FARADAY CAPITAL, L.P.

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What is the De minimis tax rule and why is it important?

The De minimis tax rule is defined as *"the threshold at which a discount bond should be taxed as a capital gain rather than an as ordinary income."*

If you are an investor in the Municipal Bond market, you may have noticed the term, De minimis, being thrown around recently. In this era of reflation, as treasury yields continue to sell off and reach new 52-week highs almost daily, this term has become increasingly important if you are a Muni investor and are concerned with the associated tax-exempt benefits of your Municipal holdings. As rates have continued to sell off, you may have noticed the all-in yield of your Municipal bonds climb as well. This is happening because the Municipal yield curve, off which all tax-exempt Municipal bonds are priced off, has also increased in yield, and has thus continued to decrease the current price of all tax-exempt bonds (remember bond yields and prices are inversely related).

But you may be thinking, aren't Municipal bonds tax exempt? Yes and no. As current tax legislation stands today, the interest income on tax-exempt Municipal bonds is federally tax exempt, and at times state tax-exempt as well (depending on the bond and the state). However, it also states "that a bond is to be discounted 0.25% from the face value of each remaining year of a bond's life before it is affected by ordinary income taxes". To put this legal jargon into layman's terms, if you as an investor buy a bond at a price lower than PAR and the dollar price of that bond is accreting at a rate higher than 0.25% per year until maturity, you will be subject to ordinary income taxes.

For example, say you see an offering on a bond that was originally issued at a price of PAR and has 10 years left to maturity but is now currently being offered to you at a price of $98. Assuming you are in the top tax bracket of 37% and top capital gains tax bracket of 20%, will you be subject to the de minimis rule on this purchase? To answer that question, there is a simple formula that we can use:

As you can see from the example, at a purchase price of $98, you would be subject to capital gains tax rate of 20%. However, if you were to buy the bond lower than a price of $97.5, you would be subject to your marginal tax rate as the gains would be considered ordinary income.

De Minimis Example

Purchase Price	Federal Tax Rate
<$97.50	37%
$97.5 - $100	20%
>$100	0%

Purchase Price: $100

Years to Maturity: 10 years

De Minimis level: $100 – (10 years * 0.25) = $97.5

Does the De Minimis tax rule affect all Municipal bonds equally?

Short answer, no. The De minimis tax rule affects tax-exempt Municipal bonds differently, depending on the coupon of the bond. As the price of bond is the product of its coupon, higher the coupon, higher the bond price, and hence lower the chance it will be affected by the de minimis rule. So, for example, if we look at the New Jersey Transportation Trust deal that issued 3%, 4%, and 5% coupon bonds back in November 2020, with maturities in 2050, we get a good idea on how coupon plays an important role in de minimis.

	NJ Trans 06/15/2050					
	3% Cpn		*4% Cpn*		*5% Cpn*	
	Price	**Ytw**	**Price**	**Ytw**	**Price**	**Ytw**
Current Px =>	$99.50	3.026	$110.10	2.814	$120.95	2.568
	$97.59	3.126	$108.75	2.964	$119.04	2.768
	$95.73	3.226	$107.43	3.114	$117.17	2.968
	$93.92	3.326	$106.13	3.264	$115.33	3.168
40bp widening to hit De minimis =>	$92.16	3.426	$104.84	3.414	$113.52	3.368
			$103.58	3.564	$111.75	3.568
			$102.33	3.714	$110.01	3.768
			$101.10	3.864	$108.31	3.968
			$99.76	4.014	$106.63	4.168
			$97.23	4.164	$104.99	4.368
			$94.40	4.314	$103.38	4.568
165bp widening to hit De minimis =>			$92.45	4.464	$101.79	4.768
					$100.38	4.968
					$97.47	5.168
					$94.59	5.368
300bp widening to hit De mimimis =>					$91.83	5.568
Deminimis Px = $100 - ((2050-2021) * 0.25) = $92.75						

Impact of De Minimis on Liquidity

As we saw above, different coupon bonds are affected differently by yield curve moves. As lower coupon bonds are more affected by interest rate moves and thus more likely to be subject to the De Minimis rule, they will tend to trade at higher yields compared to otherwise similar higher coupon bonds as buyers would demand more yield for the significantly higher tax rate they may face. Further, these lower coupon bonds due to increased tax complications may face further issues in liquidity terms due to a lower buyer base who would prefer to shy away from these type of bonds in an increasing interest rate environment.