Municipal Bonds

# Taxation While Bond is Held

Interest Income

Interest paid on a large number of bonds issued by or on behalf of state or local governments is not tax-exempt. These are generally private purpose bonds (such as industrial development bonds and “private activity” bonds) and arbitrage bonds. For tax purposes, such non-exempt issues are government bonds taxed like Treasury bonds.

Interest on certain categories of private purpose bonds is tax-exempt, although tax-exempt interest on some private activity bonds is a tax preference item for both the individual and corporate alternative minimum tax. IRC Sec. 57(a)(5).

Municipal bonds (often referred to as "munis") are bonds issued by state and local governments and their instrumentalities. There are two principal categories of municipal bonds: general obligation bonds and revenue bonds. General obligation bonds (GOs) are backed by the taxing power of the state, city or other governmental entity that issued them. GOs are generally issued to fund ongoing governmental operations or capital expenditures. Revenue bonds are issued to finance specific revenue-producing capital investment projects, such as toll roads and bridges, sewer systems (assessable to affected property owners) airports and stadiums (paid for by users). Revenue bonds are sometimes used to help finance the construction of facilities that will be operated by non-governmental parties, such as hospitals, factories and industrial parks, governmental involvement being based upon the importance of the project to the economic or social well-being of the state or local community.

The most notable feature of munis is that the interest paid is generally exempt from federal income taxation. (This differs from U.S. Treasury securities, which are not exempt from federal income tax.). In most states that have an income tax, interest on munis issued by other states is subject to the state tax; however, most states exempt interest on bonds issued by that state or its instrumentalities. Certain of these issues may be unattractive to financial institutions because a ratable portion of the institution’s interest expense must be allocated to the tax-exempt bonds and the part so allocated is not deductible. IRC Sec. 265(b). In addition, some obligations are tax-exempt under special legislation.

Municipal Bonds

The fact that muni interest is free of federal income tax means that these bonds may be issued at lower rates of interest than would be the case for taxable bonds. The higher the bondholder's marginal federal income tax rate, the more valuable the tax-free feature of munis. Thus, investors in municipal bonds are primarily those in the higher tax brackets. In evaluating an investment in a municipal bond an investor would compare its tax-free yield with the after-tax yield that could be achieved from a corporate bond or Treasury security. Thus, the difference in dollar yield between a muni and a corporate bond would be primarily attributable to the income tax payable by the investor on the interest received with respect to the taxable security. Refer to the next section for a formula that can be used to compute the taxable equivalent yield of tax-free muni yield, plugging in the taxpayer's federal rate bracket.

Whether a particular issue meets the requirements for tax exemption can involve complex legal and factual questions. Law firms specializing in municipal debt offerings, often called “bond counsel,” provide legal opinions concerning the validity of bond issues which generally include the exemption of interest from federal income tax. These opinions are customarily printed on the bonds. It has been held that where bonds issued by a city as tax exempt were later found invalid under state law, the interest on them was not excludable from gross income under Code section 103(a). Rev. Rul. 87-116, 1987-2 CB 44.

The tax treatment of tax-exempt issues is explained under this heading.

The Formula for Calculating Taxable Equivalent Yield

Subtract the federal marginal tax bracket percentage from 1, and then divide the tax-free rate by the result.

Example 1

Assume:

* 30 percent tax bracket
* 4.75 percent tax-free bond

4.75 divided by 0.7 (1 minus 0.30) equals 6.78 percent. Thus, a taxable investment paying more than 6.78 percent is required to exceed the return on the 4.75 percent tax-exempt.

Municipal Bonds

In the 35 percent bracket, the divisor would be 0.65 (1 minus 0.35) and the taxable-equivalent yield would be7.3 percent.

The Formula for Calculating Tax-Exempt Equivalent Yield

To find the tax-exempt equivalent of a taxable yield subtract the federal marginal tax bracket percentage from 1, and then multiply the taxable rate by that number. The result is the tax-free rate.

Example 2

To find the tax-exempt equivalent of a taxable yield subtract the federal marginal tax bracket percentage from 1, and then multiply the taxable rate by that number. The result is the tax-free rate.

Assume:

* 7 percent taxable investment yield
* 30 percent tax bracket

7 multiplied by 0.7 (1 minus 0.30) equals 4.90 per cent. Thus a 4.90 percent tax-free yield will equal a 7 percent taxable yield.  
  
In the 35 percent bracket, the multiplier would be 0.65 (1 less 0.35), so a tax-free yield of 4.55 percent will equal a taxable yield of 7 percent.

