

# Market discount municipal bonds



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## Highlight

The Revenue Reconciliation Act of 1993 (the “1993 Act”) established new rules for the tax treatment of “market discount” municipal bonds. Although the 1993 Act did not place any new taxes on municipal bonds, it did change the rate at which taxes may be assessed. Previous to the 1993 Act, all accretion in the value of a bond purchased at a market discount was taxed as a capital gain at the time the bond reached maturity or was sold. The current law holds that municipal bonds purchased after April 30, 1993 will have their accrued market discount taxed as ordinary income.

Investors should also be aware that if the purchase price exceeds the de minimis threshold, the full amount of the discount is taxed as ordinary

income, rather than just the amount that exceeds the threshold. Investors should always seek their own tax advice with respect to the taxation of market discount bonds.

## Background

The 1993 Act sought to re-establish favorable tax treatment of capital gains for individuals. Net capital gains were generally taxed at the taxpayer’s ordinary income tax rate, but were subject to a then maximum rate of 28% for individuals (the Taxpayer Relief Act of 1997 subsequently created a new maximum long-term capital gain rate of 20%). The law also contained provisions that prevent taxpayers from converting ordinary income to capital gains in order to take advantage of the more favorable

capital gains rate. One of the little-noticed items that fell under these anti-conversion provisions of the law was a change in the tax treatment of municipal bonds purchased at a market discount. Bonds purchased on or before April 30, 1993, are subject to the old rules that tax market discount as a capital gain.

## Market discount defined

Market discount exists when a bond is purchased in the secondary market for less than par value, or the accrued value of an Original Issue Discount (OID) bond. The amount of market discount is the difference between the purchase price of a bond and its maturity value, or its accrued value for an OID bond.

**Table 1: Allowable market discounts before taxation as ordinary income**

Complete years to maturity	Allowable discount	Complete years to maturity	Allowable discount	Complete years to maturity	Allowable discount
1	0.25	11	2.75	21	5.25
2	0.50	12	3.00	22	5.50
3	0.75	13	3.25	23	5.75
4	1.00	14	3.50	24	6.00
5	1.25	15	3.75	25	6.25
6	1.50	16	4.00	26	6.50
7	1.75	17	4.25	27	6.75
8	2.00	18	4.50	28	7.00
9	2.25	19	4.75	29	7.25
10	2.50	20	5.00	30	7.50

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The tax law allows a bond with a small amount of market discount to escape taxation as ordinary income. If the discount equals or is less than the de minimis (which means insignificant or minute) rule allows, there is considered to be no market discount and any gain from holding the bond is subject to capital gains taxes. The de minimis amount is 1/4 of 1% of the redemption price per complete year from the date of purchase to the date of maturity (see Table 1). For example, the maximum allowable discount for a bond with 30 complete years to maturity is 7.5% (30 years x 1/4%); a bond with 5 years, 4 months to maturity is allowed 1.25% (5 years x 1/4%) before being considered as market discount.

### Original Issue Discount (OID) bonds

Bonds issued at a price below par value are original issue discount or “OID” bonds. Under the revised rules for OID bonds, the treatment required is the same as for bonds issued at par, but the calculations are more involved. The investor is required to calculate the accrual of both the tax-free OID and the taxable market discount to determine the amounts of each type of income.

The original discount on a municipal OID bond is accrued over the life of the bond—even though no income is reported or taxes paid—for the purpose of determining gain or loss if the bond is sold prior to maturity. Calculation of market discount for OID bonds involves first calculating the revised issue price. For tax exempt OID bonds, this is calculated

annually using the constant interest rate method and is equal to the original issue price plus accrued OID through the date of purchase. For OID bonds market discount is the excess, if any, of the revised issue price over the purchase price.

When a market discount OID bond is held to maturity, the entire amount of the market discount will be taxed as ordinary income, but the accrual of remaining OID is tax-free. The amount of ordinary income is the difference between the value of the total discount (which consists of both market discount and OID) and the value of the OID. If an OID bond is sold prior to maturity, the amount of ordinary income is the difference between the accrued value of the total discount and the accrued value of the OID. Table 2 shows an example of the accrual of total discount and OID.

**Table 2: Example of accrual of total market discount and OID<sup>1</sup>**

30-year OID bond originally issued at 96.24 to yield 5.25%, purchased in the secondary market five years later at 87.14 to yield 6.00% when the adjusted issue price is 96.54; market discount taxable as ordinary income is 9.40 (96.54 - 87.14).

Total years held	Tax market discount	– Free gain	= Ordinary income	Total years held	Tax market discount	– Free gain	= Ordinary income	Total years held	Tax market discount	– Free gain	= Ordinary income
1	0.23	0.07	0.16	11	3.48	1.00	2.48	21	9.36	2.57	6.79
2	0.48	0.14	0.34	12	3.93	1.12	2.81	22	10.16	2.77	7.39
3	0.74	0.22	0.52	13	4.40	1.25	3.15	23	11.01	2.99	8.02
4	1.01	0.30	0.71	14	4.90	1.39	3.51	24	11.91	3.22	8.69
5	1.31	0.39	0.92	15	5.43	1.53	3.90	25	12.86	3.46	9.40
6	1.62	0.48	1.14	16	5.99	1.68	4.31				
7	1.95	0.57	1.38	17	6.58	1.84	4.7				
8	2.30	0.67	1.63	18	7.22	2.01	5.25				
9	2.67	0.77	1.90	19	7.89	2.19	5.70				
10	3.06	0.89	2.17	20	8.60	2.37	6.23				

## OID bond examples: A–C

### A. Calculation of market discount (30-year bond with 25 complete years remaining to maturity)

No market discount		Market discount bond	
Coupon:	5.00%	Coupon	5.00%
Yield at issue:	5.50%	Yield at issue:	5.25%
Issue price:	92.69	Issue price:	96.24
Adjusted issue price:	93.25	Adjusted issue price:	96.54
Current price:	88.31	Current price:	87.14
Yield to maturity:	6.00%	Yield to maturity:	6.00%
Market discount:	4.94	Market discount:	9.40
(Less than de minimis amount of 6.25)		(Exceeds de minimis amount of 6.25)	

### B. Taxation if held to maturity (25 years)

No market discount		Market discount bond	
Par:	100.00	Par:	100.00
Purchase price:	88.31	Purchase price:	87.14
Capital gain:	4.94	Ordinary income:	9.40
Tax-free gain:	6.75	Tax-free gain:	3.46
Current price:	88.31	Current price:	87.14

### C. Taxation if sold 5 years prior to maturity (held for 20 years)

No market discount		Market discount bond	
Selling price:	96.15	Selling price:	95.74
Purchase price:	88.31	Purchase price:	87.14
Capital gain:	4.90	Ordinary income:	6.23
Tax-free gain:	2.94	Tax-free gain:	2.37



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<sup>1</sup> All accrual schedules are calculated using the effective-interest method for both market discount and OID. The taxpayer may elect to use the straight-line method for accruing market discount. Straight-line accrual, while simpler to calculate, has the disadvantage of increasing the amount of market discount amortized in the early years, which may result on higher taxable income if the bond is sold in the early years of its remaining life. Amortization of original issue discount (OID) must be done using the effective interest rate method.

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