

# 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

### 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

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.

### 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.

## Disclaimer

The information contained in this report has been compiled by RBC Wealth Management from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC Wealth Management, its affiliates or any other person as to its accuracy, completeness or correctness. The material contained herein is not a product of any research department of RBC Capital Markets, LLC or any of its affiliates. Nothing herein constitutes a recommendation of any security or regarding any issuer; nor is it intended to provide information sufficient to make an investment decision. All opinions and estimates contained in this report constitute RBC Wealth Management's judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. This report is not an offer to sell or a solicitation of an offer to buy any securities. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. Nothing in this report constitutes legal, accounting or tax advice or individually tailored investment advice. This material is prepared for general circulation to clients and has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Diversification does not assure a profit or protect against loss. Bond investors should carefully consider risks such as interest rate, credit, repurchase and reverse repurchase transaction risks. Non-investment grade rated bonds (a.k.a. high yield bonds) tend to be subject to larger price fluctuations than investment grade rated bonds and payment of interest and principal is not assured. Investing in municipal bonds involves risks, such as interest rate risk, credit risk and market risk, including the possible loss of principal. Clients should contact their tax advisor regarding the suitability of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on state of residence. Income from municipal bonds could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. The investments or services contained in this report may not be suitable for you and it is recommended that you consult your financial advisor if you are in doubt about the suitability of such investments or services. To the full extent permitted by law neither RBC Wealth Management nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct, indirect or consequential loss arising from, or in connection with, any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior written consent of RBC Wealth Management in each instance. RBC Wealth Management is a division of RBC Capital Markets, LLC, member NYSE/FINRA/SIPC, which is an indirect wholly-owned subsidiary of the Royal Bank of Canada and, as such, is a related issuer of Royal Bank of Canada and part of the RBC Financial Group. Additional information is available upon request. ©2022 Royal Bank of Canada. All rights reserved.