Example 3

Taxable equivalent yield calculations have an extra wrinkle if the muni is exempt from both state and federal tax and the bond owner itemizes deductions. The "effective" state tax rate must be calculated (to account for the fact that state income taxes paid are an itemized deduction for federal income tax purposes). You can't simply add the state rate to the federal rate in the formulas above.

Assume:

* 5 percent state tax bracket
* 30 percent federal bracket

Municipal Bonds

The effective state tax rate is 3.5 percent (the 5 percent state tax rate minus 30 percent of that rate). Thus, for purposes of calculating taxable equivalents, the tax rate used would be 33.5 percent (the sum of the federal rate (30 percent) and the effective state rate (3.5 percent)).

Interest that would have been tax-exempt if paid by the issuer will generally be tax-exempt if paid by a private insurer on the issuer’s default. Rev. Rul. 72-134, 1972-1 CB 29. It makes no difference whether the issuer or the underwriter pays the premium on insurance obtained by the issuer covering payment of the principal and interest or whether the individual investors obtain their own insurance. Rev. Rul. 72-575, 1972-2 CB 74; Rev. Rul. 76-78, 1976-1 CB 25.

A bondholder, however, may *not* exclude from gross income interest paid or accrued under an agreement for defaulted interest if the agreement is not incidental to the bonds or is in substance a separate debt instrument or similar investment when purchased. An agreement will be considered both incidental to the bonds and not a separate debt instrument or similar investment if, at the time it is purchased, the premium is reasonable, customary, and consistent with the reasonable expectation that the issuer of the bonds, rather than the insurer will pay debt service on the bonds. Rev. Rul. 94-42, 1994-27 IRB 5.

Interest guaranteed by the U.S. or corporations established under federal law may not be tax-exempt. See below.

Interest Guaranteed by U.S. or Corporations Established under Federal Law

Interest on bonds issued by states, territories, and possessions or their political subdivisions which would otherwise be exempt from federal income tax may not be exempt if payment of interest or principal is federally guaranteed. IRC Sec. 149(b); Treas. Reg. §1.149(b)-1.

Generally, an obligation issued after December 31, 1983, is federally guaranteed and not tax-exempt if payment of principal or interest (in whole or in part, directly or indirectly) is guaranteed by: (1) the United States, (2) any U.S. agency, (3) under regulations to be prescribed, any entity with authority to borrow from the United States (the District of Columbia and U.S. possessions are usually excepted) or, (4) if proceeds of the issue are to be used in making loans so guaranteed. IRC Sec. 149(b).

Municipal Bonds

Exceptions to this rule include certain bonds guaranteed by the Federal Housing Administration, the Veterans’ Administration, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association, and the Student Loan Mortgage Association. Some housing program obligations and qualified mortgage bonds and veterans’ mortgage bonds are also excepted, provided proceeds are not invested in federally insured deposits or accounts. Bonds insured or guaranteed by Connie Lee Insurance Company are not considered “federally guaranteed.” Notice 88-114, 1988-2 CB 449.

Issues Secured by Certificates of Deposit

Some state and local obligations are secured by certificates of deposit federally insured by the Federal Savings and Loan Insurance Corporation (FSLIC) or the Federal Deposit Insurance Corporation (FDIC) up to $100,000 per bondholder. Bonds issued after April 14, 1983, other than any obligations issued pursuant to a binding contract in effect on March 4, 1983, are denied tax-exempt status if 5% or more of the proceeds of the issue are to be invested in federally insured deposits or accounts. IRC Sec. 149(b)(2)(B).

Tax-Exempt Issues Guaranteed by Letter of Credit

State or local government obligations guaranteed by letters of credit issued by banks whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) will *not* be treated as federally guaranteed obligations (which are denied tax-exempt treatment). *Federal Deposit Ins. Corp. v. Philadelphia Gear Corp.*, 476 U.S. 426 (1986), *on remand*, 795 F.2d 903 (10th Cir. 1986), *rev’g* 474 U.S. 918 (1985), *aff’g in part, rev’g in part* 587 F. Supp. 294 (W.D. Okla. 1984).

Other Guarantees

Interest on bonds issued to develop geothermal energy (otherwise tax-exempt) must be included in income if repayment of principal or interest is guaranteed under Title V of the Department of Energy Act of 1978. Rev. Rul. 80-161, 1980-1 CB 21.

