INVESTMENT COMPANY INSTITUTE

MEMO# 6193

September 2, 1994

APPLICATION OF ORIGINAL ISSUE DISCOUNT AND MARKET DISCOUNT RULES TO TAX-EXEMPT OBLIGATIONS

* See Institute Memorandum to Accounting/Treasurers Members No. 24-93, Pension Members No. 28-93 and Tax Members No. 28-93, dated August 9, 1993. September 2, 1994 TO: ACCOUNTING/TREASURERS COMMITTEE NO. 46-94 MONEY MARKET FUNDS AD HOC COMMITTEE NO. 17-94 TAX COMMITTEE NO. 30-94 RE: APPLICATION OF ORIGINAL ISSUE DISCOUNT AND MARKET DISCOUNT RULES TO TAX-EXEMPT OBLIGATIONS ____ The tax treatment of market discount on tax-exempt obligations was changed by the 1993 tax bill, for obligations purchased after April 30, 1993, from capital gain to ordinary income.* In late July, there were a number of press reports regarding the treatment of tax-exempt bonds issued at a premium and with a final maturity in excess of 12 months that do not pay interest at least annually. The press reports indicated that these bonds might have market discount (taxable as ordinary income), even when traded in the secondary market at a premium, as a result of the application of the original issue discount rules to these bonds. The attached memorandum describes the interplay of the original issue discount and market discount rules that apply to tax-exempt bonds. Included in the memorandum is a discussion of IRS Notice 94-84, which effectively provides that no market discount will exist for a tax-exempt bond, issued at a premium with an original maturity of one year or less, that is purchased in the secondary market at any price equal to or greater than par. We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment