculate (0.25 points multiplied by the number of years to maturity), successful execution may be more nuanced.