If Bond Has Original Issue Discount

Tax-exempt obligations are sometimes issued at a price which is lower than their face amount at maturity. This original issue discount is not included in income but is treated as interest exempt from federal income tax just as stated interest received is exempt. IRC Sec. 1272(a); Rev. Rul. 73-112, 1973-1 CB 47. Treatment of this interest on sale or

If Bond Has Market Discount

redemption of the bond is discussed below at Tax at Redemption or Sale.

It is not uncommon to find tax-exempt bonds sold on the market at a discount because the market price of bonds has fallen to adjust to higher interest rates generally available on the market. Unlike original issue discount, market discount does not represent tax-exempt interest. The IRS reasons that market discount, in contrast to original issue discount, is not interest paid by the issuer for its use of borrowed money. Rev. Rul. 73-112, above; Rev. Rul. 60-210, 1960-1 CB 38; Rev. Rul. 57-49, 1957 CB 62. As in the case of taxable bonds, market discount is not included in income prior to sale, retirement, or other disposition. Furthermore, there is no election to include market discount in income as it accrues, as there is in the case of taxable bonds. IRC Sec. 1278(b)(1). Such an election with respect to taxable obligations does not affect tax-exempt obligations. IRC Sec. 1278(a)(1)(C). Treatment of market discount on sale is discussed below, at Tax at Redemption or Sale.

If Bond Traded “Flat”

Where tax-exempt bonds trade “flat” (at a price which makes no allocation between principal and unpaid interest accrued up to the date of sale) because interest is in default, any payment attributable to interest which accrued before the purchase is a return of basis, not tax-exempt interest. Amounts received in excess of basis are capital gain. *R. O. Holton & Co. v. Comm.*, 44 BTA 202 (1941); *Noll v. Comm.*, 43 BTA 496 (1941). Any payment of interest attributable to defaulted interest which accrued after purchase of the bond is interest when it is received. It does not make any difference whether the amounts are received from the obligor or from a purchaser, or whether or not the obligation is held to maturity. *Fisher v. Comm.,* 209 F.2d 513 (6th Cir. 1954), *cert. den.* 374 U.S. 1014; *Jaglom v. Comm.,* 36 TC 126 (1961), *aff’d,* 303 F.2d 847 (2d Cir. 1961); *Allen Tobey v.Comm.,* 26 TC 610 (1956); *Shattuck v. Comm.,* 25 TC 416 (1955); *First Kentucky Co. v. Gray,* above; Rev. Rul. 60-284, above.

Municipal Bonds

Tax-exempt interest on private activity bonds other than qualified 501(c)(3) bonds is a tax preference item for both the individual and the corporate alternative minimum tax. The interest may be reduced by any deduction not allowable in computing regular tax which would have been allowable if the interest were includable in gross income. (e.g., amortizable bond premium). IRC Sec. 57(a)(5)(A). The preference item includes exempt-interest dividends paid by a mutual fund to the extent attributable to such interest. IRC Sec. 57(a)(5)(B).

The alternative minimum tax applies to such bonds issued after August 7, 1986 (or on or after September 1, 1986 in the case of bonds covered by the “Joint Statement on Effective Dates of March 14, 1986”). Interest on bonds issued to refund immediately pre-August 8, 1986 bonds (or, in some cases, pre-September 1, 1986 bonds) is not an item of tax preference (see the Conference Report, TRA ’86, p. 333). IRC Sec. 57(a)(5)(C).

Effect on Social Security

Tax-exempt interest is included in the calculation made to determine whether social security payments are includable in gross income. IRC. Sec. 86(b)(2)(B). It has been determined that although this provision may result in indirect taxation of tax-exempt interest, it is not unconstitutional. *Goldin v. Baker,* 809 F.2d 187 (2d Cir. 1987), *cert. den.,* 108 S.Ct. 69 (1988).

Deduction of Interest Expense

No deduction is allowed for interest on indebtedness “incurred or continued to purchase or carry” obligations the *interest* on which is tax-exempt. IRC Sec. 265(a)(2). Whether debt was “incurred to purchase or carry” obligations on which interest is tax-exempt depends on the individual taxpayer’s purpose for borrowing. Rev. Proc. 72-18, 1972-1 CB 740, as modified by Rev. Proc. 74-8, 1974-1 CB 419. Where the necessary purpose to use borrowed funds to *buy or carry* tax-exempt interest obligations is shown, the interest deduction will be denied, even though no tax-exempt interest is currently being received. *Clyde C. Pierce Corp. v. Comm.*, 120 F.2d 206 (5th Cir. 1941); *Illinois Terminal R.R. Co. v. U.S.*, 375 F.2d 1016 (Ct. Cl. 1967). Furthermore, the deduction is denied even though the taxpayer’s motives are not tax avoidance but to realize a taxable profit from sale instead of interest. *Denman v. Slayton*, 282 U.S. 514 (1931).

