



About Original Issue Discount Bonds

What are Original Issue Discount Bonds?¹

Original issue discount bonds (OID bonds) are commonly thought of as bonds that, when originally issued, were sold at a price less than their par amount, with the difference being the amount of original issue discount (OID). While that is usually the case mathematically, the path through the tax law to get to that result is more complex.

OID bonds are technically bonds that have an issue price that is less than the bond's stated redemption price at maturity. The issue price of a bond is the first price at which a substantial amount of the bonds of the issue with identical terms are sold to the public in the initial offering. In the case of a fixed rate bond, the stated redemption price at maturity, is not in fact the amount that is required to pay off the bond at maturity. Rather, it is the sum of all payments of principal and interest on the bond throughout its term, other than interest payable at least annually at a single fixed rate throughout the term of the bond. The amount of OID is equal to the amount by which the stated redemption price at maturity exceeds the issue price.

Under the very technical tax rules, there can be counter-intuitive results, including bonds with an issue price above their par amount being treated as OID bonds.²

However, subject to one notable exception, the vast majority of municipal bonds have a stated redemption price at maturity equal to the par amount of the bond, and the amount of OID is simply the difference between the par amount of the bond and its issue price.

The one exception is the category of OID bonds known as capital appreciation bonds (CABs), sometimes referred to as "Zeros." These are bonds that pay no interest until maturity. CABs are usually, but not always, non-callable. CABs have an initial principal amount equal to their issue price, and the bondholder who buys in the initial offering at the issue price and holds to maturity has a basis in the CABs that increases (or "accretes") as the OID accrues until maturity, at which point the accreted value is equal to the stated maturity value of the CAB.

¹ This document does not address variable rate OID bonds, contingent interest OID bonds and other types of OID debt instruments not commonly offered to municipal bond investors. This document is not intended to provide tax advice. Consult with your tax adviser.

² An example is a bond issued 12/1/2014 and maturing 1/1/2026 with a stated principal amount of \$10,000, an issue price of \$11,000 (i.e., a price of 110), interest at a 6.0% rate payable each 1/1 and 7/1 starting 1/1/2016 (more than one year after the issue date). Since no interest is payable at least annually throughout the term of the bond, the bond has no Qualified Stated Interest and the stated redemption price at maturity is the sum of all payments of principal and interest on the bond throughout its term ($\$10,000 + [\$10,000 \times 3.0\% \times 20] + \650 {the first interest payment}) = \$16,650. The amount of OID is \$5,650 ($\$16,650 - \$11,000$).



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The De Minimis Rules

There are two different de minimis rules that relate to OID bonds.

The first is the De Minimis OID Rule, which applies only to taxable bonds, and provides that, if the amount of OID is less than a de minimis amount, the bond is treated as having no OID. The de minimis amount is equal to $\frac{1}{4}$ of 1 percent of the stated redemption price at maturity times the number of complete years to maturity. If a taxable OID bond with de minimis OID is purchased in the initial offering at the issue price and held to maturity and the bond is a capital asset in the hands of the owner, the difference between the price paid by the bondholder and the principal repayment should be a capital gain.

The De Minimis OID Rule does not apply to tax-exempt bonds and, if a tax-exempt OID bond purchased at the issue price in the initial offering is held to maturity, any OID associated with the bond would be treated as tax-exempt interest.

The second de minimis rule is the De Minimis Market Discount Rule, which only indirectly applies to OID bonds, but has significant effects, particularly for tax-exempt OID bonds. The market discount rules address secondary market transactions and require that gains on the sale of a bond with market discount, to the extent such gain is not in excess of the accrued market discount, are treated as ordinary income and not as a capital gain.

For a bond that is not an OID bond, market discount is equal to the excess (if any) of the stated redemption price at maturity over the basis of the bond immediately

after its purchase by the taxpayer. In the case of an OID bond, market discount is equal to the excess (if any) of the revised issue price over the basis of the bond immediately after its purchase by the taxpayer.

The De Minimis Market Discount Rule provides that if the market discount is less than $\frac{1}{4}$ of 1 percent of the stated redemption price of the bond at maturity multiplied by the number of complete years to maturity (after the taxpayer acquired the bond), the market discount shall be considered to be zero.

