

DISCOUNT AND PREMIUM BONDS: DEALING WITH THE TAX ISSUES

By Clark M. Blackman II and Ellen J. Boling

From a tax standpoint, life would be simpler if all bonds were purchased at their par value. But this is seldom the case, and the task of understanding the tax rules is not easy given the wide variety of debt instruments and the complexity of the regulations issued.

As you begin to move into your retirement years, you may consider reallocating your investment portfolio to include a higher concentration of bonds. Needless to say, if you do this outside of your tax-deferred retirement accounts and you use individual bond issues, you will have a number of tax-related concerns to worry about.

This article deals with tax issues relating to bonds that you own outside of a retirement account. The tax reporting requirements outlined are not applicable if bonds are owned inside an IRA or other retirement plans.

From a tax standpoint, life would be much simpler if all bonds were purchased at their par value. In other words, a bond having a par value (redemption value at maturity) of \$1,000 would be purchased for \$1,000.

Since this is seldom the case, investors need a basic understanding of the tax laws applicable to bonds purchased at prices below or above par. Understanding these tax laws is not an easy task given the wide variety of debt instruments, the complexity of the regulations issued in this area, and—let's face it—the dull nature of the topic. Nevertheless, we will forge ahead with a discussion of original issue discounts, market discounts, and market premiums.

ORIGINAL ISSUE DISCOUNTS

Why can you purchase a debt instrument for \$900 that has a redemption price of \$1,000? Because the bond, note, or other debt instrument either does not pay interest on an ongoing basis or pays interest at a rate that is lower than current market interest rates. This price discount is, in effect, additional interest income to you. Even though there are many different types of debt instruments, discounts come in only two broad forms: original issue discount (OID) and market discount.

Defined in familiar terms, original issue discount is the excess of redemption (face) value when the debt comes due, over what was "originally" paid for it when it was first issued. For example, if Joe lends Ed \$6,000 and Ed agrees to pay Joe \$10,000 six years later, the loan has \$4,000 of original issue discount. Currently, the Internal Revenue Service says that original issue discount is interest income to Joe and should be recognized as such over the life of the loan.

One of the complicating factors with original issue discount is that the tax rules governing the concept have changed several times since 1969. Therefore, different original issue discount rules could apply if you hold bonds from different periods. The tax law has "progressed" from the pre-May 28, 1969, rules requiring no recognition of original issue discount until the instrument is sold to the current "solution" that was part of the Tax Reform Act of 1984 (Internal Revenue Code sections 1272 to 1274). This article deals with the post-1984 rules (IRC sections 1271 to 1278), although different rules may apply to debt issued prior to January 1, 1985. There have been minor changes in the rules since 1984 that have been incorporated into this article where applicable.

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EXCEPTIONS TO O.I.D. RULES

Before we get into the mechanics of reporting and calculating original issue discount, we must point out that certain debt instruments are exempt from the rules requiring recognition of income, including:

- Original issue discount municipal bonds (the exemption does not cover "stripped" tax-exempt obligations);
- U.S. savings bonds;
- Debt instruments with maturities of one year or less; and
- Debt issued by an individual before March 2, 1984, or loans of less than \$10,000 between individuals who are not in the business of lending money.

In addition, "de minimis" rules apply (meaning you can disregard the original issue discount rules) if the discount is less than a quarter of 1% of the stated redemption price multiplied by the number of full years from the date of original issue to maturity. An example of how the de minimis rule is applied can be found in Example 5 in the discussion of market discounts. From a practical point of view, the vast majority of individuals purchasing original issue discount securities will not benefit from this rule.

REPORTING O.I.D

One of the kinder acts of Congress is embodied in Section 6049 of the Internal Revenue Code, requiring brokers and other middlemen to calculate and report original issue discount for you. This reporting is required on Form 1099-OID if the total for the calendar year is \$10 or more. Copies of the form are sent to the IRS and to you.

How do brokers know which debt instruments have original issue discount and how do they know how much to report? IRS Publication 1212 is issued annually and lists publicly offered original issue discount debt instruments. In addition, this publication is full of

tables and charts designed to assist brokers with original issue discount calculations.

In the past, one problem with original issue discount reporting was that all too often the amount reported to you may have been determined on the assumption that the instrument was held the entire calendar year. If the debt was purchased or sold during the year, recalculations were required by you or your accountant to determine actual original issue discount. Congress once again came to the rescue by issuing Treasury Regulations 1.6049-4(b). Brokers and other middlemen are required to report actual original issue discount includable in your gross income. (Tax preparers love this, brokers hate it.)