The taxpayer’s purpose in borrowing requires an examination of all the facts and circumstances involved. *Indian Trail Trading Post, Inc. v. Comm.*, 60 TC 497 (1973), *aff’d per curiam* 503 F.2d 102 (6th Cir. 1974). Purpose can be established by direct or

Municipal Bonds

by circumstantial evidence. According to IRS guidelines, if the loan proceeds can be directly traced to the purchase, there is direct evidence of a purpose to *purchase.* Nonetheless, this evidence is not conclusive, as the IRS acknowledges in pointing out that the deduction is not denied where proceeds of a bona fide business borrowing are temporarily invested in tax-exempt interest obligations. Rev. Rul. 55-389, 1955-1 CB 276.

Use of tax-exempt interest obligations as collateral for debt is direct evidence of a purpose to *carry* the obligations. *Wisconsin Cheesemen, Inc. v. U.S.*, 388 F.2d 420 (7th Cir. 1968); Rev. Proc. 72-18, above. The Tax Court has determined that the use of tax-exempt municipal bonds as collateral did not, of itself, establish the necessary purpose to carry the bonds. See *Lang v. Comm.*, TC Memo 1983-318, 46 TCM 335. However, in another decision, the use of tax-exempt municipal bonds as collateral *did* establish a direct relationship between the carrying of the bonds and the borrowing, even though the loan proceeds were used for an investment purpose. See *Rifkin v. Comm.*, TC Memo 1988-255.

Lacking direct evidence, if the facts and circumstances support a reasonable inference that the purpose of the borrowing was to purchase or carry tax-exempt interest obligations, the deduction will be denied. However, a deduction will not be denied merely because the investor also holds such tax-exempt obligations. *Ball. v. Comm.*, 54 TC 1200 (1970). Generally, the interest deduction will not be disallowed if borrowing is for a personal purpose (and the interest would otherwise be deductible). Thus, an individual who holds tax-exempt municipal bonds and takes out a mortgage to buy a residence is not required to sell his municipal bonds to finance the purchase. Rev. Proc. 72-18, Sec. 4.02, above.

Similarly, the deduction will not generally be denied if the indebtedness is incurred or continued in connection with the active conduct of a trade or business (other than as a dealer in tax-exempt obligations) and the loan is not in excess of business needs. Nonetheless, if the business need could reasonably have been foreseen when the tax-exempt obligations were bought, a rebuttable presumption arises that there was a purpose to carry the tax-exempt obligations by means of borrowing. *Wisconsin Cheesemen, Inc. v. U.S.*, above; Rev. Proc. 72-18, Sec. 4.03, above.

On the other hand, where there is outstanding indebtedness not directly connected with personal expenditures, which is not incurred or continued in connection with active conduct of a business, and where the individual owns tax-exempt obligations, a purpose

Municipal Bonds

to *carry* the tax-exempt obligations *will* be inferred, but may be rebutted. This inference will be made even though the debt is ostensibly incurred or continued to purchase or carry other portfolio investments not connected with the active conduct of trade or business. Thus, deduction of interest on a margin account by an individual holding tax-exempt obligations was disallowed, even though only taxable securities were purchased in that account. *Bernard P. McDonough v.Comm.*, 577 F.2d 234 (4th Cir. 1978). (The management of one’s personal investments is not considered a trade or business. *Higgins v. Comm.*, 312 U.S. 212 (1941).) A limited partnership interest is generally considered a passive activity. Ann. 87-4, 1987-3 IRB 17. If the taxpayer borrows to buy such an interest while holding tax-exempts, it is possible that the IRS will infer an intent to carry tax-exempt obligations and will disallow the interest deduction.

According to guidelines, there will generally be a direct connection between borrowing and purchasing or carrying existing tax-exempt interest obligations if the debt is incurred to finance new portfolio investment. This presumption can be rebutted, the IRS says, by showing the taxpayer could not have sold his holdings of tax-exempt interest obligations. But it cannot be overcome by showing the tax-exempts could have been sold only with difficulty or at a loss, or that the investor owned other investment amounts that could have been liquidated, or that an investment adviser recommended that a prudent man should maintain a particular percentage of assets in tax-exempt obligations. Rev. Proc. 72-18, Sec. 4.04, above.

