Bond Case Briefs

Municipal Finance Law Since 1971

Don't Let The IRS Catch You With The Forgotten De Minimis Rule.

Woe be to the municipal bond investors who forgot the De Minimis Tax Rule. It has been 10 to 15 years since municipal bonds traded at discounts to their $1,000 face value for a lengthy period of time. Sure, munis got nuked during the March 2020 pandemic panic and sold at deep discounts as the panic worsened. But today's scenario is very different.

As the Federal Reserve and bond market push interest rates higher, all bond prices continue to decline. If you are looking to purchase low coupon discounted municipal bonds then heed these words. There may be tax consequences.

Investors buy municipal bonds for tax free safe income—period. But when rates rise and bond prices fall to a certain level then the IRS, in its infinite wisdom, has a rule. That rule is called the De Minimis Tax Rule. Here's the gobbly gook definition:

> The de minimis tax rule sets the threshold at which a discount bond should be taxed as a capital gain rather than as ordinary income. The rule states a discount that is less than a quarter-point per full year between its time of acquisition and its maturity is too small to be considered a market discount for tax purposes. Instead, the accretion from the purchase price to the par value should be treated as a capital gain, if it is held for more than one year. To determine if a municipal bond is subject to the capital gains tax or ordinary income tax, multiply the face value by 0.25%, then multiply the result by the number of full years between the discounted bond's purchase date and the maturity date. Subtract the derived de minimis amount from the bond's par value. If this amount is higher than the purchase price of the discount bond, the purchased bond is subject to the ordinary income tax rate. If the purchase price is above the de minimis threshold, capital gains tax is due. In other words, if the market discount is less than the de minimis amount, the discount on the bonds is generally treated as a capital gain upon sale or redemption rather than as ordinary income.

In plain English, if you purchase a discounted municipal bond make sure the discount doesn't come back to you on sale or at maturity as ordinary income or capital gains. These kinds of surprises can really wreck your tax planning.

With inflation everywhere, a strong economy and a Federal Reserve that has curbing high inflation as their top priority—interest rates will continue to climb. Therefore, all bond prices will continue to fall.

If you own 1.50% to 2.50% coupon municipal bonds and decide to sell them, beware. The bids on such bonds will run from low to terribly low. That's because educated buyers will demand deeper discounts to make up for the ordinary income or capital gains your bonds will cost them. Fair enough as long as the buyers and sellers each know the rules.

So dust off your Investopedia to make sure de minimis doesn’t take a tax bite out of your tax free bonds.

Forbes

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