Tax effect on municipal discount securities

Original-issue discount should be treated as tax-exempt income, IRS ruling states

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Do you, like many bankers, consider the difference between the original purchase price of municipal bonds and their maturity value as income? For most investors, municipal securities are capital assets; any gain or loss is a capital gain or loss.

Under Section 582 of the Internal Revenue Code, however, the sale or exchange of a bond, debenture, note, certificate, or other evidence of indebtedness by a financial institution is not considered a sale or exchange of a capital asset. Thus, it is ordinary gain or loss.

Fallacy. Based on many security analysis and investment texts, one could easily assume that the original discount is indeed subject to taxes. But the correct method is to treat it as interest income that is tax-exempt—a difference that can have a major impact on portfolio buy-and-sell decisions.

Section 103 (a) (1) of the Internal Revenue Code states that gross income does not include interest on the obligations (notes and written agreements of purchase and sale providing for deferred interest-bearing payments) of a state or its political subdivisions.

If these obligations are issued at a discount, is the discount considered deferred interest—exempt from federal income tax? Is the discount tax-exempt for only the original holder or for all subsequent purchasers?

Before addressing these questions, let's examine the reasons for the existence of original-issue discount bonds.

Rationale. Municipalities issue general obligation bonds to fund capital projects, which are paid off when taxes or revenues are collected in future periods. These bonds may be sold at a discount, the amount of which is determined by the current financial market rates and state municipal laws.

Tallahassee, Fla., for example, is limited by law to pay no more than a 7.5% coupon rate on its bonds. Therefore, if the city issues bonds during high-interest-rate periods, they will be offered at a discount. And when the underwriters package the bonds for sale to the investing public, they may provide lower coupon rates on the longer maturities.

Clarification. In 1973, the IRS clarified the tax treatment of discount bonds with a ruling stating that the original-issue discount on state or municipal obligations should be treated as tax-exempt interest and that any subsequent gain or loss due to market forces should be considered as a gain or loss, not tax-exempt interest. Under the ruling, the original discount must be apportioned evenly over the terms of the obligation and treated as interest income. Moreover, the tax-exempt discount must be apportioned among the original holder and any subsequent purchasers.

In 1980, this ruling was modified to apply only to original-issue discount municipal securities. The IRS states that unless there is an understanding from the time of issue that it will be redeemed before maturity, the tax exemption will apply only to the apportioned discount earned during the time the investor actually held the bond. The remainder would be considered taxable income.

It should be noted that expectation of redemption is a major factor in determining whether an early redemption results in income that is totally tax-free, partially tax-free, or partially taxable.

Two flows. Actually, the only difference between deferred tax-exempt interest income and regular interest income is in the timing of the two flows. Interest income is a cash flow each period; apportioned gain represents only a paper flow until the bond is sold or redeemed.

As an example, let's assume that a bank has a marginal tax rate of 46% and buys an original-issue, 20-year municipal bond—one with a par value of $1,000 carrying a stated coupon rate of 8%, although the current tax-exempt market rate is 11%. In order to yield the market rate, the bond would sell at a discount. Using the present-value technique, its price would be $637.07.

Let's then assume that the bond is bought at a discount of $362.93, apportioned as tax-free interest income at a rate of approximately $18.15 per year.

Because it is reasonable to believe that market rates will not remain constant, let's consider two cases: (1) the market rate increases to 13% one year from now, and (2) the market rate decreases to 9% one year hence. In both cases, a comparison is made between treating the original discount as tax-free income and treating it as a taxable income when the bond is sold at the end of the year.

Case 1. If the market interest rate increases to 13%, the price of the bond at the end of one year decreases to $555.04.

If the bond is sold at the end of the first year and the original discount is treated as tax-free income, a loss of $100.18 will result from the sale ($637.07 purchase price plus $18.15 apportioned, tax-free interest, minus $555.04 selling price).

The loss, which is treated as an ordinary loss due to market forces, results in a tax savings of $46.08 ($100.18 x .46), assuming that an ordinary loss is used to offset other ordinary income. The net proceeds to the bank will be $601.12 ($555.04 sales price plus $46.08 tax savings).

If the bond is sold at the end of the first year and the original discount is incorrectly treated as a taxable loss, the loss will amount to $82.03 ($555.04 sales price minus $637.07 purchase price.). In this situation, there is only a $37.73 tax savings ($82.03 x .46). The net proceeds to the bank are equal to $592.77 ($555.04 sales price plus $37.73 tax savings).

