Municipal Bonds: Tax Free, with Exceptions

Understanding AMT & De Minimis Impacts

Founding Father Benjamin Franklin famously remarked: “In this world, nothing is certain except death and taxes.” While death remains an absolute force, taxes, though difficult to escape, can be reduced. Municipal bonds issued by local and state governments, commonly referred to as tax-exempt bonds, generate tax-exempt income that is typically exempt from federal and often state taxation as well, offering domestic investors an opportunity to reduce their tax burden.

The transition to the Trump administration in early 2025 brought tax policy to the forefront, as key provisions of the 2017 Tax Cut and Jobs Act (TCJA) were scheduled to expire at the end of the year. Given the looming deadline, the Trump administration prioritized making these provisions permanent and ultimately succeeded with the passage of the 2025 One Big Beautiful Bill Act (OBBBA). Notable provisions established by the OBBBA include making the TCJA’s reduced individual tax rates permanent, expanding the standard deduction, and preserving higher Alternative Minimum Tax (AMT) exemption amounts and phaseout thresholds, the last of which maintained a significantly reduced AMT exposure for middle- and upper-middle-income taxpayers.

During OBBBA negotiations, the tax treatment of municipal bonds was a focal point of debate. Early drafts of the bill raised concerns about the longstanding federal tax exemption, including private activity bonds (a subset of municipal bonds issued to support more private projects such as airports, student loans, and infrastructure), raising the specter of the exemption being curtailed or repealed. However, the final legislation preserved the full tax-exempt status and even expanded it to include financing for spaceport infrastructure, underscoring the essential role municipal bonds play in national development. Since New York City issued the first municipal bond in 1812 to fund canal construction, the total stock of municipal debt has grown steadily, currently totaling over $4 trillion in outstanding bonds supporting the expansion of critical infrastructure and services across America, according to Federal Reserve (Fed) data.

Yet, as Benjamin Franklin proclaimed, taxes remain difficult to avoid and with the OBBBA now law, it is important to examine two areas within municipal bonds where tax consequences may still arise: the AMT and the de minimis tax rule. This paper will explore both, outlining their implications for municipal bond investors.

Alternative Minimum Tax

The Internal Revenue Service (IRS) explains “Under the tax law, certain tax benefits can significantly reduce a taxpayer’s regular tax amount. The alternative minimum tax applies to taxpayers with high economic income by setting a limit on those benefits.” In other words, the AMT operates alongside the regular income tax requiring certain taxpayers to calculate their tax liability twice, once under the regular rules and once under AMT rules, with the higher calculated result being the tax liability.

To determine AMT liability, taxpayers begin with calculating regular taxable income, followed by adding back specific AMT “preference items” such as state and local tax deductions, personal exemptions, and miscellaneous business expenses. After subtracting an AMT exemption amount, the remaining income is taxed utilizing the AMT rate structure.

Municipal Bonds: Tax Free, with Exceptions

Understanding AMT & De Minimis Impacts

Below is a chart reflecting the key provisions since 2017:

Feature	Pre-TCJA (Before 2018)	TCJA (2018-2025)	OBBBA (2025-present)
AMT Exemption (Single)	$54,300	$70,300 (indexed)	Permanently set at TCJA levels
AMT Exemption (Married Joint)	$84,500	$109,400 (indexed)	Permanently set at TCJA levels
Phaseout Threshold (Single)	$120,700	$500,000	Permanently set at TCJA levels
Phaseout Threshold (Married)	$160,900	$1,000,000	Permanently set at TCJA levels
Corporate AMT	In effect	Repealed	Remains repealed
Common Triggers	SALT, personal exemptions, misc. deductions	Fewer triggers due to deduction limits/removals	Same as TCJA
Expiration	N/A	Set to expire at the end of 2025	Made permanent by OBBBA

While municipal bond interest generally remains exempt from federal income tax, private activity bonds are included in AMT calculations under IRS code. Complicating the issue further, if a taxpayer is not subject to AMT, they pay no tax on interest earned from these bonds. Due to the potential tax exposure, AMT bonds typically offer excess yield over non-AMT bonds.

For example, the tables below compare two State of Texas general obligation (GO) bonds. Although both carry identical AAA credit ratings and are irrevocably backed by the state's full faith and credit, proceeds from the one on the left is utilized to fund student loans, classifying it as a private activity bond under IRS rules and therefore subject to AMT.

