De Minimis Dilemma

Background

Most municipal bonds issued over the past 30 years have had a coupon of at least 5%, though the proportion declined as market interest rates fell over time. For example, the percentage of the market value of bonds with a coupon of at least 5% in the ICE BofA US Municipal Securities Index[1] was 94% in December 1996, 90% in December 2006, 84% in December 2016, and 67% as of September 2023. The more interest rates fell, the more lower coupon bonds (below 5%) were issued. Lower coupons helped address retail demand for bonds with lower price premiums over face value, which increased substantially on higher coupon bonds when market rates were much lower than they are today. Snapshots of the Index on the above dates indicate that bonds with coupons of at least 4% but less than 5% increased from 4.5% in 1996, to 9.3% in 2006, to 11.4% in 2016, and to 23% in 2023. For those periods the proportion of bonds with coupons of at least 2% but less than 4% increased from 0.1%, to 0.8%, to 2.5%, to 7.0%. The effect of the rapid increase in market interest rates over the past two years on the prices of bonds in the Index has been to send many of them below par value, particularly the ones with coupons less than 5%. For example, prior to 2023 in all three of the above snapshots of the Index, the proportion of bonds with coupons of at least 2% but less than 5% priced at a discount to par was 2.3%–2.4% of the market value of the Index. As of September 30, 2023, that proportion was 27.5%, with nearly all these lower coupon structures priced at a discount.

Tax-exempt municipal bonds are subject to market discount rules established by the IRS. The greater a bond's market price is above its face value (accreted value for an original issue discount bond), the greater its cushion against the de minimis threshold under IRS market discount rules. The de minimis threshold lies a certain amount of points below a bond's face value (accreted value for an original issue discount bond). The discount accretion on a tax-exempt bond purchased in the secondary market may have adverse tax consequences for the holder if the bond was acquired below the de minimis threshold. Because municipal bonds issued with lower coupons may trade closer to par value (or at a discount to par value in many cases) than a bond with, say, a 5% coupon, its price may be more adversely affected by a rise in market interest rates, particularly if the price falls below the de minimis threshold due to the more adverse tax implications. Investors in these securities should know the risks associated with market discount bonds.

Who's Affected

- Investors in tax-exempt securities generally avoid purchasing bonds in de minimis because of the potential adverse tax consequences.
- The potential adverse tax consequences associated with bonds in de minimis do not apply to investors who purchased securities in the new issue market.

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Key Terms

Market discount arises when a debt instrument purchased in the secondary market has decreased in value since its issue date, generally because of an increase in market interest rates. Market discount is the difference between the revised issue price of a bond and the cost basis in the bond. The revised issue price is par for a bond originally issued at a price greater than or equal to par. However, the revised issue price for a bond originally issued at a price below par (an original issue discount bond) is the issue price plus the accreted original issue discount to the date of purchase. The de minimis rule states that if the market discount (revised issue price less purchase price) is less than 0.250 multiplied by the number of full years to maturity after acquisition, the market discount is treated as a capital gain for tax purposes if the bond is held to maturity or sold for a price above the purchase price. If the discount is greater than the de minimis threshold, the accrued market discount realized at maturity must be treated as ordinary income rather than as a capital gain for tax purposes. However, if the bond is sold above the purchase price prior to maturity, part of the accrued market discount realized may be treated as a capital gain and part as ordinary income, depending on how much market discount has accrued up to the sale date. To calculate the accretion, the IRS uses the constant-yield method, which accelerates as the life of the bond shortens. The de minimis rule described here applies only to individuals, not to corporations that buy tax-exempt securities.

Original issue discount (OID) arises when a debt instrument is issued at a price below its face value (such as a zero-coupon bond). The amount of OID at issuance is the difference between the stated redemption price at maturity and the issue price. OID is calculated at the time of issuance and is allocated, as stated above, using the constant-yield method over the life of the security. Investors annually receive Form 1099-OID detailing the OID applicable in each year. The annually accreted OID is considered interest income and is taxed as such. Therefore, the OID on tax-exempt bonds is tax free, while the OID on taxable securities is subject to taxation as interest income. However, OID bonds purchased in a secondary market transaction may be subject to the de minimis rule discussed above. An OID bond has market discount if the purchase price is less than the revised issue price (original issue price plus the accreted OID up to the purchase date). The tax consequences related to the de minimis rule do not apply to investors who purchase OID bonds in the new issue market.

