THE DEMINIMIS RULE

Market discounts on municipal bonds

Generally, the accrued market discount on a municipal bond is treated as ordinary income when the bond is sold or redeemed. The exception is the bond with a small discount, defined by the *de minimis* rule. The exception could allow you to pay less in taxes, so it is helpful for you to understand when it applies.

WHAT IS THE DE MINIMIS RULE?

Market discounts on municipal bonds acquired after April 30, 1993, are taxed as ordinary income rather than capital gains when the bonds mature or are sold. (It is not necessary to recognize the market discount accretion annually for tax purposes.) This law is intended to prevent taxpayers from converting ordinary income to capital gains. It also makes the tax treatment of municipal bonds consistent with taxable bonds; market discounts on most taxable bonds have been treated as ordinary income since 1984.

The *de minimis* rule says that if a discount is less than 0.25 percent of the face value of a bond for each full year from the time of purchase to maturity, then it is too small to be a market discount for tax purposes. It is then treated as a capital gain, which has a lower tax rate.

For example, a 10-year bond is bought at $980 giving it a $20 discount (face value of $1,000). The *de minimis* threshold for this bond is computed by multiplying the face value of the bond by 0.25 percent (.0025) times the number of years to maturity. For this bond the de minimis threshold would be calculated using the following equation:

$1,000 (face value of the bond) x .0025 x 10 (years to maturity) = $25 (de minimis threshhold)

The discount of $20 is less than the *de minimis* threshold of $25, so the capital gains rate would be applied.

BONDS SOLD BEFORE MATURITY

There is another dimension to the tax consequences of market discount bonds for those that are sold before maturity. If a bond outside the *de minimis* zone is sold before maturity, the selling price will determine whether capital gains or losses exist.

For example, a bond with 10 years to maturity is purchased at a price of $97 and sold after five years.
Since the bond falls outside of the *de minimis* zone the market discount will be subject to ordinary income tax.
To determine the tax burden the investor must calculate the accreted value of the market discount on the bond and apply their marginal income tax rate to this value.
(Accreted value is the theoretical price a bond would sell at if market interest rates were to remain at current levels.)

The accreted value of the market discount is $150 or the discount value of the bond ($1,000-9,700 = $300) divided by the term to maturity and then multiplied by the number of years the security was held by the investor. In this example, the accreted value would be computed by dividing the discount value by the term to maturity and multiplying that figure by the number of years the bond was held by the investor.

300 (discount value)/ 10 (term to maturity) = 30 x 5 (years held by the investor) = 150.

Therefore, if this particular bond is sold for a price less than or equal to $98.5 (97 + 1.5) any gain is taxed at the investor's individual income tax rate. If the bond is sold above 98.5 the gain is taxed at the capital gains tax rate.

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AFTER-TAX YIELD

Once the *de minimis* threshold is crossed, the investor's ordinary income tax rate and capital gains tax rate at the time the bond is sold or redeemed become a factor in how to value the bond. Since no one can be certain what tax rates will be in the future, convention is generally to calculate the after-tax yield on the bond using the highest 2005 marginal tax rate, producing the most conservative result.

For individuals, the highest marginal federal tax rate is 35 percent and the maximum capital gains tax rate is 15 percent. For corporations, the highest tax rate and the maximum capital gains tax rate are both 35 percent. (Of course state tax treatment will also have an effect on the after-tax yield of municipal bonds.) Tax reporting requirements vary for different types of corporate investors, so they must evaluate how the market discount rules affect their particular situation when making investment decisions.

If the investor's ordinary income and capital gains tax rates are the same, the primary disadvantage to the investor in purchasing a market discount bond is that gains classified as ordinary income cannot be used to offset capital losses. If market discount bonds are priced relatively cheap to compensate for a general tax disadvantage, they could represent value for tax-indifferent investors.

ORIGINAL ISSUE DISCOUNT

The change in tax rules does not affect the way original issue discount (OID) municipal bonds are treated. (OID is the discount from par value at the time a bond is issued.) There is no taxation of the OID on the municipal bonds because the difference between the discount price and the matured value is considered interest, which is tax-exempt. However, if an OID bond is purchased at a market discount, the market discount is taxed as ordinary income at the time the bond is sold or redeemed, as with other tax-exempt securities.

A market discount on an OID bond occurs when a bond is purchased in the secondary market at a price below the adjusted basis (issue price plus accrued OID) of the bond. In order to evaluate the market discount on an OID bond, compute the adjusted basis of the bond using the original yield (the constant interest rate method), and compare this price to the purchase price. The market discount is the excess, if any, of the adjusted basis over the purchase price, and taxed as ordinary income.

For example, assume a 20-year bond issued at 90 is sold after 10 years. The adjusted basis of the bond is 93.50. If the buyer pays less than 93.50 for the bond, the difference represents market discount, which is taxed as ordinary income at maturity. The remaining 6.50 points represent OID, which is not taxed.

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