



Understanding the Risk in Discounted Municipal Bonds

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The market discount rule is one of those arcane regulations in municipal taxation that many investors and financial advisors ignore, either because they are unaware of its adverse consequences or because they don't know what to do about them. As the market discount rule grows in impact with the recent rise in interest rates, understanding this important topic is vital.

At my firm, we are seeing many retail investors' portfolios that have as much as 10% of their holdings unnecessarily exposed to the ordinary income taxation of market discount for new buyers.

Overview of market discount

Under current rules adopted in 1993, some or all of the gain from the sale or maturity of a municipal can be taxed as ordinary income, regardless of the length of holding. This taxation can dramatically affect both the value of a bond and its duration.

A market discount bond is one purchased in the secondary market at a discount to its original price. This is true whether the original price was itself discounted or at par. For example, if a \$100 bond were issued at par 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 minimus threshold of one-quarter point of discount per year to maturity. If there is less market discount than this threshold 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 threshold, the market discount will be taxed as ordinary income.

For example, if a bond has 20 years remaining to maturity, the de minimus threshold would be five points below the original purchase price. For a bond purchased at \$95 or higher for a par or original issue premium bond, the market discount would be taxed as *capital gains*. If the purchase price were below that level, however, 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 \$94.90, all 5.1 points of market discount would



be subject to ordinary income tax, while at \$95 the 5.0 points of market discount would be subject only to capital gains taxation.

It should be clear from this example why this matters to investors. A buyer of the market discount bond at \$94.90 should expect to owe tax of 35% 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 slightly less than one point – about \$1. Often, the seller would pay for this tax by giving 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). Although one might consider the capital gains taxation for the bond with a purchase price of \$95, the market often trades as if capital gains tax rates are zero, since capital gains can be offset with capital losses. Ordinary income generally cannot be offset, which is why this change in taxation matters and will have a significant effect on valuation and liquidity.

In addition, the duration of a bond increases when the bond is subject to ordinary income taxation on its discount. When interest rates change, the amount of taxes due will change, as will the price. In our example, where a bond not subject to ordinary income taxation declined by \$1, say from \$94.90 to \$93.90, the bond subject to market discount would decline from about \$93.94 to \$92.75, a change of \$1.19. The extra \$0.19 is for the tax burden on the increased market discount. The duration has increased by close to 20%. The fact that the duration increases may also affect the price realized, as the municipal yield curve slopes upward – investors expect to get paid for taking on higher durations.

Intuitional versus retail structures

In our example, a 20-year bond would not be subject to the ordinary income taxation of the market discount until its price declines below 95, both for 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 with a 10-year call was a yield of 4%. It would not be unusual for the underwriter to offer two callable 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%. For a new buyer, the “retail” 4% coupon bond issued at par will be subject to ordinary income taxation on the market discount 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 \$108.2, will need to decline by 13.2 points before the price reaches the de minimus threshold of 95, which occurs when rates have risen by 141 basis points. It is not surprising that professional institutional investors concentrate on



owning premium bonds; there is significantly greater "market discount protection" for original-issue premium bonds.

To be clear, any bond purchased at a price above the de minimus threshold will not result in ordinary income taxation on the discount for that original purchaser, but if the bond subsequently falls in price to below the de minimus threshold, it could be worth less to any prospective new buyer. Given the recent rise in interest rates, this chilling effect on bond purchases is increasingly problematic. The bond can therefore be worth more to its current holder than to a new buyer, and the mark-to-market value of these bonds should fall given the lower "bid" price. A potential further complication is that a smaller market of buyers is willing to buy bonds subject to the ordinary income taxation at all; many do not want to realize ordinary income. By reducing a bond's liquidity, this effect can further reduce its value.

Conclusion

We often hear that buy-and-hold investors do not care about the liquidity of their bonds, since they do not plan to sell them. That may be the case for certain investors, but it is not a given. If you could have avoided the drop in values in 2008 or, more recently, in November of 2010, why wouldn't you? Even for investors who expect to never need the cash, there could be reasons that they will want to sell bonds before maturity. Changed circumstances are often unexpected, and liquidity needs can change as well. One clear example would be a bond with a deteriorating credit profile, which you might want to sell to avert further price declines. With deteriorating credit as a backdrop, why own a bond that is a likely candidate for ordinary income taxation?

With the recent rise in rates, market discount has moved from the realm of potential risks to an actual risk investors are realizing every day. Investors should be aware of their bonds' liquidity and proactively restructure portfolios as market environments change, ideally well in advance of an adverse development regarding the bond's issuer. And it is precisely when considering such adjustments that advisors and investors should not forget about taxation on market discounts. It might make all the difference.

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