IRET Congressional Advisory

June 3, 1993 No. 17

HOUSE TAX BILL PROVISION ON MARKET DISCOUNT BONDS: ASSAULT ON TAX EXEMPT BONDS; DOUBLE TAX ON SAVING

Bonds are generally issued at face value and pay explicit interest on the face amount. If interest rates rise after the bond is issued, the price of the bond will fall. A new buyer will receive the higher market interest rate in the implicit form of a gradual rise in the price of the bond toward face value at maturity plus the explicit interest payment in force at the time of issue. The gradual rise in price is called accrued market discount.

In the case of original issue zero coupon bonds, the bond is originally issued at a discount — the original issue discount, or OID — and all interest is paid in the form of a rise toward face value at maturity — accrued OID. In this case, a market discount from the accrued OID value due to a subsequent rise in interest rates provides added interest to the new buyer over time. The accrued market discount in this case is any gain in excess of the rise due to the accrued OID that constitutes the implicit interest payments in force at the time of issue.

> ***In the case of tax exempt bonds, interest is not supposed to be taxed. If the rise from market discount to face value is interest, as the House admits, then there should be no tax at all on the rise if the bond is tax exempt. Far from changing the current capital gains treatment of such increases to ordinary income, the correct adjustment is to exempt such gains from tax entirely.***

Under current law, when a bond purchased at market discount is later sold or reaches maturity, the accrued market discount is treated as interest income, taxable at ordinary rates. (A rise in price in excess of the implicit interest — as would occur if interest rates subsequently fell — is considered a capital gain.)

There are two exceptions to the interest treatment of accrued market discount. Gains on bonds issued before July 18, 1984 (when current law treatment began) and gains on tax exempt bonds are treated as capital gains when the bonds are sold. (Note that this component of the interest on tax exempt bonds is not tax exempt under current law.) The House tax bill would eliminate these two exceptions, and treat any gain resulting from purchase at a market discount as ordinary income.

It is correct to consider as interest the rise in the price of a bond from a discounted level at time of purchase toward face value at maturity. Bonds may pay interest explicitly by coupon or implicitly by accrual from a discounted price. There is no economic difference between the two methods. What is at issue is not whether the price increase due to accrued market discount is interest or a capital gain. What is at issue is the correct tax treatment of interest however it is paid. Under current law, some interest is treated correctly, and some incorrectly. Instead of moving toward the correct tax treatment of all interest, the House bill would increase uniformity by treating all accrued market discount interest incorrectly. In the process, the House bill would move the tax code in the wrong direction, and would worsen the current tax bias against saving.

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the free market economy.

1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

The income tax is biased against saving. Income is taxed when earned. If used for consumption, there is little additional federal tax. If used for saving or investment, it is taxed again on the returns. A neutral tax code would either give a deduction for amounts saved and tax the gross returns (akin to a deductible IRA) or give no deduction and tax none of the returns on saving (akin to the treatment of coupon interest on tax exempt bonds). All saving would be given one or another of these treatments.

In the case of bonds, neutral treatment calls either for allowing a deduction for the purchase of a bond while taxing the interest and accrued market discount, or allowing no deduction and not taxing the interest (as with current tax exempt bonds) or the accrued market discount. In particular, under the latter treatment, the rise in the price of a bond purchased at market discount would be treated as non-taxable interest under a neutral tax code. Insofar as the accrued market discount on old bonds is currently accorded capital gains treatment rather than ordinary income treatment, it faces a reduced rate of double taxation. This is a tiny step in the right direction, and should not be eliminated. If anything, it should be extended to all bonds.

In the case of tax exempt bonds, interest is not supposed to be taxed. If the rise from market discount to face value is interest, as the House admits, then there should be no tax at all on the rise if the bond is tax exempt. Far from changing the current capital gains treatment of such increases to ordinary income, the correct adjustment is to exempt such gains from tax entirely.

The current tax exempt treatment of explicit tax exempt bond coupon interest (or zero coupon tax exempt accrued OID) is the proper way to treat all interest income. The House proposal erodes one of the few areas of the tax treatment of saving and investment that is correct and unbiased. The House proposal would move the tax code closer to universal double taxation of saving, raise the cost of capital and reduce saving in the United States, and slow the growth of investment, productivity, wages, and employment.

Stephen J. Entin
Resident Scholar

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.