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MSRB Warns of Liquidity, Tax Concerns on Discounted Bonds.

Investors in municipal bonds should take into account that rising interest rates this year could lead bonds trading at a discount to be less liquid than those trading at par value, the Municipal Securities Rulemaking Board warned Friday.

Investors should also monitor their portfolios for bonds falling to a significant discount price, according to the MSRB's issue brief warning investors of the new tax and liquidity issues they could face in this new higher interest rate environment.

"With the rise in interest rates and corresponding decline in municipal bond prices since the beginning of 2022, there has been a significant increase in the amount of bonds being offered and trading at substantial discounts to their par value," said John Bagley, MSRB chief market structure officer. "While these bonds may appear attractive because of their higher yields, investors need to understand that they could face tax consequences and have a harder time selling these bonds."

The MSRB issued the brief in response to its own internal analysis, noting that bond yields were up 90 to 120 basis points. While those figures were not quite as large as those exhibited during the COVID-19 market dislocation in March 2020, they are still significant, Bagley said.

"Bonds trading at substantial discounts away from high yield is not something the market and individual investors have had to deal with very much in the last ten to fifteen years," Bagley said.

Bonds trading at a discount on the secondary market could trigger the Internal Revenue Service's de minimus discount rule, which, "determines whether the price appreciation (or accretion) of a bond that is purchased at a discount will be taxed at the ordinary income tax rate or if it will be taxed at the capital gains rate," the MSRB issue brief said.

"If the market discount is less than one quarter of 1% of the stated redemption price of the bond at maturity, multiplied by the number of complete years to maturity from when the taxpayer acquires the bond, the market discount will be deemed de minimis and treated as a capital gain for tax purposes if the bond is held to maturity, redeemed or sold for a price above the purchase price," the MSRB issue brief said. "If the discount is greater than this de minimis threshold, the accrued market discount realized at maturity must be treated as ordinary income."

But tax concerns aren't the only consideration investors should have in mind in this new rate environment.

"It is important to note that bonds that reach a substantial discount can have significantly less liquidity than bonds trading around par or at a premium," the MSRB issue brief said. "If an investor needs to sell a bond that is at a significant discount, there may be fewer willing purchasers."

Investors also need to consider the fact that such a market discount would constitute material information and need to be disclosed by dealers under MSRB Rule G-47 on time of trade disclosure.

If interest rates continue to rise, regulators may take an interest in wider de minimis disclosure, but that may take time. Firms could also see the matter as a chance to better inform clients about liquidity risk, which may or not be a problem for each individual investor.

“This is not a message to not buy these types of bonds, it is just to make sure investors have all the information,” Bagley said.

But what happens at the Federal Reserve in the coming months could have further influence on how these bonds trade and how exposed one is to tax and liquidity risk.

“If interest rates go back down, this could become less of an issue,” Bagley said. “If interest rates stay here and go up, it could be an issue for a while.”

By Connor Hussey

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