Municipal Securities Rulemaking Board

Tax and Liquidity Considerations for Buying Discount Bonds

Given the significant rise in interest rates, this educational document focuses on the potential impact to investors of the current market environment on bond prices and the liquidity and tax implications of buying certain types of municipal bonds in the secondary market.

BACKGROUND

Interest rate risk, one of the most important factors to consider when investing in fixed income markets, is the risk to a bond posed by changes in interest rates. Generally, interest rates and bond prices have an inverse relationship, such that, as interest rates rise, bond prices tend to fall (and vice versa). Read more about interest rate risk here.

During periods of rising interest rates, many municipal bonds will be offered and traded at a "discount." An investor buys a bond at a discount when the dollar price paid is below the stated face value of $100.00 per bond[1] (also known as par). Tax-exempt bonds can trade at a significant discount to par when interest rates are high. Investors need to understand the potential tax implications of buying bonds at significant discounts, as well as the potential for these bonds to have less liquidity than bonds trading around par or at a premium, which means above par.

TAX CONSIDERATIONS

With more bonds available for purchase at a significant discount, it is important that investors understand the potential federal income tax implications of the IRS's *de minimis* rule. This rule determines whether the price appreciation (or accretion) of a bond that is purchased at a discount will be taxed at the ordinary income tax rate, or if it will be taxed at the capital gains tax rate. Generally, if the discount falls within a specified *de minimis* threshold, it is deemed to be too small to be treated as a market discount. As a result, the appreciation upon the sale or exchange of the bond will be treated as a capital gain rather than as ordinary income.

If the market discount is less than one quarter of 1% of the stated redemption price of the bond at maturity, multiplied by the number of complete years to maturity from when the taxpayer acquires the bond, the market discount will be deemed *de minimis* and treated as a capital gain for tax purposes if the bond is

[1] Generally, municipal bond prices are quoted in reference to the face or par value of the bond. So a price of $100.00 is equal to 100% of the face or par value of a bond (typically $1,000). Accordingly, the price $100.00 actually equates to $1,000 (100% x 1,000) per bond. As an additional example, a price of $97.50 is equal to 97.50% of the face or par value of a bond. Accordingly, the price $97.50 actually equates to $975 (97.5% x 1,000) per bond.

held to maturity, redeemed or sold for a price above the purchase price. If the discount is greater than this *de minimis* threshold, the accrued market discount realized at maturity must be treated as ordinary income. However, if the bond is sold above the purchase price before maturity, such premium may be taken into account in determining the total amount of market discount upon sale.

For a bond with 10 full years before the maturity and a stated redemption price at maturity of par, the *de minimis* threshold is calculated to be 0.25% x 10 (number of full years to maturity) = 2.5%. So, for a bond with 10 full years until maturity purchased at a price from $97.50[2] to $99.999, the discount would be deemed to be *de minimis* if held to maturity. If, however, for example, an investor purchased 20 bonds with 10 full years until maturity at a price of $95.00, the market discount would not be considered *de minimis*, and the investor would have to declare the full amount of the discount ($50 per bond x 20 bonds = $1,000) as ordinary income at maturity.

EXAMPLE

The following example is a scenario of an actual municipal bond transaction.

ON FEBRUARY 14, 2022

investor purchased	with a	maturing	at a	and a dollar price
25 bonds	**2.00% coupon**	**October 15, 2038**	**2.72% yield**	**$90.402**

These bonds had 16 full years until maturity when purchased, so the *de minimis* threshold would be

0.25% x 16 = 4.0%

The *de minimis* price threshold for the bond is **$100 – $4 = $96.00**

Because this bond was purchased at a discount outside the *de minimis* threshold, the amount of market discount ($2,399.50) would be treated as ordinary income, assuming the bond was held to maturity.

$100.00 – $90.402 = $9.598 per bond x 25 bonds = $2,399.50

[2] See footnote 1 regarding municipal bond pricing.

LIQUIDITY CONSIDERATIONS

It is important to note that bonds that reach a substantial discount can have significantly less liquidity than bonds trading around par or at a premium. This is a key factor because if an investor needs to sell a bond that is at a significant discount, there may be fewer willing purchasers. Many investors who might otherwise consider purchasing the bonds could want higher income than a discount bond would provide and may not want the tax consequences associated with buying a tax-exempt bond at a substantial discount.

CONCLUSION

Investors should monitor their portfolios for bonds falling to a significant discount price because the bonds could become less liquid and more difficult to sell, even if the bonds were purchased around par or at a premium.

Buying deeply discounted bonds can be part of an overall portfolio strategy if the investor understands the tax implications and is comfortable with buying a potentially less liquid bond. Investors may wish to compare yields on deeply discounted bonds to those bonds trading around par or at a premium. Investors should look to be compensated for the tax consequences and potential illiquidity when buying large discount bonds with higher yields as opposed to buying bonds trading near par or at a premium. In the example on page 2, the investor bought the bonds at 2.72% when benchmark AAA rates in 16 years were about 1.80%, a significant pickup in yield. Investors should consider talking to their tax advisor and financial professional before purchasing any deeply discounted tax-exempt bonds.