AMT Example

Issuer	State of Texas
CUSIP	882724C70
AMT Treatment	AMT
Issue Date	06.01.2022
Maturity Date	08.01.2030
Call	Noncallable
Coupon Rate	5.00%
Issue Yield/Price	2.87% / $115.368

Non-AMT Example

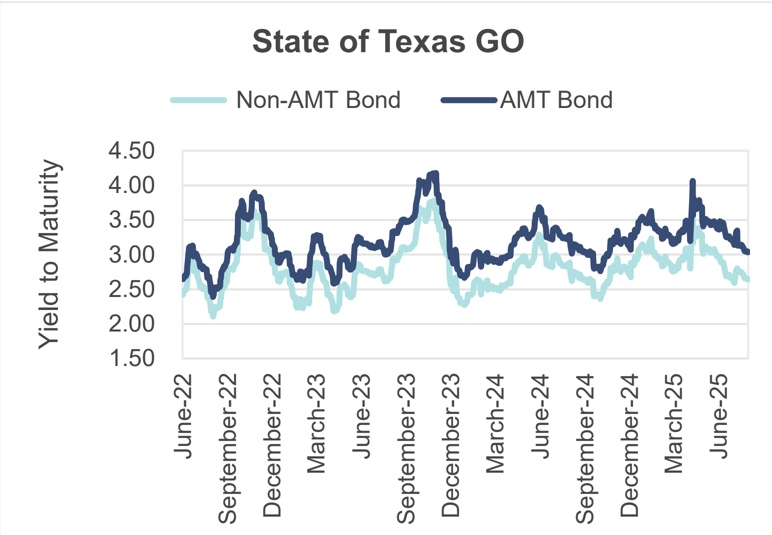
Issuer	State of Texas
CUSIP	882724A31
AMT Treatment	Non-AMT
Issue Date	05.10.2022
Maturity Date	08.01.2030
Call	Noncallable
Coupon Rate	5.00%
Issue Yield/Price	2.78% / $116.217

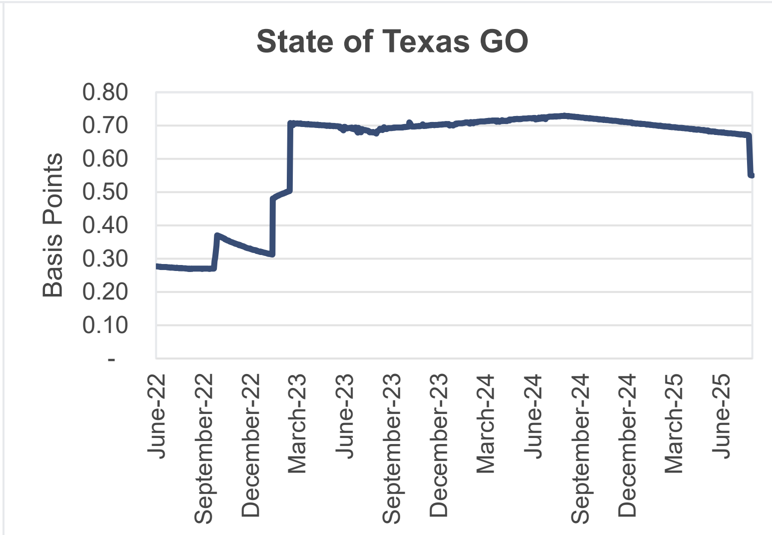
STERLING CAPITAL

Municipal Bonds: Tax Free, with Exceptions

Understanding AMT & De Minimis Impacts

As shown in the charts below, bonds subject to AMT consistently offer additional yield compared to their non-AMT counterparts. The historical yield premium varies due to overall tax policy and market conditions. In recent years, uncertainty around tax reform coupled with elevated issuance has pushed the additional yield demanded from investors ranging between 30 and 70 basis points (bps). Yet, with tax policy uncertainty removed following the passage of OBBBA, demand improved and compressed the yield spread to the current level of approximately 55 bps.





De Minimis Tax

Merriam-Webster defines de minimis as “lacking significance or importance.” However, in the context of municipal debt, it refers to the IRS’s threshold for determining the tax treatment of bonds purchased at a market discount. The IRS considers a bond to be purchased at a market discount “if its stated redemption price at the maturity is greater than its basis after its acquisition” or more simply put, if its purchase price is lower than its redemption (maturity) value. The tax treatment of the acquired bond is determined by whether this market discount is in excess of the IRS de minimis threshold.