Due to an increase in market in-

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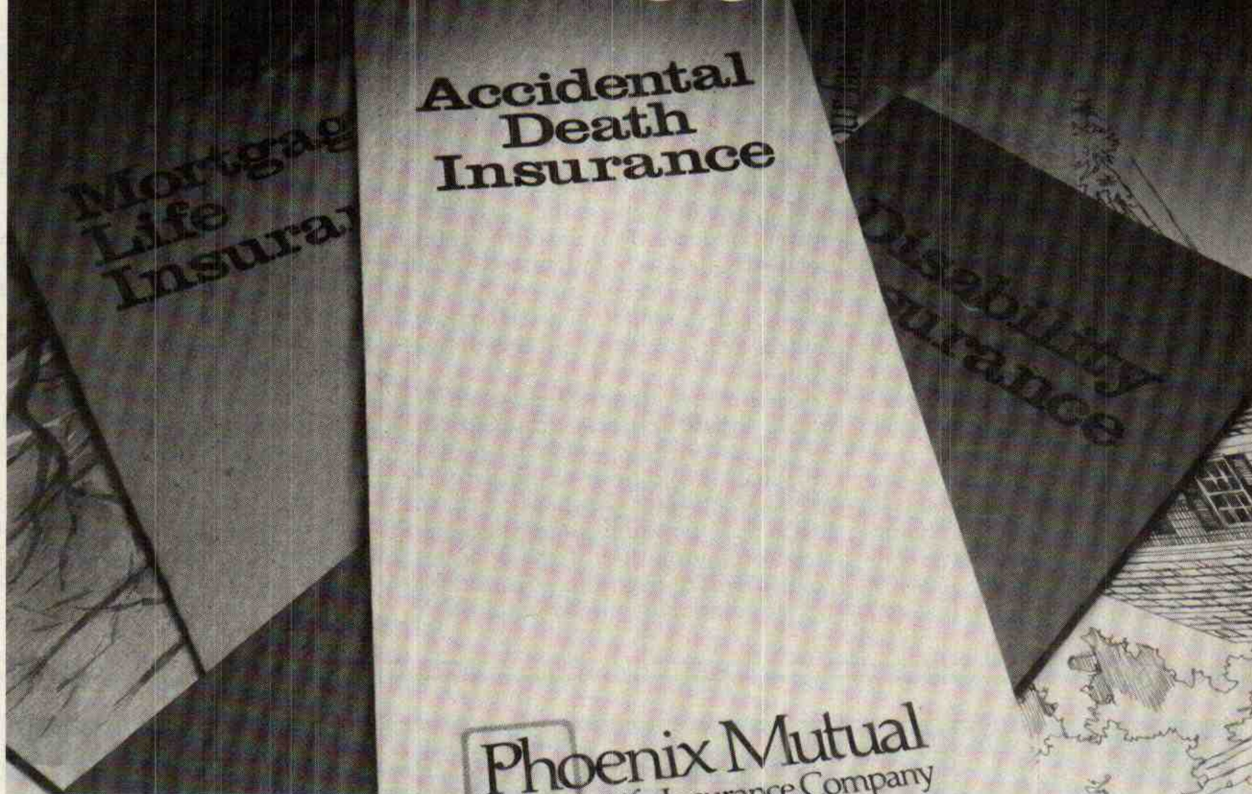

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terest rates, the treatment of the original discount as tax-free interest income in this case results in a greater loss for tax purposes and a smaller tax liability.

Case 2. If the market interest rate decreases to 9%, the price of the bond at the end of the first year increases to $716.01.

If the bond is sold at the end of the first year and the original discount is treated as tax-free interest, a gain of $60.89 will result from the sale ($716.01 sales price minus the $637.07 purchase price and $18.15 apportioned tax-free interest). The gain, treated as ordinary income, results in a $28.01 tax liability ($60.89 x .46). The net proceeds after taxes for the bank are equal to $688.00 ($716.01 sales price minus $28.01 tax liability).

If the bond is sold at the end of the first year and the original discount is incorrectly treated as a taxable gain, a $78.94 gain will be recognized ($716.01 sales price minus $637.07 purchase price). In this situation, there is a tax liability of $36.31 ($78.94 x .46), and the net proceeds, after taxes, are equal to $679.76 ($716.07 sales price minus $36.31 income tax liability).

In this case, with a decrease in market interest rates, the correct treatment of the original discount as tax-free interest results in a smaller, taxable gain and higher net proceeds after taxes.

Premium bonds. A logical counterpart of the discount bond is the premium bond. Section 170 of the Internal Revenue Code indicates that an original issue premium on state or municipal bonds must be apportioned over the term of the obligation.

This in turn implies that premium bonds should sell at a disadvantage. At maturity there would be no taxable loss. If sold prior to maturity for less than original purchase price, the loss would be reduced by the amortized premium. And if the bond was sold for more than the adjusted value, the taxable gain would be increased. Overall, the reduction in ordinary taxable loss and increase in ordinary taxable gain would result in lower after-tax returns for the bank.

Steps to take. Due to the current misinformation about the tax treatment of municipal bonds selling at a discount when first issued, there are several implications worth noting.

A bank should make sure that its tax department treats original-issue discounts as tax-free income.

The bank's municipal bond portfolios should be reviewed to see if older purchases may now be desirable tax losses; because of high interest rates, the loss could be magnified by the apportioned income.

Another step would be for the bank to review its trust accounts and determine if any alternations are advisable.

A final implication of our analysis is this: Discount bonds offered with a discount (possibly even with a "penalty yield") may indeed be an outstanding buy. □

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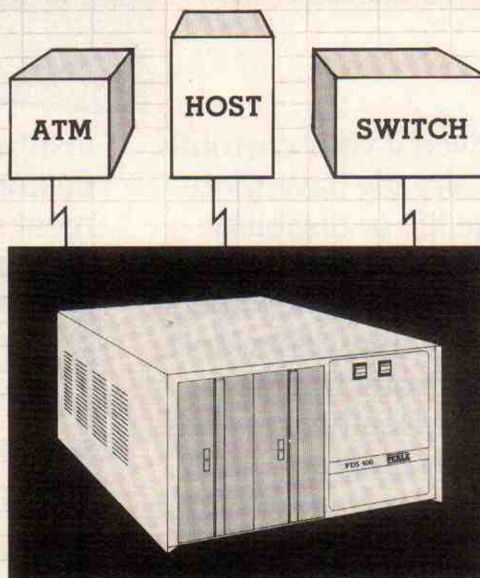

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