ASSET PRESERVATION ADVISORS

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Help your clients understand the "De Minimis" Rule

With changes to the tax code and the risk of a rising rate environment, we believe now is a good time to meet with your clients and their CPAs to help reduce related risks to your clients' portfolios.

The Latin expression "*de minimis non curat lex*" means that the law is not concerned with trivial matters. With continued tax law changes coming out of Washington and high earners taxed at higher rates (or deductions being reduced), there is nothing trivial about having to pay taxes on what they believe is a tax-exempt investment. As an advisor, when you recommend high-quality municipal securities to your clients, generally you make that allocation with a few thoughts in mind; 1) safety of principal 2) lower standard deviations of volatility and 3) providing income that is federally and (in most instances) state exempt from taxation. However, in some instances, price appreciation of municipal bonds purchased at a discount in the secondary market can actually be TAXABLE! The rate at which these discounted securities can be taxed depends on a somewhat obscure section of the Internal Revenue Code referred to as the *de minimis tax rule.*

Background

The *de minimis rule* determines whether the price appreciation (price accretion) of securities purchased at a discount will be taxed at the ordinary income or capital gains tax rate. The *de minimis rule* was added to the tax code in 1993 changing the treatment of tax from capital gains to ordinary income, but with certain key exceptions applied to smaller market discounts.

A large supply of bonds issued over the past twenty years (at face value) have had coupons of at least 5%. In fact, if you looked at the Bank of America U.S. Municipal Index, the percentage of bonds in that index in 2016 was 84%. Nevertheless, as interest rates have fallen, more municipal bonds have been issued at lower coupons. According to Bloomberg, in 2016 the number of bonds issued at just 2% was 8,468 bonds. That number continues to grow as many new issues have been structured with 2 percent or 3 percent in recent years. Lower coupon bonds have addressed demand with lower price premiums over face value as higher coupon bonds have increased appreciably as interest rates have declined. So, with the potential of interest rates rising, the *de minimis rule* creates a potential tax risk that can have a meaningful impact not only on the after-tax returns of investors in higher tax brackets, but also on how municipal securities are priced.

The Basics

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 interest rates or a credit concern. 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 *(note: To calculate the accretion, the IRS uses the constant- yield method, which accelerates as the life of the bond shortens and in this example only applies to individuals and not corporations. Make sure you consult with your clients' CPA).*

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. 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 purchased in the secondary market may be subject to the *de minimis rule*. An OID bond has a market discount if the purchase price is less than the revised issue price (original issue price plus the accreted OID up to the purchase price). But remember, the tax consequences related to the de minimis rule do not apply to investors who purchase OID bonds in the new issue market.

De minimis threshold = lower of par or OID – (0.25% x full years to maturity)

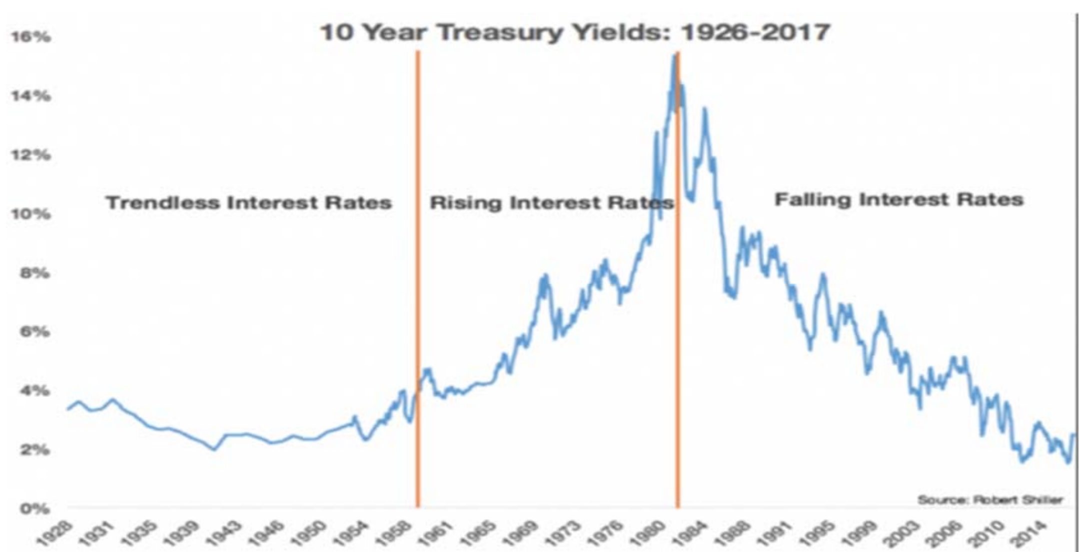
For some municipal investors in high tax brackets, taxation of the bond's market discount can have a noteworthy impact on the after-tax returns. For a discounted municipal security purchased at a price below the de minimis threshold, price accretion is subject to the new ordinary income rate (37% Federal Marginal Rate plus Medicare Tax of 3.8% = 40.8% for top earners). Conversely, the accretion of a security purchased at a discount, but at a price above the de minimis boundary, is subject to a much lower capital gains rate (20% Capital Gains Rate plus Medicare Tax of 3.8% = 23.8% for top earners) if the bond is held for longer than one year.