The IRS formula to determine the de minimis threshold is:

$$\text{De Minimis Threshold} = \text{Maturity Value} - (0.25\% \times \text{Number of Full Years to Maturity})$$

As an example, a bond maturing in five years with a maturity price of $100 would be calculated using the following formula to determine what the de minimis threshold purchase price would be:

$$(100 - (0.25 \times 5)) = 98.75.$$

Therefore, if the bond is purchased below the de minimis threshold, or 98.75, the price appreciation up to maturity value is taxed as ordinary income, which is typically at a higher rate than capital gains.

Source for both charts: Bloomberg L.P. The right-hand chart shows AMT additional yield. Charts are for illustrative purposes only. Yields are subject to market conditions and are therefore expected to fluctuate. Specific securities identified and described do not represent all of the securities purchased, sold or recommended to clients. There are no assurances that securities identified will be profitable investments. The securities described are neither a recommendation nor a solicitation. Security information is being obtained from resources the firm believes to be accurate, but no warrant is made as to the accuracy or completeness of the information. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful.

STERLING CAPITAL

Municipal Bonds: Tax Free, with Exceptions

Understanding AMT & De Minimis Impacts

Of course, with the IRS involved, there is often another rule to remember. De minimis tax consequences of discount bonds are not universal, but rather applicable from the perspective of every individual investor's own experience. Therefore, if a bond is purchased above the threshold and subsequently begins trading below the threshold as market conditions evolve, the original purchase remains unaffected for tax purposes. To illustrate, consider a bond issued by the State of North Carolina in 2019 at a price of $100 with a 2% coupon.

Bond Issued at Par in 2019

Issuer	State of North Carolina
CUSIP	6582564M1
Issue Date	09.19.2019
Maturity Date	06.01.2032
Call	06.01.2029 at $100 (par)
Coupon Rate	2.00%
Issue Yield/Price	2.00% / $100

At issuance, our example was priced at par ($100), or above the IRS de minimis threshold, meaning no additional tax consequences for original holders if held to maturity. This is illustrated in the following Bloomberg L.P. tax calculations:

09.19.2019 Yield: 2.0%

NORTH CAROLINA ST PUB IMPT-SER B State NC Cusip 6582564M1
Coupon 2.000 Maturity 6/01/32 Issued 9/19/19 @ 100.000 (2.000)
Revised Issue Price 100.000 Market Discount Cutoff Price 97.000 (2.273)

Investor Information		
Face Amount ($)	1,000,000.000	
Purchase	09/19/19	@ 100.000 *
Sell (Maturity)	06/01/32	@ 100.000

*Bond Purchased at Revised Issue Price

Tax Item	Amount	Rate	Tax
Capital Gain	0.000 X	23.80 =	0.000
Income Gain	0.000 X	40.80 =	0.000
Interest Gain	0.000 X	0.00 =	0.000

Total Tax($) 0.00 due 6/01/32

Yet, beginning in 2022, the Fed pivoted to a restrictive monetary policy, prompting municipal bond yields to rise. As a result, prices adjusted lower, reflecting the upward movement in yields. As market yields rose above 2%, our example bond breached the de minimis threshold, accelerating its decline and reflecting the possible tax consequences for future buyers.

Municipal Bonds: Tax Free, with Exceptions

Understanding AMT & De Minimis Impacts

According to the Bloomberg tax calculator, (shown below), for any potential buyer at 2025 market levels the bond generates a tax liability of approximately $49k, assuming the highest federal income tax bracket.

06.30.2025 Yield: 4.01%


NORTH CAROLINA ST PUB IMPT-SER B State NC Cusip 6582564M1
Coupon 2.000 Maturity 6/01/32 Issued 9/19/19 @ 100.000 (2.000)
Revised Issue Price 100.000 Market Discount Cutoff Price 98.500 (2.235)