CALCULATING O.I.D.

Even though brokers are required to calculate and report original issue discount, it is still important for you to understand the mechanics of the calculation. This will help you estimate the amount of taxable income, and phantom income, associated with a bond purchase. You must report original issue discount using a single rate of compound interest reflecting the actual economic accrual of interest. This means that original issue discount is allocated over the time that the debt is held based upon the instrument's "internal rate of return," compounding at least once a year. (This can be calculated using most financial calculators.)

Example 1: Laurie purchases a five-year \$1,000 bond on January 1 for \$600. The calculated internal rate of return is 10.756%. The original issue discount reported by Laurie in Year One is \$65 ($\600×0.10756). In Year Two, original issue discount reported by Laurie is \$72 ($\665×0.10756).

By using the internal rate of return to calculate original issue discount, the adjusted basis of the bond at maturity will equal the redemption

price. Thus, if Laurie holds the bond to maturity, the entire original issue discount will be properly reported as interest income and no capital gain or loss will result at that time.

Although the above example has been kept very simple to illustrate the mechanics of original issue discount, the calculations can get complicated when dealing with such issues as stripped bonds, interest-bearing bonds, contingent payment bonds, inflation-indexed bonds, and acquisitions and dispositions in the middle of a calendar year. IRS Publication 1212 should be referred to when dealing with these and other more complicated situations.

O.I.D.S ON MUNIS

Although tax-exempt bonds (other than stripped tax-exempt obligations) are exempt from the original issue discount rules, you must calculate original issue discount to determine the basis of the debt when you dispose of it. The accrued original issue discount, which is calculated under the same method as used for taxable obligations, is an addition to your cost basis.

Example 2: Assume in Example 1 that Laurie's bond is tax-exempt. Upon maturity, she would have no gain for federal tax purposes, since the accumulated original issue discount equals \$400. Her purchase price of \$600 plus accumulated original issue discount equals her pay-off of \$1,000. If, however, she sells her bond at the end of Year Two for something other than \$737 ($\$600 + \$65 + \72), she will have a taxable gain or loss.

"Stripped" tax-exempt obligations are not afforded the same treatment as other original issue discount municipal bonds. If you purchase or hold tax-exempt bonds that have been stripped of their coupon, you may end up with some amount of taxable income each year you own the bond. This is a complex area and you are referred to IRS Publication 1212, or your adviser, if you own or

are considering purchasing any such bonds. We include an IRS example of how to treat such bonds for the stout of heart and those of you who love to unravel mathematical puzzles. All others please skip this and go to the discussion of market discounts.

Example 3: A tax-exempt obligation is issued for \$100 on January 1, 1997, with a coupon rate of 10% (compounded semiannually). Its coupon is stripped on January 1, 1998, and matures for a face value of \$100 on January 1, 2000. The right to receive the principal amount is sold for \$79.21, reflecting a 12% (compounded semiannually) yield to maturity at the time of the strip. The tax-exempt part of original issue discount on the stripped bond is limited to \$17.73, which is the difference between the stated redemption price of the obligation (\$100) and the issue price that would produce a 10% yield to maturity (\$82.27). The part of the original issue discount that is treated as coming from an obligation that is not tax-exempt is \$3.06, which is determined by finding the excess of total original issue discount on the stripped bond (\$20.79) over the tax-exempt original issue discount portion (\$17.73).

MARKET DISCOUNTS

If you purchase a bond on the secondary market, it may have a "market" discount. Market discount arises when the value of the debt obligation decreases after its issue date, typically because of an increase in market interest rates.

Is there a difference between original issue discount and market discount? Well, no and yes. While there may be no economic difference between market discounts and original issue discounts, Congress adopted a different set of tax rules. The most pronounced difference between the two sets of rules is that market discount is not required to be included in income currently (but

may be if elected). Instead, the market discount is taken into account upon disposition of the instrument. Yes, the accrued portion is still reported as interest income upon sale, but in most cases it sure beats paying taxes currently.

Example 4: CJ purchases a \$10,000 bond for \$9,200 in January 1998. The bond was originally issued by Corporation X in January 1995. The \$800 difference between the face amount and CJ's cost is market discount. The \$800 will be reported as interest income on CJ's tax return on an amortized basis or upon disposition, depending on whether the election was made.