If a fractional part of the indebtedness is *directly* traceable to holding tax-exempt interest obligations, the same fractional part of interest paid will be disallowed. In any other case, where the interest deduction is to be disallowed, an allocable portion of the interest is disallowed. The portion is determined by multiplying the total interest on the debt by a fraction. The numerator is the average amount during the tax year of the taxpayer’s tax-exempt obligations (valued at adjusted basis), and the denominator is the average amount during the tax year of the taxpayer’s total assets (valued at adjusted basis) minus the amount of any indebtedness the interest on which is not subject to disallowance under Section 265(a)(2). Rev. Proc. 72-18, Secs. 7.01, 7.02, above. See also *Bernard P. McDonough v. Comm.*, TC Memo 1982-236.

If a partnership incurs debt or holds tax-exempt obligations, the partners are treated as incurring or holding their partnership share of each such debt or tax-exempt obligation. The purposes of the partnership in borrowing are attributed to the general partners. Rev. Proc. 72-18, Sec. 4.05, above.

However, if an individual’s investment in tax-exempt obligations is insubstantial, the requisite purpose will generally not be inferred in the absence of direct evidence.

Municipal Bonds

Investment will generally be considered insubstantial if the average amount of tax-exempt obligations (valued at their adjusted basis) is not more than 2% of the average adjusted basis of his portfolio investments and any assets held in the active conduct of a trade or business. Rev. Proc. 72-18, Sec. 3.05, above.

The IRS has ruled that the interest deduction will be disallowed on a joint return if indebtedness that was incurred by one spouse is allocable to the acquisition of tax-exempt securities by the other. Rev. Rul. 79-272, 1979-2 CB 124.

If the proceeds of a short sale are used (as determined under the foregoing rules) to “purchase or carry” tax-exempt obligations, certain expenses of that short sale may not be deducted. IRC Sec. 265(a)(5).

Deduction of Bond Premium

An individual who owns any tax-exempt interest bearing bond (or debenture, note, certificate, or other evidence of indebtedness) *must* amortize any premium he paid for the bond; the part of the premium allocable to the year is not deductible. IRC Sec. 171; Treas. Reg. §§1.171-1(a)(1)(i), 1.171-1(b). (The premium paid, in effect, reduces the annual interest; therefore, because the tax free interest received each year represents in part a tax free return of premium, premium is not deductible.) The individual *must* reduce his basis each year by the amount of premium allocable to the year. IRC Sec. 1016(a)(5).

# Tax at Redemption or Sale

Payment of Stated Interest

If the buyer paid the seller any stated interest accrued, but not yet due at the date of the sale, that amount is recovered tax free as return of capital. See Rev. Rul. 69-263, 1969-1 CB 197.

Capital Recovered Tax Free

Out of the amount he receives on sale or redemption of the bond, the seller may recover an amount equal to his adjusted basis tax-free. If the bond was purchased at a premium, the seller’s basis for determining gain or loss is adjusted to reflect the amortization of the premium.

.

Municipal Bonds

Bonds Issued After September 3, 1982 and Acquired After March 1, 1984

With respect to a bond both issued after September 3, 1982 and acquired after March 1, 1984, the owner’s basis is increased by the amount of tax-exempt original issue discount which accrued while he owned the bond (subject to an adjustment if he purchased the bond at a price in excess of the issue price plus original issue discount accrued up to the time he acquired it). IRC Sec. 1288(a)(2).

*On obligations with maturities of more than one year,* OID accrues daily at a constant rate as it does generally for taxable original issue discount bonds issued after July 1, 1982, except that discounts of less than 1/4 of one percent times the number of years to maturity are accounted for. IRC Sec. 1288(b)(1).

*For obligations with maturities of one year or less,* discount will accrue daily on a ratable basis, as it does for taxable short-term government obligations. IRC Sec. 1288(b). Daily portions are determined by dividing discount by the number of days after the day the taxpayer acquired the bond up to and including the day of its maturity. Discount on short-term taxable government obligations is “acquisition discount” (the difference between any particular owner’s basis in the obligation and its face value at maturity) instead of original issue discount. The taxpayer apparently may make an irrevocable election to use a constant rate (under regulations) with respect to individual short-term obligations. IRC Sec. 1288(b).

Bonds Acquired On or Before March 2, 1984 or Issued Before September  4, 1982

With respect to any bond acquired on or before March 1, 1984 or any bond issued on or before September 3, 1982, whenever acquired, the seller’s basis is not adjusted to reflect annual accrual of original issue discount accrued up to the date of sale. TAM 8541003. Nonetheless, to the extent there is gain on sale or redemption, an amount equal to original issue discount allocable to the period the investor held the bond is excludable as tax-exempt interest which accrued over the period it was held.

