

Discount Munis and De Minimis:

With the recent uptick in interest rates over the past few months, we are starting to see some lower coupon municipal bonds that were originally issued above par, now trading at a discount (below \$100). This brings up important taxation concerns – How is the gain taxed, and what effect does the taxation have on liquidity/performance of lower coupon securities.

It is important to understand that if you purchase a discounted Municipal bond in the secondary market, depending on the size of the discount and original issue price, the investor may be subject to either a capital gain tax or required to include the gain as ordinary income.

Tax Liability for \$50,000 Municipal Bond Purchased Below Par						
Coupon	Maturity	YTM	Purchase Price	Purchase Amount	Maturity Amount	Taxable Income at Maturity
2.75%	3/15/2027	3.50%	\$93.72	\$46,860	\$50,000	\$3,140
3.00%	3/15/2027	3.50%	\$95.81	\$47,905	\$50,000	\$2,095
3.50%	3/15/2027	3.50%	\$100.00	\$50,000	\$50,000	-
4.00%	3/15/2027	3.50%	\$104.19	\$52,095	\$50,000	-

The tax implication requires potential investors to be compensated with a higher return (lower price) for purchasing “discount municipal bonds” to offset the tax liability. This places added pressure on the price of lower coupon municipal securities and reduces the liquidity of bonds trading under par. In a rising interest rate environment, securities now priced near par could eventually fall to a discount and drop further in price relative to similar credit/maturity premium municipal bonds to compensate for the tax implications.

AHB's Take:

Since the financial crisis we have experienced a very low interest rate environment and this issue has not yet been a concern. But as the FOMC continues its interest rate normalization process, this issue will be more relevant. At AHB we manage customized portfolios of individually owned Investment-Grade Municipal Bonds. We typically purchase premium bonds with calls that protect our investors from this risk.