



INFORMATION ON THE DE MINIMIS TAX RULE

One of the primary benefits of municipal securities is that coupon income received, in most cases, is exempt from federal income taxation. It's crucial to remember, however that the price appreciation of securities purchased at a discount in the secondary market can be taxable. The tax rate for these discount securities will depend on the Internal Revenue Code referred to as the de minimis tax rule.

In the raising interest rate environment, the de minimis rule creates a potential tax risk that can have a meaningful impact not only on the after-tax returns of investors in the upper tax brackets, but also on how securities are priced.

De Minimis Rule

The De Minimis rule determines if the price appreciation (sometimes called price accretion) of securities purchased at a discount will be taxed at the ordinary income tax rate or the capital gains tax rate. In the past this accretion was treated as a capital gain. In 1993 the federal tax code was revised to treat the accretion of discounted municipal bonds as ordinary income, but with certain exceptions applied to smaller market discounts.

The De Minimis rule states that if a discount is less than 0.25% of the face value for each full year from the date of purchase to maturity, then it is too small (de minimis) to be considered a market discount for tax purposes. Instead the accretion should be treated as a capital gain.

The De Minimis threshold price determines if the accretion of the market discount is taxable at the ordinary income or the capital gain tax rate. It is defined as follows:

De Minimis threshold = lower par or original issue discount (OID) – (0.25% x full years to maturity)

For some investors, especially those in higher tax brackets, taxation of bond's market discounts can have a noteworthy impact on after-tax returns. For a discounted municipal security purchased at a price below the De Minimis threshold, price accretion is subject to the ordinary income tax rate which could be above 40% for top earners. Subsequently, the accretion of a security purchased at a discount, but at a price above the De Minimis boundary is subject to a much lower capital gains tax rate if the bond is held for longer than one year.

Impact of market discounts in a rising interest rate environment

In the years following the 2008 financial crisis, through March 22, the US economy experienced an extraordinary period of declining and persistently low interest rates. As a consequence, municipal bond investing did not require careful consideration of the de minimis tax rule. The majority of the municipal market did not price below the de minimis threshold, and given low interest rates prior to 2022, most municipal securities traded at a significant premium.

This has changed after Fed raised rates near zero in 2022. In a rising rate environment, declining bond prices implies that more municipal securities could fall between the de minimis threshold. Also, the prolonged long interest rate environment of the past contributed to an uptick in municipal issuance with lower coupon bond structures at lower prices than their higher coupon counterparts.

As higher interest rates drive bond prices lower, those securities issued at or near par may now be more vulnerable to negative tax and liquidity implications associated with the de minimis rule.

- **Tax Impact.** Given the higher tax rate any buyer would incur as a result of purchasing bonds below the de minimis threshold, securities trading near or below the boundary will likely trade at an even lower price (and higher yield) to compensate investors for the impact of additional taxes. The traditional tax-sensitive municipal buyer may shun securities with any tax consequences, even in instances when yields compensate investors for the higher tax treatment.

These dynamics, in effect, may create a “price cliff” as bonds approach the de minimis cutoff. The impact of higher taxes and diminished liquidity may cause bond prices to deteriorate more rapidly than they otherwise would if the price was higher and further from this threshold.

The significance of rising rates: an example

Consider the following example using a municipal security that was issued at par with 10 years to maturity:

De minimis threshold: $100 \text{ (lower of par or current original issue discount price)} - (0.25\% \times 10 \text{ (full years to maturity)}) = \97.50

- If the security was purchased below \$97.50, the entire accretion from the purchase price to \$100 would be subject to the ordinary income tax rate (40.8% for top earners)
- If the security was purchased at a price between \$97.50 and \$100, the entire accretion from purchase price to \$100, under the de minimis rule, would be subject to the capital gains tax rate (23.8% for top earners) if held for greater than one year
- If the security was purchased at a premium (\$100 or higher), there would not be accretion (or tax consequences) associated with the bond as it matures

Tax Treatment of Price Accretion

Purchase Price	< \$97.50	\$97.50 to \$100	\$100+
Tax Rate on Price Accretion	43.4%	23.8%	0%

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Prices and yields are subject to change based upon market conditions and may fluctuate daily. Even though municipal bonds are exempt from federal income tax, but they may be subject to state and local taxes.