



MOORS & CABOT
INVESTMENTS

Banking & Advisory Group

**INVESTMENT
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Perspective on *de minimis*

Tax Treatment of Market Discount on Tax-Exempt Securities

The Internal Revenue Code of 1986, as amended (the "Code") contains a provision governing the tax treatment of municipal securities purchased at a discount. The treatment of market discount is relevant for municipal bond investors, and some confusion has arisen over the application of this provision.

Market Discount and its Taxation

Market discount generally exists when a bond is purchased on the secondary market at a price below par (i.e., 100%). Market discount is the difference between the purchase price of a bond and its stated redemption price at maturity. For bonds sold at original issue discount ("OID"), market discount is the difference between the purchase price and the issue price of the bond plus accreted OID. Accreted market discount is generally taxed as ordinary interest income in the year that a bond is sold, redeemed or transferred.

Changes in the Tax Treatment

Before May 1, 1993, market discount on municipal securities was treated as a capital gain, not as ordinary income. Under current law, accreted market discount is taxed as ordinary income at the time that a bond is sold, redeemed or transferred. The new treatment applies to bonds acquired after April 30, 1993; whereby discount bonds acquired before May 1, 1993 are still subject to capital gains.

The de minimis Rule

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The *de minimis* rule governs the treatment of small amounts of market discount. Under the *de minimis* rule, if a bond is purchased with a small amount of market discount (i.e., [an amount less than 0.25% of the face value of the bond] x [the number of complete years between the bond's acquisition date and its maturity date]) the market discount is considered to be zero. If the market discount is less than the above *de minimis* amount it is generally treated as a capital gain upon disposition or redemption rather than as ordinary income.

Market Discount is not the Same as OID

OID is established when a bond is issued at a price below its maturity value. OID represents interest paid by the issuer ... at maturity ... and is generally tax-exempt. Market discount is created when a bond falls in value after issue and is not treated as tax-exempt income (as it does not represent an interest expense of the issuer). An OID bond may be subject to market discount rules if purchased after issue and is purchased below its cash accreted value.

The accrual on an OID municipal bond is recognized annually as income, and is required to be reported for informational purposes, but is not subject to ordinary income taxation. Accreted market discount is not subject to annual taxation and is only reported at disposition or redemption ... as taxable income.

The Market Discount Rule

For bonds acquired after April 30, 1993, the amount of its market discount is accreted between the bond's acquisition date and maturity date. Accreted market discount is included as ordinary, taxable income in the year that a bond is sold, redeemed, etc. Investors may choose accretion by the "straight-line" or the "constant interest rate" methods. The "constant interest rate" method corresponds to the economic accrual of interest based on the yield at the time the bond is purchased.

The Market Discount Rule for OID Bonds

Market discount for OID bonds arises when the OID bond is purchased on the secondary market at a price below the revised issue price of the OID bond (i.e., the OID bond's issue price plus accrued OID). The revised issue price for tax-exempt OID bonds 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. The "constant interest rate" method corresponds to the economic accrual of interest based on the yield on an OID bond at the time the OID bond is issued.

As with other tax-exempts', market discount on OID bonds is accreted from the date it is purchased to the maturity date. Accreted market discount is taxed as ordinary income at the time the OID bond is disposed.