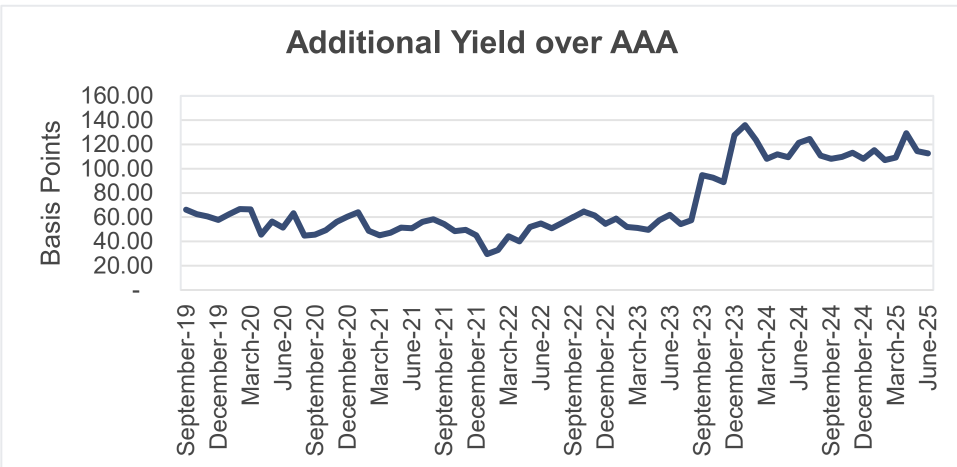
Investor Information		
Face Amount ($)	1,000,000.000	
Purchase	06/30/25	@ 87.990*
Sell (Maturity)	06/01/32	@ 100.000

*Non OID Bond with Market Discount

Tax Item	Amount	Rate	Tax
Capital Gain	0.000 X	23.80 =	0.000
Income Gain	12.010 X	40.80 =	4.900
Interest Gain	0.000 X	0.00 =	0.000

Total Tax($) 49,000.80 due 6/01/32

As potential tax consequences emerge, market discount bond yields typically adjust more aggressively to higher levels than the overall market driven by less anticipated demand for the bond and degraded liquidity. As shown in the chart below, the additional yield over the London Stock Exchange Group AAA 2032 maturity curve increased from approximately 66 bps to 113 bps in June 2025.

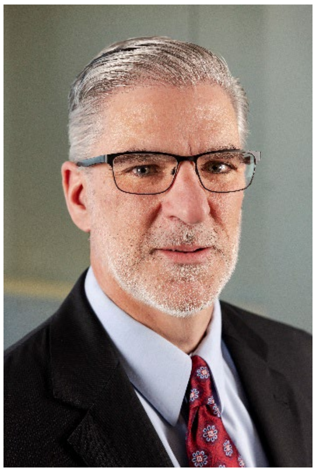


Conclusion

We believe that municipal bonds remain a cornerstone of tax-efficient investing and offer meaningful benefits to investors seeking to reduce their tax liabilities. However, to fully realize these advantages, investor understanding of the nuances of the AMT and the IRS de minimis rule is essential for informed decision making. While passage of the 2025 OBBBA provided clarity on tax policy, the broader tax landscape remains subject to change. Therefore, investors must remain vigilant in evaluating the potential implications of these provisions on their municipal bond portfolios. By working with knowledgeable financial advisors and staying current on tax regulations, investors can continue to leverage municipal bonds effectively, navigating the complexities of the tax code to preserve the benefits of tax-exempt income.

Source for top chart: Bloomberg L.P. Sources for bottom chart: Bloomberg L.P.; London Stock Exchange Group. Data is as of 06.30.2025. Charts are for illustrative purposes only. Yields are subject to market conditions and are therefore expected to fluctuate. Specific securities identified and described do not represent all of the securities purchased, sold or recommended to clients. There are no assurances that securities identified will be profitable investments. The securities described are neither a recommendation nor a solicitation. Security information is being obtained from resources the firm believes to be accurate, but no warrant is made as to the accuracy or completeness of the information. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful.

Important Information



Michael McVicker
Executive Director | Head of Municipal Credit Analysis

Michael McVicker, Executive Director, joined SCM in 1992 and has investment experience since 1992. Mike is Head of Municipal Credit Analysis and responsible for portfolio management of enhanced cash and short-intermediate municipal portfolios, as well as Associate Portfolio Manager responsibilities for the state-specific municipal bond portfolios for the Sterling Capital Funds. Prior to joining the Fixed Income team, he was SCM's Director of Operations managing the client reporting and performance team. Mike received his B.S.B.A. in Finance with a minor in Psychology from the University of North Carolina at Charlotte.

All Investing carries risks, including but not limited to:

Fixed Income Market Risk: Fixed income securities markets may, in response to governmental intervention, economic or market developments (including potentially a reduction in the number of broker-dealers willing to engage in market-making activity), or other factors, experience periods of increased volatility and reduced liquidity.

