

Understanding De Minimis as it Relates to Municipal Bonds



James Thompson
Co-Portfolio Manager
Aquila Tax-Free Fund For Utah

The primary benefits offered by municipal bonds are generally well known to investors. Chief among these benefits is steady, predictable income, which is typically exempt from federal income tax—and, in some cases, also exempt from state and local income tax, depending on whether you are a resident of the state in which the bonds are issued.

However, something that municipal bond investors may not be aware of is a potential tax liability as it pertains to discounted bonds. While income from municipal securities may be tax-exempt, price appreciation on a bond purchased at a discount in the secondary market is generally taxable. And how this tax is treated pertains to the *de minimis rule*, a tax rule that defines when a municipal bond redemption may be considered a capital gain rather than ordinary income.

De minimis does not affect the way original issue discount (“OID”) municipal bonds are treated. The term “OID” is a discount from par value at the time a bond is originally issued. There is no taxation of the original issue discount because the difference between the discount price and the matured value is considered interest, which is tax-exempt. However, if an OID municipal bond is purchased at a discount in the secondary market, the discount amount generally taxed as ordinary income at the time the bond is sold or redeemed, as with other tax-exempt securities.

In this article, we’ll discuss the de minimis rule, along with key considerations for investors, particularly in periods of rising interest rates.

De Minimis Defined

The accrued market discount on a municipal bond is typically treated as ordinary income when it is sold or redeemed. An exception is a bond with a small discount, defined by the de minimis rule. According to this rule, if a discount is less than 0.25% of the face value of a bond for

each full year from the time of purchase to maturity, then it is considered too small to be a market discount for tax purposes. It is then treated as a capital gain rather than ordinary income, thereby providing a tax advantage to investors.

For example: Consider a hypothetical 10-year bond bought at \$980, giving it a \$20 discount (assuming a face value of \$1,000). The de minimis “threshold” for this bond is computed by multiplying the face value of the bond by 0.25% (.0025) times the number of years to maturity. For this particular bond, the de minimis threshold is calculated using the following equation:

$$\text{\$1,000 (face value of the bond)} \times .0025 \times 10 \text{ (years to maturity)} = \text{\$25 (de minimis threshold)}$$

In this example, the discount of \$20 is less than the de minimis threshold of \$25, so the de minimis exception—and, therefore, capital gain tax treatment (rather than ordinary income)—would apply.

Effects on Market Discounts

The consequence of a municipal bond “crossing the threshold” may affect its relative valuation and market liquidity. Once a bond’s price exceeds the de minimis threshold, it is generally considered less attractive on a relative basis, which may have a significant impact on prevailing bids in the marketplace and its daily pricing.

There are a number of important factors that go into determining the price and relative valuation of municipal bonds. These include the security type (e.g., general obligation or revenue bond), credit rating of the issuer, maturity date, yield, expected liquidity, among others. De minimis and its potential tax consequence can also influence the price of a bond in the secondary market.

In a rising interest rate environment, higher yields can result in deeper price discounts, and with them, the need for greater awareness of the de minimis rule. As higher interest rates drive bond prices lower, those securities issued at or near par may be more vulnerable to negative

continued on next page...

Understanding De Minimis as it Relates to Municipal Bonds

tax and liquidity implications associated with de minimis.

Although municipal bond investors often hold their bonds until the stated maturity, there may be reasons why they may choose to sell them prior to the maturity date. Keep in mind that if investors receive a price greater than their cost basis, the gain may be subject to capital gains tax (cost basis is the acquisition price after adjusting for any premiums paid or discounts received, if not an original issue discount bond).

Conclusion

While municipal bonds generally offer income exempt from federal income tax (and in some cases, exempt from state and local income tax), investors should carefully consider all aspects and characteristics, just as they would with any investment vehicle. The de minimis rule defines pricing parameters and potential tax treatment for municipal bonds subject to market discounts. The rule is of particular significance in periods of rising interest rates, as it can influence relative price valuations and market liquidity.

This information is general in nature and is not intended to provide investment, accounting, tax or legal advice. Tax laws are subject to change. Aquila Distributors LLC does not provide investment, accounting, tax or legal advice. Individuals should seek tax advice based upon their particular situation and individual financial goals.

Mutual fund investing involves risk; loss of principal is possible. Investments in bonds may decline in value due to rising interest rates, a real or perceived decline in credit quality of the issuer, borrower, counterparty, or collateral, adverse tax or legislative changes, court decisions, market or economic conditions. State-specific fund performance could be more volatile than that of funds with greater geographic diversification.

Before investing in the Fund, carefully read about and consider the investment objectives, risks, charges, expenses, and other information found in the Fund prospectus. The prospectus is available from your financial advisor, when you visit www.aquilafunds.com or call 800-437-1020.