What is all the hype about the De Minimis Tax Rule?

How Are Municipal Bonds Taxed?

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A bond is a debt security issued by a company or government to raise money and cover spending needs. A municipal bond, also known as a muni, is debt security used to fund capital expenditures for a county, municipality, or state. Municipal bonds are commonly tax-free at the federal level but can be taxable at state or local income tax levels or under certain circumstances.

KEY TAKEAWAYS

- Municipal bonds are debt securities issued by state, city, and county governments to help cover spending needs.
- From an investor's perspective, munis are interesting because they are not taxable on the federal level and often not taxable at the state level.
- Munis are often favored by investors in high-income tax brackets because of the tax advantages.
- If an investor buys the muni bonds of another state, their home state may tax interest income from the bond.
- It is beneficial to check the tax implications of each specific municipal bond before adding one to your portfolio, as you might be unpleasantly surprised by unexpected tax bills on any capital gains.

Overview of Municipal Bonds

For an investor, one of the major advantages of munis is that they are typically exempt from federal income tax. These debt securities are often excused from local and state tax as well, particularly when the bond's investor lives in the state in which the bond was issued.

Essentially, when investors buy a municipal bond, they loan money to the bond's issuer in exchange for a specified number of interest payments over a set period of time. The end of this period is referred to as the bond's maturity date, defined as when the investor's full investment principal is returned. Municipal bonds, because they are tax-exempt, are popular among individuals in higher income tax brackets.

While munis are generally assumed to be tax-free, investors should determine a bond's tax consequences before investing. If an individual invests in a bond issued by an agency of their home state, there is rarely state tax charged. However, if they buy the bonds of another state, their home state may tax their interest income from the bond.

While the interest income is usually tax-exempt for municipal bonds, capital gains realized from selling a bond are subject to federal and state taxes. The short-term or long-term capital gain, or loss, on a bond sale, is the difference between the selling price of the bond and the original purchase price of the bond.

Municipal Bonds and Capital Gains

When buying munis on the secondary market, investors must be aware that bonds purchased at a discount (less than par value) will be taxed upon redemption at the capital gains rate. Note that this tax does not apply to coupon payments, only the principal of the bond.

For example, the table below shows three different bonds, all maturing in two years, and all of which give the buyer a return of 4% if purchased at their net present value price:

Bond	Required Rate of Return	Coupon Rate	Cash Flow at End of Year 1 (Coupon)	Cash Flow at End of Year 2 (Coupon+ Principal)	Net Present Value
Par	4%	4%	$4	$104	$100

Premium	4%	6%	$6	$106	$103.77
Discount	4%	2%	$2	$102	$96.22

The difference between the net present value and the principal payment at maturity is taxed at a capital gains rate of 15%.[1] In this case, the discount bond (from above) will be worthless to the buyer, as shown below.

Bond	**Required Rate of Return**	**Coupon Rate**	**Cash Flow at End of Year 1 (Coupon)**	**Cash Flow at End of Year 2 (Coupon + Principal - Tax)**	**Net Present Value**
Discount (Not Taxed)	4%	2%	$2	$102	$96.22
Discount (Capital Gains Tax of 15%)	4%	2%	$2	$101.34 (Tax=$100 - $95.62 x 0.15)	$95.62

An investor could end up paying $96.22 for a bond that is only worth $95.62 without knowing that the gain is subject to capital gains tax. So when looking at a muni bond offered for sale on the secondary market, the investor must look at the price of the bond, not just the yield to maturity, to determine whether tax consequences will affect the return.

The bad news is that while discount bonds are taxed, bonds purchased at a premium do not work similarly; they cannot offset capital gains by providing capital losses. This tax rule runs contrary to that of most investments, including other types of bonds, because the Internal Revenue Service treats tax-free instruments differently than their taxable counterparts.

Therefore, when analyzing yields for muni bonds offered on the secondary market, the yield-to-maturity figure is usually sufficient to determine an expected return. For discount bonds, one must also factor in the negative tax implications that can arise from capital gains.

Municipal Bonds and "De Minimis"

One of the most confusing concepts related to muni bonds is the de minimis tax rule. This nugget of tax law states that if you purchase a bond at a discount and the discount is equal to or greater than a quarter-point per year until maturity, then the gain you realize at the redemption of the bond (par value minus purchase price) will be taxed as ordinary income, not as capital

gains. This could mean the difference between paying 15% and 37% on the gain[2] for those in the top tax bracket.

