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Purchasing Out-of-State Municipal Bonds at a Premium

Tax Considerations for NY Residents

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Key Takeaways

- Buying out-of-state municipal bonds at a premium may not offer the tax benefits you expect.
- Under NY tax law, you can only deduct the amortized premium if you itemize your deductions.
- Work with a tax professional who can help you understand and evaluate your options.

The tax implications of purchasing a bond at a premium (for more than face value) depend on the type of bond you buy and where you live. You can handle the premium for taxable bonds in a couple of ways, but there's only one option for tax-exempt (municipal) bonds. Additionally, a quirk in the New York state tax law creates other considerations for NY residents who purchase non-NY municipal bonds at a premium.

Before we delve into this quirk, it's important to understand the tax treatment options for the premium paid on taxable and tax-exempt bonds.

Taxable Bonds

When you purchase a taxable bond, your earned interest is taxed at your ordinary income tax rate. You'll also have a capital loss equal to the premium amount when you sell the bond or it matures. Let's look at an example.

An individual purchases a $100,000, 5-year corporate bond with a 4% coupon for $105,000, based on market conditions dictating a 3% yield on this bond.[1] They receive $4,000 in interest income annually and will realize a capital loss of $5,000 when the bond matures ($105,000 purchase price minus $100,000).

Assuming the individual is in the highest tax bracket, here is the after-tax benefit of owning this bond:

	Cash Flow	Tax Rate[2]	Tax (Cost) Benefit	After-Tax Cash Flow
Interest Income	$20,000	37%	($7,400)	$12,600
Capital Loss at Maturity	($ 5,000)	20%	$ 1,000	($4,000)
Total	$15,000	-	($6,400)	$ 8,600

On a pretax basis, they receive $15,000 in income as they expected (five years of interest at 3%).

To improve their after-tax income, the individual can elect to amortize the bond premium. The annual amortization will offset the interest income with a corresponding reduction in the bond's tax basis.

If the individual holds the bond to maturity, there won't be any gain or loss on the disposition. Amortization essentially reduces the amount of income taxed at ordinary rates by sacrificing the capital loss, which would otherwise offset any capital gains.

	Cash Flow	Premium Amortization	Taxable Amount	Tax Rate	Taxes	After-Tax Cash Flow
Interest Income	$20,000	($5,000)	$15,000	37%	($5,550)	$9,450
Capital Loss at Maturity	($5,000)	$0	$0	-	$0	$0
Total	$15,000	-	-	-	-	$9,450

By amortizing the bond premium, the individual increases their after-tax yield by nearly 10% ($850).

Given the rules regarding the election and the computation of amortization, it's best to work with a professional tax advisor who can do the calculations for you.

How does the tax treatment differ for tax-exempt bonds?

Tax-Exempt Bonds

For federal tax purposes, your only option is to amortize the premium. Also, there's no corresponding deduction because the interest isn't taxable. Even though amortization doesn't provide a current tax benefit, it does reduce the bond's tax basis. When the bond matures, the par value is the basis, and there's no capital loss to realize.

New York Tax Treatment of Municipal Bonds

If you're a NY resident and purchase a NY tax-exempt bond, there is no issue—the federal and state tax treatment are the same. That is not the case when you buy an out-of-state municipal bond at a premium.

Since the bond generates taxable interest income for NY, you should technically be able to deduct the bond premium amortization. But according to NY tax law, the deduction is only available as an itemized deduction.

This treatment means you won't receive any benefit if you take the standard deduction. And even if you do itemize, you may not benefit fully if your itemized deductions are scaled back due to your income level. Let's look at another example:

A NY resident with NY income in excess of $1,000,000 purchases a 5-year $100,000 Washington state tax-exempt bond with a 3% coupon for $105,000 since market conditions dictate a 2% yield on this bond.

For federal tax purposes, the individual won't pay taxes on the interest. They also won't incur a capital loss at maturity since the premium was fully amortized.

At the state level, the individual will be taxed on the $15,000 of interest($3,000 × 5 years). They are entitled to an itemized deduction for the premium amortization.

However, since their income is greater than $1,000,000, they're not eligible to take any itemized deductions other than 50% of their charitable contributions. As such, they don't enjoy any tax benefits and will earn a lower after-tax yield on the bond. Below is a comparison of the impact of itemizing versus not itemizing.

NY taxpayer uses the standard deduction or loses their itemized deductions

	Cash Flow	Taxable Amount	Tax Rate[3]	Tax (Cost) Benefit	After-Tax Cash Flow
Interest Income	$15,000	$15,000	6%	($900)	$14,100
Itemized Deduction	$0	$0	-	-	-
Bond Maturity	($5,000)	$0	-	$0	($5,000)
Total	$10,000	-	-	($900)	$9,100

NY taxpayer itemizes deductions

	Cash Flow	Taxable Amount	Tax Rate[3]	Tax (Cost) Benefit	After-Tax Cash Flow
Interest Income	$15,000	$15,000	6%	($900)	$14,100
Itemized Deduction	-	($5,000)	6%	$300	($4,700)
Bond Maturity	($5,000)	$0	-	$0	-
Total	$10,000	-	-	($600)	$ 9,400

While the pretax cash flow is identical in both scenarios ($10,000), the after-tax cash flow is approximately 3% lower for the non-itemizing taxpayer ($9,100 versus $9,400).

Lessons Learned

If you plan to purchase out-of-state municipal bonds at a premium, be sure to keep the above in mind when calculating after-tax yields. You would be surprised by how many professional bond managers don't consider the lost amortization deduction when calculating the yield on an out-of-state premium bond, thereby falsely believing their clients are getting a higher after-tax yield than they actually are.

As with any investment, it's not important how much you make but how much you keep after taxes. This advice holds true even if you don't live in NY. To preserve and grow your wealth, you need to understand the federal and state tax consequences of your decisions before you act.

Put Our Expertise to Work for You

Our tax specialists have vast knowledge of and experience with both state and federal tax laws. They can help you understand the impact your actions may have not only on your current tax bill but also future ones. Contact a Cerity Partners advisor or visit the tax planning and preparation section of ceritypartners.com to learn more.

Len is a Partner in the New York office and has more than 30 years of wealth management experience, specializing in taxes, financial planning and investment advice for individuals and their related entities.

¹ Time value of money is ignored herein, whereas it would be a factor in the calculation of the premium.
² Local income taxes and the surtax on Net Investment Income are ignored for simplification.
³ The 6% tax rate is an assumed rate for illustrative purposes.

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