

Tax Implications of Buying Discounted Municipal Bonds Subject to the De Minimis Tax Rule

Introduction

Municipal bonds are debt securities issued by states, cities, counties, and other governmental entities to finance their capital expenditures, such as building schools, highways, or sewer systems. These bonds typically offer tax-exempt interest income, making them attractive to investors looking to minimize their tax liabilities. However, buying municipal bonds at a discount can introduce complex tax implications, particularly with the de minimis tax rule.

Understanding the De Minimis Tax Rule

The de minimis tax rule is a regulation that applies to the discount at which a municipal bond is purchased. Specifically, it determines whether the discount is considered a capital gain or ordinary income upon sale or redemption. The rule helps prevent investors from converting what would typically be tax-exempt interest into taxable ordinary income.

Calculation of De Minimis Threshold

To calculate the de minimis threshold, you need to understand the following factors:

- The bond's face or par value.
- The number of full years between the bond's acquisition date and its maturity date.
- The bond's acquisition price.

The de minimis threshold is determined by multiplying the bond's face value (i.e. the price when issued) by 0.25% and then multiplying the result by the number of full years to maturity. Then subtract this result from the face value to determine the de minimis threshold. If the purchase price is greater than the de minimis threshold you will incur a capital gain upon sale or redemption. If the purchase price is less than the de minimus threshold you will pay ordinary income tax upon sale or redemption.

Tax Implications Further Explained

Discount Above the De Minimis Threshold

If the discount at which the bond is purchased exceeds the de minimis threshold, the entire discount is treated as taxable ordinary income. Upon sale or redemption, the investor will owe taxes on the accrued market discount, which is the difference between the bond's purchase price and its face value.

Discount Below or Equal to the De Minimis Threshold

If the discount falls within or below the de minimis threshold, it is treated as a capital gain rather than ordinary income. This means that upon sale or redemption, the discount will be taxed at the capital gains rate, which is typically lower than the ordinary income tax rate.

Tax Treatment Upon Sale or Redemption

The tax treatment of the discount depends on how long the investor holds the bond:

- **Short-Term Capital Gains:** If the investor holds the bond for one year or less, the discount is taxed as a short-term capital gain at the investor's ordinary income tax rate.
- **Long-Term Capital Gains:** If the investor holds the bond for more than one year, the discount is taxed as a long-term capital gain, which typically benefits from reduced tax rates.

Conclusion

Understanding the de minimis tax rule and its implications is crucial for investors considering the purchase of discounted municipal bonds. By calculating the de minimis threshold and recognizing the tax treatment of the bond's discount, investors can make informed decisions and optimize their tax liabilities. As always, consulting with a tax advisor is recommended to navigate the complexities and ensure compliance with applicable tax regulations.