The amount of tax free discount apportioned to any holder is the amount that bears the same ratio to the original issue discount as the number of days he held the bond bears to the number of days from the date of original issue to the date of maturity, assuming there was no intention at issue to call the obligation before maturity. Rev. Rul. 73-112,

Municipal Bonds

1973-1 CB 47. If the bond is redeemed before maturity, any unaccrued original issue discount realized is taxable as capital gain, not excludable interest, except that in the case of a bond issued before June 9, 1980, it is recovered tax free as tax-exempt interest. Rev. Rul. 80-143, 1980-1 CB19; Rev. Rul. 72-587, 1972-2 CB 74.

Market Discount

Tax-exempt bonds may be discounted on the market to adjust to a higher rate of interest available on the market than the coupon rate offered by the bond. If a bond was bought on the market at such a discount reflecting a decline in value of the obligation after issue, this market discount does not represent tax-exempt interest paid by the issuer. Rev. Rul. 73-112, above; Rev. Rul. 60-210, 1960-1 CB 38; Rev. Rul. 57-49, 1957-1 CB 62. Market discount is the amount by which the purchase price is less than the face value of the bond (or, in the case of a bond originally issued at a discount, less than the issue price plus the amount of original issue discount apportioned, as above, to the previous holders). On the sale or redemption of a tax-exempt bond, gain which represents recovery of market discount is taxable.

With respect to tax-exempt bonds purchased *after* April 30, 1993, market discount recovered on sale is treated as taxable interest instead of capital gain. IRC Secs. 1276(a), 1278(a)(1). For tax-exempt bonds purchased *before* May 1, 1993, gain attributable to market discount has generally been treated by the Service as capital gain. Rev. Rul. 60-210, above; Rev. Rul. 57-49, above. Capital gain is not exempt from federal income tax. *Willcuts v. Bunn*, 282 U.S. 216 (1931); *U.S. v. Stewart*, 311 U.S. 60 (1940); Rev. Rul. 81-63, 1981-1 CB 455.

Capital Gain

Gain in excess of interest will generally be capital gain, including gain from any premium paid on call (see Premium Paid on Call), below). For tax years 2003 through 2012, long-term capital gain is generally taxed at a rate of 0% or 15% depending on the individual’s tax bracket. These favorable tax rates are scheduled to expire at the end of 2012, absent Congressional action. Unless Congress acts to extend the current treatment, long-term capital gain rates will revert to the higher rates that were in effect prior to 2003 (20% or 10%, depending on the taxpayer’s tax bracket). Bonds issued after June 30, 1983 must be in registered form in order to treat gain as capital (as opposed to ordinary) gain. IRC. Sec. 1287.

Municipal Bonds

Loss

If a loss is realized on the sale or redemption of a tax-exempt bond, it is a capital loss. However, if “substantially identical” obligations were acquired (or a contract for their acquisition was made) within 30 days before or 30 days after the sale, the loss will be subject to the “wash sale” rule.

The owner’s basis in the bond is adjusted to include any tax-exempt original issue discount which accrued while he owned the bond (subject to an adjustment if he purchased the bond at a price in excess of the issue price plus original issue discount accrued up to the time he acquired it). IRC Sec. 1288(a)(2).

With respect to any bond acquired on or before March 1, 1984 or any bond issued on or before September 3, 1982, whenever acquired, the seller’s basis is not adjusted to reflect annual accrual of original issue discount. Consequently, loss on sale is determined without regard to the amount of original issue discount accrued up to the date of sale. TAM 8541003.

Bonds issued after June 30, 1983 must be in registered form in order to deduct loss on sale. IRC Sec. 165(j)(1). If the sale is made to a related party, the loss deduction may be disallowed. IRC Sec. 267(a).

# Issues Not Tax-Exempt

Short-term obligations issued on a discount basis and payable without interest at a fixed maturity date of one year or less are treated like U.S. Treasury bills. IRC Secs. 1271(a)(3), 454(b). Obligations with maturities of more than one year are treated like U.S. Treasury notes and bonds. IRC Secs. 1271, 1272.

# Reporting Tax-Exempt Interest

Every person required to file a tax return for a taxable year beginning after December 31, 1986 must report on the return the amount of tax-exempt interest received or accrued during that taxable year. IRC Sec. 6012(d).