CAPITAL MARKETS GROUP

The De Minimis Tax Rule

Rising rates generally mean falling bond prices, resulting in more bonds being purchased at a discount to their face value. This market shift may result in tax-exempt municipal bonds being subject to market discount rules for federal income tax purposes. It is important that investors understand the potential tax risks associated with municipal bonds bought at a discount.

Generally, interest on municipal bonds is exempt from federal income tax. When a municipal bond is purchased at a discount, however, the discount may be subject to federal income tax when the bond matures or is otherwise disposed of. The tax rate applicable in this situation – either the capital gains tax rate or the ordinary income tax rate – is determined by applying a provision known as the "de minimis tax rule."

What is the De Minimis Tax Rule?

The de minimis tax rule says that if the discount on the bond is less than a minimum threshold (i.e. the discount is "de minimis"), then the discount is taxed at the capital gains tax rate, which is generally a maximum of 20%. If the discount is equal to or greater than the threshold, then the discount is taxed at the rate for ordinary income, which may be as high as 37% under current law. The de minimis threshold is defined as 0.25% of the bond's face amount for each full year from the purchase date to maturity.

How to Calculate the De Minimis Threshold

The below equation can be useful when determining if the de minimis tax rule applies to a municipal bond purchased at a discount and whether the discount is taxed as capital gain or ordinary income when the bond matures or is otherwise disposed of.

De Minimis Threshold Calculation:

1. Multiply the face value of the bond (i.e. the price when issued) by 0.25%.
2. Take the result above and multiply it by the full number of years between the time you purchased the discounted bond and the bond's maturity.
3. Subtract the above result from the face value to determine the de minimis threshold.

Purchase Price > **De Minimis Threshold** = **Capital Gains Tax**

Purchase Price < **De Minimis Threshold** = **Ordinary Income Tax**

In general, if the purchase price is greater than the de minimis threshold calculated, then the discount may be subject to capital gains tax when the bond matures or is otherwise disposed of. If the purchase price is less than or equal to the de minimis threshold, the discount may be subject to ordinary income tax at maturity or on a subsequent disposition of the bond.

To illustrate, let's consider a tax-exempt municipal bond issued at par with 15 years to maturity. Using this equation, we can determine the de minimis threshold as follows:

1. 100 * 0.25% = 0.25
2. 0.25 * 15 = 3.75
3. 100 - 3.75 = 96.25

If the purchase price of the municipal bond is less than or equal to the de minimis threshold amount of 96.25, the discount is generally subject to the ordinary income tax rate.

If the purchase price of the municipal bond is greater than the de minimis threshold amount of 96.25, the discount is generally subject to the capital gains tax rate. If the bond was held for more than one year, the applicable tax rate should be the long-term capital gains rate.

If the municipal bond is purchased at a premium, meaning greater than 100% of its par value, there should generally be no taxable event associated with the purchase price of the bond.

Next Steps:

Review your portfolio holdings and access additional resources.

- **IRS:** Tax Exempt Bonds
- **MSRB:** About Original Issue Discount Bonds

Scan above QR code to bookmark a current digital copy of this flyer and to access the resource links.

Speak with your financial advisor and tax professional to learn more about the de minimis tax rule.

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