For example, let's take the discount bond from the previous example. Because it is a two-year bond, we can calculate that purchasing it for $99.50 or less will mean falling into the de minimis rule and being taxed at the ordinary income tax rate:

Par Value	-	(Amount Allowable * Years to Maturity)	=	De Minimis Cutoff
$100	-	(0.25 * 2)	=	$99.50

Since the net present value for this bond is well below $99.50, we need to calculate the tax consequences when the gain on the principal is taxed as ordinary income, as indicated here:

Bond	Required Rate of Return	Coupon Rate	Cash Flow at End of Year 1 (Coupon)	Cash Flow at End of Year 2 (Coupon + Principal - Tax)	Net Present Value
Cap. Gains Tax (15%)	4%	2%	$2	$101.34	$95.62
Ordinary Income Tax (37%)	4%	2%	$2	$100.38 (Tax = $100 - $95.62 x 0.37)	$94.73

While an investor might pay $95.62 if only accounting for capital gains tax, the true value is much lower—only $94.73. At the time of purchase, the buyer must recognize whether the bond is subject to de minimis because the after-tax return could be substantially less than expected.

Municipal Bonds and Federal Taxes

The federal government does not tax most activities of states and municipalities, thereby giving most muni bonds tax-exempt status. However, some activities do not fall under this tax exemption. For instance, coupon payments for muni bonds sold to fund those activities are federally taxed, with one common example is a bond issued to fund a state's pension plan obligation. When this type of bond is for sale, brokers selling the bond should readily know whether it is taxable.

The IRS includes municipal bond income in the modified adjusted gross income (MAGI) when determining how much of a Social Security benefit is taxable.[3]

Another more harrowing example of taxable munis are those that are issued as tax-free, then later become taxable if and when the IRS determines the proceeds are being used for purposes that do not fall under tax-exempt status. This is very rare, but when it happens, it leaves a lot of very unhappy investors; their coupon payments are taxed as ordinary income and, if they choose to sell the bond, the price they receive will be reduced because buyers would require a higher yield on a taxable bond.

Generally, taxable munis are still exempt from state and local taxes, so investors in states with high-income taxes may find that they get a better after-tax return than with other fixed-income investments that are fully taxable at all levels, such as corporate bonds or certificates of deposit.

The Alternative Minimum Tax

Although it is relatively uncommon, some muni bonds are federally taxed if the holder is subject to alternative minimum tax (AMT). If you are unsure whether a specific muni is subject to AMT, consult the broker before purchase.

For example, a bond that is used for a particular municipal improvement that is not backed by the credit of a state or municipality, but rather that of a corporation (such as an airline backing an airport improvement bond), would be subject to AMT.

Zero-Coupon Municipal Bonds

Zero-coupon municipal bonds, which are bought at a discount because they do not make any interest or coupon payments, don't have to be taxed. In fact, most aren't. As long as you're investing in a local municipal bond, taxes won't be a concern. This provides a big advantage over taxable bonds, even with lower interest. To determine whether or not a tax-free bond is a better option than a taxable bond, simply apply the Tax Equivalent Yield (TEY) formula.

Another important note here is that you will likely be subject to a capital gain or loss if you sell the bond before it matures. If you sell higher than the adjusted issue price, then you book a capital gain. If you sell for less than the

adjusted issue price, you suffer a capital loss, which can be utilized to reduce your overall tax bill.

The biggest and most obvious benefit of zero-coupon bonds is that you're buying the bond at a big discount to its face value. This is also known as the original issue discount or OID. For example, you can buy a $1,000 bond for $500. However, most zero-coupon municipal bonds are sold in denominations of $5,000. Either way, you're buying at a tremendous discount. This, in turn, allows you to buy more bonds if you so desire. The longer the bond has to mature, the bigger the discount you will receive.

Of course, you have to hold up your end of the bargain to see the greatest benefits. And that simply means that you must remain patient until the bond matures. By doing so, you will see a substantial return that's also tax-free. And if you're the type of person who does not like guesswork or worrying about economic conditions, it is worth considering a zero-coupon municipal bond because you will receive one payment at maturity, which is based on the principal invested plus the interest earned (compounded semi-annually) at a predetermined yield.

Most zero-coupon municipal bonds mature between eight and 20 years. If you're a risk-averse investor and you're looking towards retirement, then it's highly recommended that you discuss zero-coupon municipal bonds with your financial advisor.

$3.9 trillion

The municipal market size in the United States.[4]

Municipal bonds are one of the safest investments you will find with an average default rate of 0.08% between 1970 and 2019, according to an annual study by Moody's credit agency.[5] Indeed, most zero-coupon municipal bonds are rated A or higher by the rating agencies, but it's still important to check the quality of the issuer. If you're uncertain or questioning whether or not you made a good decision, you can ease your mind by purchasing insurance for the bond.