Credit Risk: The possibility that an issuer cannot make timely interest and principal payments on its debt securities such as bonds. The lower a security's rating, the greater its credit risk. Changes in actual or perceived creditworthiness may occur quickly.

Interest Rate Risk: The possibility that the value of the investments will decline due to an increase in interest rates. Interest rate risk is generally higher for longer-term debt instruments and lower for shorter-term debt instruments.

Liquidity Risk: The possibility that certain securities or derivatives may be difficult or impossible to sell at the time and the price that would normally prevail in the market. The seller may have to lower the price, sell other securities instead or forego an investment opportunity, any of which could have a negative effect on performance.

Income Risk: The possibility that the portfolio's income will decline due to a decrease in interest rates. Income risk is generally high for shorter-term bonds and low for longer-term bonds.

Municipal Securities Risk: Municipal obligations are issued by or on behalf of states, territories, and possessions of the United States and their political subdivisions, agencies and instrumentalities and the District of Columbia to obtain funds for various public purposes. Municipal obligations are subject to more credit risk than U.S. government securities that are supported by the full faith and credit of the United States. The ability of municipalities to meet their obligations will depend on the availability of tax and other revenues, economic, political, and other conditions within the state and municipality, and the underlying fiscal condition of the state and municipality. As with other fixed income securities, municipal securities also expose their holders to market risk because their values typically change as interest rates fluctuate.

Tax Risk: The risk that the issuer of securities will fail to comply with certain requirements of the Internal Revenue Code, which would cause adverse tax consequences. Changes or proposed changes in federal or state tax laws may cause the prices of tax-exempt securities to fall and/or may affect the tax-exempt status of the securities in which the strategy invests.

STERLING CAPITAL

Important Information

Disclosures

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

The opinions contained in this presentation reflect those of Sterling Capital Management LLC (SCM), are for general information only, and are educational in nature. The opinions expressed are as of the date of publication and are subject to change without notice. These opinions are not meant to be predictions and do not constitute an offer of individual or personalized investment advice. They are not intended as an offer or solicitation with respect to the purchase or sale of any security. This information and these opinions are subject to change without notice. All opinions and information herein have been obtained or derived from sources believed to be reliable. SCM does not assume liability for any loss which may result from the reliance by any person upon such information or opinions.

Investment advisory services are available through SCM, an investment adviser registered with the U.S. Securities & Exchange Commission and an indirect, wholly-owned subsidiary of Guardian Capital Group Limited. SCM manages customized investment portfolios, provides asset allocation analysis, and offers other investment-related services to affluent individuals and businesses.

SCM does not provide tax or legal advice. You should consult with your individual tax or legal professional before taking any action that may have tax or legal implications.

Specific securities identified and described do not represent all of the securities purchased, sold or recommended to clients. There are no assurances that securities identified will be profitable investments. The securities described are neither a recommendation nor a solicitation. Security information is being obtained from resources the firm believes to be accurate, but no warrant is made as to the accuracy or completeness of the information.

Technical Terms: **The Alternative Minimum Tax (AMT)** is a separate federal tax system designed to ensure that high-income individuals, estates, and trusts pay at least a minimum amount of tax, regardless of the deductions, exemptions, and credits they claim under standard tax rules. This parallel calculation prevents wealthier taxpayers from using tax benefits to reduce their tax liability to a minimal amount or zero. **The One Big Beautiful Bill Act (OBBBA)** is a U.S. federal statute passed by the 119th United States Congress containing tax and spending policies that form the core of President Donald Trump's second-term agenda. The bill was signed into law by President Trump on July 4, 2025. **The Tax Cuts and Jobs Act (TCJA) of 2017** was a major overhaul of the U.S. tax code, significantly lowering corporate and individual income taxes. Signed into law by President Donald Trump, the TCJA was designed to stimulate economic growth. While many business provisions were made permanent, most of the individual tax changes were temporary and originally set to expire after 2025. (The technical terms are sourced from Corporate Finance Institute.)

A Note on Indices: The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

Bloomberg L.P. Information: “Bloomberg®” and the Bloomberg indices are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited (“BISL”), the administrator of the index (collectively, “Bloomberg”) and have been licensed for use for certain purposes by Sterling Capital Management LLC and its affiliates. Bloomberg is not affiliated with Sterling Capital Management LLC or its affiliates, and Bloomberg does not approve, endorse, review, or recommend the product(s) presented herein. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to the product(s) presented herein.

STERLING CAPITAL