Face Value		Years to Maturity	De Minimis Threshold	Face Value		Years to Maturity	De Minimis Threshold	Face Value		Years to Maturity	De Minimis Threshold
$10,000	0.25%	1	**$25**	$10,000	0.25%	11	**$275**	$10,000	0.25%	21	**$525**
$10,000	0.25%	2	**$50**	$10,000	0.25%	12	**$300**	$10,000	0.25%	22	**$550**
$10,000	0.25%	3	**$75**	$10,000	0.25%	13	**$325**	$10,000	0.25%	23	**$575**
$10,000	0.25%	4	**$100**	$10,000	0.25%	14	**$350**	$10,000	0.25%	24	**$600**
$10,000	0.25%	5	**$125**	$10,000	0.25%	15	**$375**	$10,000	0.25%	25	**$625**
$10,000	0.25%	6	**$150**	$10,000	0.25%	16	**$400**	$10,000	0.25%	26	**$650**
$10,000	0.25%	7	**$175**	$10,000	0.25%	17	**$425**	$10,000	0.25%	27	**$675**
$10,000	0.25%	8	**$200**	$10,000	0.25%	18	**$450**	$10,000	0.25%	28	**$700**
$10,000	0.25%	9	**$225**	$10,000	0.25%	19	**$475**	$10,000	0.25%	29	**$725**
$10,000	0.25%	10	**$250**	$10,000	0.25%	20	**$500**	$10,000	0.25%	30	**$750**

Source: Schwab Center for Financial Research calculations, as of 1/2017

Does it really matter? Yes, it does!

The U.S. economy has experienced an extraordinary period of declining and persistently low-interest rates. As the chart below illustrates, 10-year Treasury yields have been falling since 1982. This has been an unprecedented bull market for bonds and as a consequence, municipal bond investing has not required careful consideration of the *de minimis tax rule*. Currently, given the low-interest rates we have experienced, most municipal securities trade at a premium.



Source: Robert Shiller 2017

However, if the bull market in bonds were to end and interest rates were to rise, declining bond prices would imply that more municipal securities could fall below the de minimis threshold. Also, as discussed earlier in this paper, lower interest rates have contributed to an uptick in lower-coupon bond structures at lower prices than their higher-coupon counterparts.

The Impact To Your Client

⇒ **Tax impact:** Given the higher tax rate, any buyer would incur as a result of purchasing bonds below the de minimis threshold.

⇒ **Price impact:** Bonds issued with lower coupons could trade at a discount in order to compensate for higher yields. However, securities trading near or below the boundary will likely trade at even LOWER prices (and higher yield) to compensate investors for the impact of additional taxes.

⇒ **Liquidity impact:** Potential taxes associated with the *de minimis rule* may also lead to demand distortions in the marketplace as the result of the reduced buyer base. The traditional tax-sensitive municipal buyer may shun securities with any tax consequences, even in instances when yields compensate investors for the higher tax treatment.

The impact, in effect, may create a "price cliff" as bonds approach the de minimis cutoff. The impact of higher taxes and **diminished** liquidity may cause bond prices to deteriorate more rapidly than they otherwise would if the price was higher and further from this threshold.

Example

- Assume your client buys a 3% coupon bond at par with a 10-year maturity.
- Also, assume that interest rates increase by 50 bps. So the same credit could be issued at par with the same maturity at a 3.5% coupon.
- Your client who is unfamiliar with the *de minimis rule* might believe that a previously issued 3% coupon bond only needs to trade down to around \$96 (to produce the same market yield of 3.5%). However, if that's the case, the bond would have fallen below its de minimis threshold of approximately \$97.50 (0.25bps x 10 years).
- The problem with your client's thinking is the market will also account for the additional tax implications associated with the market discount and that particular bond is likely to trade closer to a dollar price of \$93 to produce the after-tax return of 3.5% (for high-income individuals).

For this reason, we believe the *de minimis rule* does matter to your clients' portfolios.

Take Action

Whether you're a Senior Financial Adviser with a large book of business or a new adviser looking to bring assets over to your firm, here are the advantages to understanding the *de minimis rule*.

- If you have purchased bonds for your clients or it's being run by an asset manager, look within the portfolios for lower coupon bonds that could be affected by this rule. With rates at current levels, it may make sense to harvest those bonds and swap them for "like" credit, duration, but with a higher coupon.

- You may want to look at moving out of the large municipal mutual fund or ETF positions and examine a separately managed account. A lot of 40 Act Funds and ETFs are forced to buy new issue bonds and are likely going to have an allocation in lower coupon bonds. Since these instruments offer limited transparency, APA believes now would be the time look at swapping to a managed program (note: this only makes sense with the municipal liquidity of over $250,000).
- Have a discussion with clients about this rule and suggest a meeting with their CPA as a team. This can create a center of influence (COI) as most advisers are not up to speed on this issue.
- Lastly, ask your clients (or prospects) if they have municipal bonds outside of the realm of your perspective. Offer to look at the portfolio and offer suggestions to make sure those individuals do not have to pay any more in taxes on their municipal bonds than they should.

Partner With Us

Asset Preservation Advisors specializes in managing high-quality tax-exempt municipal bond portfolios for wirehouses, family and multi-family offices, registered investment advisers and institutional clients. We believe our concentration in municipals gives a unique advantage in issues such as the *de minimis rule*. In this environment, we favor municipal bonds with very high coupons (priced at a premium), in part because they are less likely to be subject to the tax, liquidity and ultimately price consequences associated with this tax rule. Higher coupon bonds can also offer additional protection against rising rates since the cash-flows give owners of the bonds principal back (in the form of a higher coupon) that can be reinvested at a higher yield.

For more information on this rule or any of our customized strategies, contact Stephen Colavito Managing Director/Portfolio Manager at (678) 504-4862 or scolavito@assetpreservationadvisers.com.