Thus, in the case of a bond with a 10-year maturity and a stated redemption price at maturity of par, the de minimis amount is $10 \times 0.25\% = 2.5\%$.³ If a bond has an issue price of 110, interest rates have to rise to a level that causes the value of the bond to fall 12.5 points from 110 to 97.5 before there is any market discount. In contrast, if the bond is an OID bond with an issue price of 98, a much smaller increase in interest rates will cause the value of the bond to decline from 98 to 97.5, the point at which market discount on the bond will begin.

The value of any tax-exempt bond will obviously reflect this effect and the adverse tax consequences of having a market discount bond, resulting in sharply declining values if rising interest rates cause the market discount on the bond to approach the limit of the De Minimis Market Discount Rule. In the case of a tax-exempt OID bond, the difficulty is that the bond is starting closer to that limit than is the case for a bond purchased at par or a premium.

³ Note that the rule counts only complete years, e.g. nine years, 11 months and 30 days is only nine complete years.



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Investor Considerations for Purchasing OID Bonds

Although any specific investor may have particular reasons for viewing the purchase of OID bonds as advantageous or disadvantageous, the following are general considerations.

Advantages of OID bonds may include:

- **Higher Yield** — At least with respect to deeply discounted OID bonds and CABs, the market will typically demand a higher yield (and sometimes a significantly higher yield) on those bonds than on a bond of the same maturity with no OID and higher stated interest payments.
- **Asset/Liability Matching** — Deeply discounted OID bonds and CABs provide opportunities to match assets against liabilities. Insurance companies, for example, are significant buyers of CABs because the deferral of interest payments on CABs to their maturity date permits the current investment of moneys to match long-term liabilities. Individual investors may purchase CABs to fund future college expenses of children or grandchildren or to provide funds for retirement, among other purposes.
- **Price Effect of Declines in Market Interest Rates** — The amount of OID that accrues from one compounding date to the next compounding date but is not paid is, in effect, automatically reinvested at the end of the compounding period in the same bond at the same yield as the original investment. If market interest rates decrease, that automatic reinvestment causes the OID bond to increase in

value faster than a comparable bond with no OID whose owner can only reinvest interest payments at the lower yields then available in the market.

Disadvantages of OID bonds may include:

- **Absence of Cash Flow to Pay Taxes** — If interest on the OID bond is taxable for regular federal, state or local income tax purposes or is tax-exempt for federal income tax purposes but taken into account for purposes of the alternative minimum tax, the bondholder would owe taxes with respect to the OID with no cash receipts or minimal receipts from a deeply discounted OID bond to pay those taxes.
- **Limited Liquidity** — Deeply discounted OID bonds may be more difficult to sell in the secondary market.
- **Greater Exposure to Market Discount Rules** — As discussed above, OID bonds do not have the degree of protection from the application of the market discount rules that is provided to bonds treated as purchased at par or at a premium under the De Minimis Market Discount Rule.
- **Price Effect of Increases in Market Interest Rates** — The automatic reinvestment characteristic of deeply discounted OID bonds, which is an advantage in times of declining interest rates, will exacerbate the decline in value in a rising interest rate environment. The price effect is even more severe if combined with the effect of the market discount rules discussed above.



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Deeply discounted OID bonds may be attractive to an issuer because of market conditions or debt structuring considerations.

Issuer Considerations for Offering OID Bonds

From the standpoint of the issuer, the issuance of deeply discounted OID bonds and, in particular, CABs, may be attractive because of market conditions or debt structuring considerations. The market conditions that lead issuers to consider offering such bonds include (i) the existence of a relatively flat yield curve, or (ii) the existence of a relatively steep yield curve.

In a flat yield curve environment, there may be little incremental cost to extending the duration of a new offering. In a steep yield curve environment, it may be possible to structure an issue with deeply discounted OID bonds in the later maturities and lower aggregate debt service as compared to an issue of non-discount bonds. Deeply discounted OID bonds placed in the later maturities have significantly lower debt service than non-discount bonds in each year prior to maturity because they pay little or no interest. As a result, the issuer can schedule the amortization of

other bonds of the issue in earlier years, beginning in the very first year, moving principal maturities down the yield curve and lowering the interest rates on those bonds. If the yield curve is steep enough, the combination of the acceleration of principal amortization and reduction in interest rates can more than offset the higher yields on the OID bonds, lowering aggregate debt service on the issue.

An issuer may also issue deeply discounted OID bonds for structural reasons. They could be employed by an issuer to smooth out its debt service cash flow requirements over the life of the issuer's debt service profile.



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