Bond Case Briefs

Municipal Finance Law Since 1971

Why Some Bargain Municipal Bonds Aren't Tax Free.

When individuals invest in municipal bonds they expect 100% tax-free income. Right? Well, many may unknowingly be setting themselves up for a tax bill from the IRS. How can this be? After all, we're talking munis.

It's been many years since the municipal bond De Minimis rule was relevant. Here's how it works in plain English: Say you purchase a low coupon municipal bond for a 2%, 2.25%, 2.50%, or even 3% coupon at a discount from the face value in the secondary market. If that discount breaches the IRS De Minimis threshold, then a portion of that discount can be taxed as ordinary income.

It all depends on how deeply the bond price is discounted. The simple formula to compute the De Minimis threshold is:

De Minimis threshold = Lower of par or original issue discount – (.25% X the years to maturity)

The formula basically stipulates that if you purchase a bond at a discount and the discount is equal to or greater than a quarter of a point per year until maturity, then your gain at redemption is taxed at your ordinary income tax rate rather than the more favorable capital gains rate, which are as low as 15%.

If this sounds like IRS gobbledygook, you are right. The law was created to prevent taxpayers from converting ordinary income into capital gains. Remember the only IRS rule you should commit to memory is: Whatever is best for the government and worst for the taxpayer is the correct rule interpretation .

Here's an example: Assume you purchased 50 XYZ Unified School District municipals, 2.00% coupon maturing September 1, 2028 originally issued at par, 100. If you purchased the bonds in the secondary market today at 90.288 for a 3.00% yield-to-maturity because rates rose since issuance, you will owe $2,107.50 in tax on $50,000 face value of the bonds.

The market discount cutoff price was $97.25. Okay—paying $2,107.50 in tax on 50 munis isn't the end of the world. Still, it could blindside you if your weren't aware of the De Minimis rule.
Your rule of thumb for purchasing municipal bonds should now be: If you want all your return to be tax free then invest in higher coupon bonds at par or a slight premium.

Stay away from market discounted munis. If you're doing business with a retail broker ask them to run the analytics on Bloomberg. That will quickly compute your tax liability if purchasing at a discounted price.

One caution: If interest rates rise significantly, high coupon premium bonds can decline and breach the De Minimis threshold too.

The De Minimis rule also has a significant impact on your bond price. Should you decide to sell a bond subject to the De Minimis rule your sale of the bond will be at an even deeper discount. The buyer will demand compensation for that portion of their [now] taxable return.

The reason we have not been plagued until recently with the De Minimis rule is that issuers weren't issuing many 2%, 2.25%, 2.50%, or 3% municipal bonds until 2016 when yields touched such low levels. Then post-election muni yields rose and prices declined.

If you buy munis online and your platform does not supply a De Minimis calculator better get out your pencil and paper for hand computations. There are numerous articles online written by Piper Jaffray, Pimco, Schwab, RBC and others explaining the formulas and with grids showing allowable market discounts before treatment as ordinary income kicks in.

Let this column be a red flag warning: The De Minimis rule can bite the incautious. Oh…and if you think no one will notice the discounted price you paid, the 1099s issued by the brokerage industry are extremely accurate in their reporting to the IRS.

FORBES

by MARILYN COHEN

FEB 7, 2017 @ 11:48 AM

Marilyn Cohen is founder and CEO of Envision Capital Management, a Los Angeles fixed-income money manager.