HYPOTHETICAL EXAMPLES OF MARKET DISCOUNT

CASE 1

BOND ORIGINALLY ISSUED AT A PREMIUM HELD TO MATURITY (93974EUH7)

ISSUER:	State A
Coupon:	4.000%
Dated Date:	11/16/2021
Maturity Date:	02/01/2036
Next Par Call:	02/01/2032
Issue Yield/Price:	1.55% / $123.047

HYPOTHETICAL TRANSACTION

Purchase Date:	09/30/2023
Sale Date:	Held to Maturity
Yield/Price:	4.052% / $99.500

Recall that the allowable market discount under the de minimis rule is 0.250 per year (25 basis points per year, or, one full percentage point every four years). In this case, the bond has 12 complete years to maturity. Thus, the bond may sell for up to 3.000 points less than par — that is, 97.000 — and be considered to have zero market discount for tax purposes. In this hypothetical example, the bond is priced at 0.500 point below par. Therefore, an investor who purchases this bond at the stated price on September 30, 2023, and holds it to maturity, would be required to pay only the applicable capital gain rate on the accrued discount, plus any applicable state taxes (23.8% is the top federal long-term capital gain tax rate). The federal capital gain tax due at maturity would be approximately $1,190 (0.500 x 23.8%) per $1 million face amount.

CASE 2

OID BOND HELD TO MATURITY (419792JD9)

Issuer:	State B
Coupon:	3.000%
Dated Date:	04/14/2016
Maturity Date:	04/01/2036
Next Par Call:	04/01/2026
Issue Yield/Price:	3.200%/$97.065

HYPOTHETICAL TRANSACTION

Purchase Date:	9/30/2023
Sale Date:	Held to Maturity
Yield/Price:	4.536% / $85.500

In this case, the bond was originally issued at a price below par and has 12 complete years remaining to maturity. Thus, the bond may sell for up to 3.000 points less than the revised issue price (that is, the original issue price plus the accreted OID through September 30, 2023) and be considered to have zero market discount for tax purposes. The revised issue price in this case is $97.952, and the bond is considered to have zero market discount if bought at a price above $94.952 (revised issue price less 3.000 points). However, the bond is priced 12.452 points below the revised issue price. Therefore, an investor who purchases this bond at the stated price on September 30, 2023, and holds it to maturity, would be required to pay the applicable income tax rate on the accrued discount, plus any applicable state taxes (40.8% is the top federal income tax rate, which includes the 3.8% tax on net investment income). The federal income tax due at maturity would be approximately $50,804 (12.452 x 40.8%) per $1 million face amount.

CASE 3

BOND ORIGINALLY ISSUED AT A PREMIUM SOLD BEFORE MATURITY (677522W26)

Issuer:	State C
Coupon:	3.000%
Dated Date:	02/26/2020
Maturity Date:	03/01/2030
Issue Yield/Price:	1.500% / $113.898

HYPOTHETICAL TRANSACTION

Purchase Date:	09/30/2023
Sale Date:	09/30/2025
Yield/Price:	3.985% / $94.500
Sale Price:	$96.500

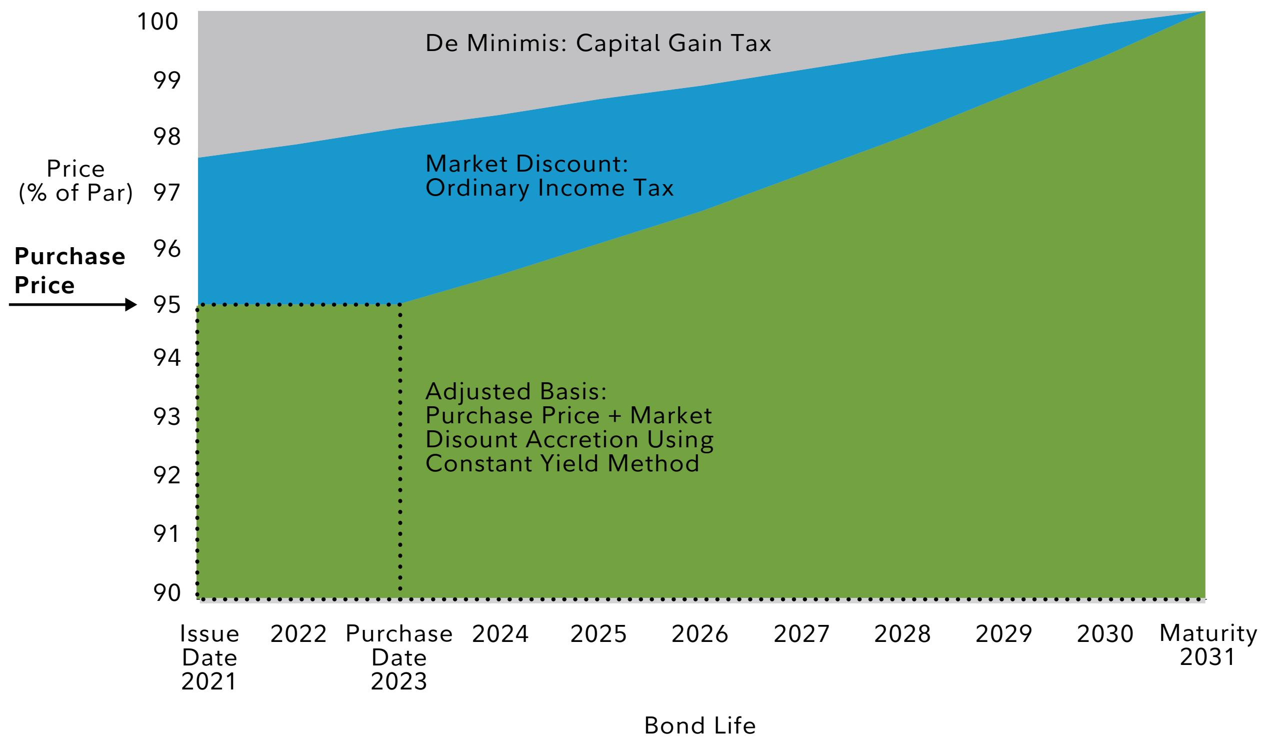
In the first two cases, the tax consequences were for bonds held to maturity. Case 3 provides an example of the tax implications of selling a bond before the maturity date. In this case, the bond was originally issued at a price above par and has six complete years remaining to maturity. Thus, the bond may sell for up to 1.500 points less than the revised issue price (par in this case) and be considered to have zero market discount for tax purposes. However, the bond is priced at 5.500 points below par. Therefore, an investor who purchases this bond at the stated price on September 30, 2023 and sells it for a hypothetical price of $96.500 two years later would be subject to capital gain and ordinary income taxes, plus any applicable state taxes. The total gain is equal to 2.000 points ($96.500 less $94.500) and is treated for tax purposes as follows: 0.434 points capital gain and 1.566 points ordinary income. The market discount accrued over the two-year holding period is taxed as ordinary income, while the remaining gain is taxed at the lower capital gain rate. The federal income tax due would be approximately $7,422 (0.434 x 23.8% plus 1.566 x 40.8%) per $1 million face amount. Note that the portion of the gain treated as ordinary income increases with the holding period up to 100% of the gain at maturity.

