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Rising Yields Are Pushing More Munis Below Par. Watch Out for the De Minimis Trap.

Municipal bond investors usually focus on one number: the tax-free yield. But as yields have climbed this year, and especially since the Fed raised rates last week for the first time since 2023, a growing number of older municipal bonds are trading below their face value. That creates a tax wrinkle that catches a lot of investors off guard. Part of the return on a discounted muni may not be tax-free at all.

The issue is called the de minimis rule, and it’s worth understanding before you buy individual munis in the secondary market or evaluate the after-tax yield of a muni fund right now.

Here’s the basic idea. When you buy a bond for less than its par value in the secondary market, the difference between what you paid and the par amount you receive at maturity is called market discount. For municipal bonds, the interest coupon is generally exempt from federal income tax, but market discount is not. It’s taxable, and the question is how.

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