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Understanding De Minimis as it Relates to Municipal Bonds.

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.

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