De Minimis Impact on Municipal Securities

C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING IN TAX-EXEMPT MUNICIPAL SECURITIES

Tax legislation that created the de minimis rules was enacted as part of the Revenue Reconciliation Act of 1993. Its intent was to eliminate the ability of investors to sell bonds with short term losses (and get an ordinary income tax offset) and purchase replacement discount bonds that would be subject to lower capital gains taxes on their appreciation to par, with payment of the capital gains tax liability being postponed until the bonds mature. In effect, investors could offset ordinary income today and not pay the partially offsetting capital gains tax until many years in the future. A good deal for investors and a bad deal for the IRS that was unlikely to persist!

Congress eliminated this discrepancy by establishing de minimis rules. Investors are now subject to ordinary income taxes on the price appreciation of discount municipals if bonds are purchased at below de minimis thresholds. A bond's de minimis level is determined by multiplying the remaining years to maturity times one-quarter of a point and subtracting from 100. The de minimis level for a five year bond is therefore 98.75 (100 - 1/4 X 5), for a ten year bond it is 97.5 (100 - ¼ X 10), etc.

A bond's downside price volatility is increased as the de minimis level is breached due to the ordinary income tax impact. In effect, each basis point increase in nominal rates will cause a 1.35 times price reaction to the downside. The impact can be amplified further if there are parallel state taxes. If an investor is concerned about price volatility, de minimis risk should be avoided in low rate environments by favoring premium bonds trading at prices that are several points above de minimis levels. This is the environment that we are currently in and have been in for several years. This issue has seldom been mentioned in the financial press as it is not widely understood and because there have not been a large number of discount bonds in the market in the prevailing low interest rate environment.

Should rates move sharply higher at some time in the future, de minimis could prove to be advantageous for total return investors. Bonds purchased at well below de minimis thresholds (and priced at generous yields to compensate for the ordinary income tax impact) would experience accelerated price appreciation in a declining rate environment.

Disclosure: The material provided is for informational purposes only and contains no investment advice or recommendations to buy or sell any specific securities. The statements contained herein are based upon the opinions of C. W. Henderson and Associates, Inc. (CWH). The views expressed by CWH on financial market trends are as of the date of this publication, based on current market conditions and are subject to change without notice. This presentation does not purport to be a complete overview of the topic stated, nor is it intended to be a complete discussion or analysis of the topic or securities discussed. This report should not be regarded by recipients as a substitute for the exercise of their own judgment and may contain numerous assumptions. Different assumptions could result in materially different outcomes. Please contact C. W. Henderson & Associates, Inc. for more complete information, including the implications and appropriateness of the strategy or securities discussed herein for any particular portfolio or client.

20 West Kinzie Street Suite 1100 Chicago, Illinois 60654 (312) 222-1401 fax (312) 832-7801 www.cwhenderson.com