Understanding Market Discount and De Minimis

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As interest rates have moved lower in recent years, bonds with lower coupons have become more prevalent in the municipal bond market. It is not uncommon to see coupons in the 2.00% to 3.00% range offered in the secondary markets. If yields were to rise in the coming years and the price of these bonds were to drop to a price below par, any purchase of these securities would be at a market discount. The market discount rule is a complex rule in municipal taxation that many investors and financial advisors do not fully comprehend. Hopefully, this memo will provide a primer on this important topic as it may become relevant again in 2021 or 2022 if rates move substantially higher.

Overview of Market Discount

The rules related to the taxation on market discount bonds were modified for municipals in 1993. There can now be tax consequences related to some or all of the gain on a municipal bond upon its sale or at maturity. This is regardless of the length of holding period. This can dramatically impact the value of a bond and its duration.

A market discount bond is one which is purchased at a discount in the secondary market to its accreted original issue discount, if any, or par. For example, if a bond were issued at par $100 and purchased in the secondary market at a price of $90, this bond would have 10 points of market discount. If the bond were originally issued at a discount (an "OID") the market discount would be the discount below the accreted OID at the time of purchase. If the bond were originally issued as an original issue premium, the market discount would be the discount below par.

The rule has a de minimis threshold of one-quarter point of discount per year to maturity. If there is less market discount than this at the time of purchase, the taxation of the market discount will be at capital gains rates. If the market discount is more than this de minimis amount, the market discount would be taxed as ordinary income.

CALCULATION OF MARKET DISCOUNT

If the bond has 20 full years remaining to maturity, the de minimis threshold would be 5 points (20 years x .25 = 5 points). A bond purchased at the accreted OID less 5 points or higher for an OID bond, or at $95 or higher for a par or original issue premium bond, this market discount would be taxed as capital gains. However, if the purchase price were below that level, the entire market discount would be taxed as ordinary income. For example, if the bond originally issued at par with 20 years remaining to maturity were purchased at $94.9, all 5.1 points of market discount would be subject to ordinary income tax, while if it were purchased at $95, the 5.0 points of market discount would be subject to capital gains.

A buyer of the market discount bond at $94.90 would owe tax of 37% (currently) on the 5.1 points in 20 years (or the accreted portion if the bond is sold earlier). The present value of that tax payment is worth a little less than one point (i.e. $1), which the seller would often pay for in a reduced price to the buyer. In other words, instead of paying $94.90 for that bond, the "after-tax" or "indifference" price to the buyer would be about $93.94 (using a 4% discount rate). The present value of the capital gains taxation for the bond with a purchase price of $95 could be considered, but the market often trades as if capital gains tax rate is zero, as capital gains can be offset with capital losses in some states. Ordinary income generally cannot be offset. As a result, this change in taxation matters and can have a significant impact on valuation and liquidity.

The duration of a bond subject to ordinary income taxation on its discount will usually be higher. Duration, or risk, is a measure of how much a bond's price will change for a change in interest rates. For a given change in interest rates, the bond price will change based on typical bond math (the discounting of future principal and interest payments) and, in addition, the amount of taxes due will also change. With the taxes due changing, the present value of those taxes changes as well, affecting the bond value. In our example, if the bond not subject to ordinary income taxation (say due to original issue discount) declined by $1 from $94.90 to $93.90, the bond subject to market discount would decline from about $93.94 to $92.75 (for simplicity also using a 4% discount rate on the taxes due), or $1.19. The extra $0.19 is for the increased tax burden on the increased market discount. The duration (change in price per change in yield) has increased by close to 20%. The fact that the duration increases may also affect the price realized, as investors expect to get paid for taking on higher durations (there's an upward slope to the municipal yield curve).

INSTITUTIONAL VERSUS RETAIL STRUCTURES

Note that in our example, a 20-year bond would not be subject to the ordinary income taxation of the market discount until the price declines below 95, for both bonds originally issued at par and bonds originally issued at a premium. This is one of the reasons why institutions prefer original issue premium bonds. New issues often offer two structures for the same maturities, a par bond generally sold to retail investors and an original issue premium bond generally sold to institutions.

For example, say the market for a 20-year bond has a yield of 4%. It would not be unusual for the underwriter to offer two bonds to the marketplace; one for retail which would be priced as a "par" bond with a 4% coupon and a second structure for institutions with a 5% coupon priced at a premium to yield 4%. The "retail" 4% coupon bond issued at par will be subject to ordinary income taxation on the market discount (to a new buyer) after the bond price declines by 5 points, which occurs when rates have risen by 38 basis points. By contrast, the "institutional" 5% coupon original issue premium bond originally costing $113.7 will need to decline by 18.7 points before the price reaches the de minimis threshold of 95, which occurs when rates have risen by 141 basis points. There is significantly greater "market discount protection" for original issue premium bonds. As a result, it is not surprising that professional institutional investors concentrate on owning premium bonds.

To be clear, any bond purchased at a price above the de minimis threshold will not result in ordinary income taxation on the discount for that purchaser, but if the bond subsequently falls in price to below the de minimis threshold, it could be worth less to a new buyer. This would occur if there was a sudden rise in interest rates. The bond can therefore be "worth more" to its current holder than to a new buyer. As a result, the mark-to-market value of these bonds should fall given the lower "bid" price. A potential further complication is that there are fewer market participants willing to buy bonds subject to the ordinary income taxation on their market discount as many do not want to realize ordinary income. We would advise clients to avoid purchasing bonds below the de minimis threshold as these securities will affect the bond's liquidity and further negatively impact value.

Conclusion

We often hear that "buy-and-hold" investors may not care about the liquidity of their bonds as they do not plan to sell them. Although this may be the expectation for certain investors, we do not believe that it should be relied upon. In our view, investors are simply not getting compensated for the illiquidity. Change in circumstance is often unexpected and liquidity needs could change as well. One clear example would be a bond with a deteriorating credit profile. With this as a backdrop, why would one want to own a bond that is a likely candidate for ordinary income taxation on market discount?

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