The FTAX function on a Bloomberg terminal may be a useful tool for estimating taxes associated with market discount bonds. Entering the CUSIP followed by the Muni function key and FTAX <GO> provides access to this page. The FTAX function allows the user to manipulate several fields, including face amount, purchase price, holding period, and tax rate.

In general, market discount has a greater impact on shorter-maturity bonds due to the smaller market discount permitted by the de minimis rule and the greater risk that a realized gain will be subject to ordinary income taxes. Once bonds fall into market discount territory, liquidity tends to diminish and price movements for small changes in yield tend to be highly volatile. This reflects the higher duration that market discount bonds may exhibit because such securities may be priced to maturity rather than to the call date. Thus, in addition to potentially paying unwelcome ordinary income taxes, investors holding bonds near the de minimis threshold may also experience an unexpected extension of their portfolio duration if interest rates rise further.

The following chart is an illustration of market discount accretion for a hypothetical non-OID 10-year bond purchased with eight years remaining to maturity at a $95 price.

ACCRETION TIME LINE FOR A NON-OID MARKET DISCOUNT BOND



Source: Fidelity Capital Markets, October 12, 2023.

Footnotes

1 ICE BofA US Municipal Securities Index: ICE BofA US Municipal Securities Index tracks the performance of U.S. dollar-denominated investment-grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market. Qualifying securities must have at least one year remaining term to final maturity, at least 18 months to final maturity at the time of issuance, a fixed coupon schedule and an investment-grade rating (based on an average of Moody's, S&P, and Fitch). Minimum size requirements vary based on the initial term to final maturity at time of issuance. Securities with an initial term to final maturity greater than or equal to one year and less than five years must have a current amount outstanding of at least $10 million. Securities with an initial term to final maturity greater than or equal to five years and less than ten years must have a current amount outstanding of at least $15 million. Securities with an initial term to final maturity of ten years or more must have a current amount outstanding of at least $25 million. The call date on which a pre-refunded bond will be redeemed is used for purposes of determining qualification with respect to final maturity requirements. Mandatory put or mandatory tender securities and original issue zero coupon bonds are included in the Index. Limited offering securities only qualify for inclusion in the U.S. municipal indices after their first settlement date are also included in the index. All secondarily insured securities, taxable municipal securities, 144a securities, securities in legal default and securities issued under the Municipal Liquidity Facility or a municipal commercial paper program are excluded from the Index. Index constituents are market capitalization weighted. Accrued interest is calculated assuming next-day settlement. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the index. The index is rebalanced on the last calendar day of the month, based on information available up to and including the third business day before the last business day of the month. New issues must settle on or before the following calendar month-end in order to qualify for the coming month. No changes are made to constituent holdings other than on month-end rebalancing dates. The rules take into account all revisions up to and including August 31, 2023.

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