As interest rates rise, many municipal bond investors have the opportunity to realize tax losses by selling bonds purchased in a lower interest rate environment (which generally are tax-deductible) and reinvesting in higher-rate coupon bonds (which generally are nontaxable). Although the benefit from tax loss swaps generally will increase as interest rates rise, investors must pay attention to market discount rules that can sharply reduce or eliminate such benefits.

Market discount is the difference between a) the lower of par or the accreted original issue discount (OID) price and b) the bond’s market price if lower. For example, the cost basis of a bond that was issued at a discount price of 95 may have accreted to 96 today (the cost basis will accrete to par as the time to maturity declines to zero). If the market price is 90, the market discount would be 6. Bonds issued at par or at original issue premiums would have a market discount of 10 if the market price is 90.

Treatment of Market Discount
Many municipal bond investors are not aware that the law changed in 1994 with respect to the treatment of the market discount on a municipal bond. Before 1994, if a bond was purchased with a market discount, that discount would be subject to capital gains taxation upon sale or maturity. Since 1994, the market discount has been subject to capital gains taxation only if the market discount at the time of purchase is less than a de minimus amount. Market discount of less than 0.25 points per full year to maturity of remaining bond life is considered de minimus. This breakpoint, called the de minimus cutoff, is a test, not an allowance. For example, the de minimus cutoff for a bond originally issued at par with 15 full years remaining to maturity would be 96.25. If this bond were purchased at a price of 97, the three points of market discount would be subject to capital gains taxation, but if it were purchased at a price of 96, the four points of market discount would be subject to ordinary income taxation.

A market discount that is greater than the de minimus amount will be subject to ordinary income taxation. The price of a bond for which a new purchaser would be subject to ordinary income taxation usually will be lower to compensate the buyer for this taxation.

For example, a bond originally issued at par but purchased with 15 years remaining to maturity at a price of 96 (and a de minimus cutoff of 96.25) would have taxes due of 1.4 points at maturity, assuming a 35-percent tax rate. The present value of this 1.4 points would equal approximately 0.7 points today assuming a discount rate of 4.5 percent (the purchase yield on the bond generally is used). However, the current bond holders would not be subject to ordinary income taxation if they purchased the bonds without a market discount or within the de minimus level, so the bonds could be “worth” more to the current holder than to a new purchaser.

In practice, the seller of a bond subject to ordinary income taxation...
on market discount will face a reduced selling price to compensate the buyer for the ordinary income taxes that will need to be paid. Sometimes the price on a bond may be lower to compensate a buyer for capital gains taxes that may need to be paid on a de minimus amount of market discount; but because capital gains can be offset with capital losses, the market rarely requires this compensation. When the market does include compensation for capital gains taxation in the price of bonds with de minimus market discounts, then the bond price would fall by the differential between ordinary income and capital gains taxation when the bond price falls below the de minimus cutoff. When the price on bonds with de minimus market discounts does not account for capital gains taxes and when the bond price falls below the de minimus cutoff, the bond will drop in value by the present value of the ordinary income taxes due at the bond’s maturity. Further declines in the bond’s value will be somewhat magnified because the taxes due at maturity would increase with larger discounts.

Several factors will affect the extent of the impact of market discount taxation on particular bonds. Generally, longer-maturity bonds have less impact because their de minimus threshold is larger and because the taxes due will be discounted over a longer time period. Accretion toward par helps shorter-term bonds have less impact from market discount taxation than intermediate-term bonds. The extent of the original issue discount is very important because the de minimus threshold is fixed (i.e., five points on a 20-year zero coupon bond will provide substantially more yield protection from market discount taxation than five points on a 5-percent coupon bond). The premium on a bond, whether original issue or secondary, increases market discount protection because the bond would have farther to fall before reaching the de minimus cutoff.

Buy-and-hold investors who mature their bonds generally do not need to be concerned about market discount taxation because it will affect only the mark-to-market valuation, not the worth of the bond. Investors who need to sell, wish to execute tax loss swaps, or otherwise are concerned with mark-to-market valuations should pay attention to the market discount cutoffs of their bonds. The impact on the value of a tax loss swap can be substantial.

For example, a 15-year bond purchased at par and held for more than one year with 10 points of market discount would generate a tax loss worth 1.5 points at a long-term capital gains tax rate of 15 percent. The present value of the 3.5 points of ordinary income tax due at maturity is worth about 1.8 points today. This would more than eliminate the benefit from the tax loss. Tax losses with a short-term holding period may be worth more to an investor who can use those losses to offset short-term gains or ordinary income (this ability may be limited). Using the above example at a short-term capital gains tax rate of 35 percent, the market discount taxation would offset half of the 3.5-point benefit from the tax loss, assuming such loss can be used to offset short-term gain or ordinary income.

Conclusion

Because the market may penalize discount bonds for being taxable before they reach the de minimus threshold, investors may want to execute tax loss swaps several basis points away from the threshold. Other factors will affect the value of a tax loss swap beyond the tax effects described. In particular, changing demand for particular coupon bonds may have a large impact on the profitability of a tax loss swap. Investors should discuss the tax loss swapping of particular bonds with investment professionals.

Investors should be aware of the impact that the taxation of market discount on municipal bonds has in general, and in particular be aware that the best bonds to sell for a tax loss swap often will be those that are not trading cheaper due to ordinary income taxation on market discounts.

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