MARKET RULE EXCEPTIONS

The market discount rules require treatment of the discount as taxable interest income upon disposition and allow you to elect to recognize this income each year. The following are exceptions to these rules:

- Short-term obligations with maturities of one year or less from date of issue. The amount of gain resulting from the market discount (not the original issue discount; any original issue discount is interest income at disposition) is treated as short-term capital gain;
- Tax-exempt obligations acquired before May 1, 1993—any gain resulting from a market discount is a taxable capital gain upon disposition;
- U.S. savings bonds—these follow their own specific rules regarding taxability;
- Certain installment obligations we won't get into here; and
- De minimis discounts (your discount is less than a quarter of 1% per year to maturity) on any bond you purchase.

The de minimis rule is a significant exemption from market discount rules, since it applies in many cases (as opposed to the original issue discount rules where it rarely, if ever, applies). The follow-

ing example should help clarify its application.

Example 5: Karen buys a \$1,000 bond with 10 years to maturity for \$980 (market discount is \$20). One quarter of 1% of \$1,000 is \$2.50, multiplied by 10 equals \$25. Because the \$20 discount is less than \$25, Karen can disregard the market discount rules. She will have a small capital gain at maturity.

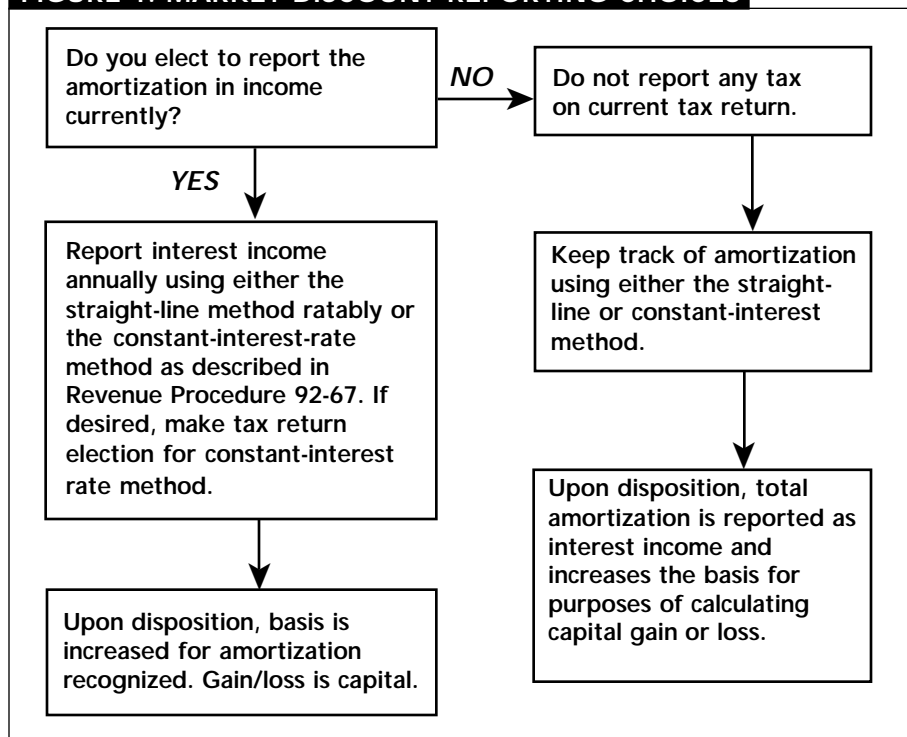
REPORTING

As discussed earlier, the original issue discount rules do not allow you a choice of when to include the amortized discount on your tax return; you do it currently. However, the market discount rules allow several reporting choices, as illustrated in Figure 1.

You have two decisions to make when dealing with market discount reporting:

- Should you elect to recognize income currently or wait until the instrument is disposed of? This election is made in a statement attached to your tax return, and if made, applies to all the market discount vehicles in your portfolio. This election is revocable. Revenue Procedure 92-67 gives specific language.
- Which amortization method should you select, the straight-line or constant-interest method? The straight-line method does not require an additional election statement with your tax return, while the constant-interest method does. The constant-interest method is elected on a bond by bond basis and becomes irrevocable once made. Revenue Procedure 92-67 also provides direction for this election. The constant-interest method is calculated as shown earlier in Example 1. The straight-line method is calculated as follows:

Example 6: On January 1, 1997, "B" purchases a five-year \$1,000 bond for \$800. The bond matures on January 1, 2001. Under the

FIGURE 1. MARKET DISCOUNT REPORTING CHOICES

straight-line method, the market discount is amortized at \$50 per year (\$200 divided by the four years remaining).

BOND PREMIUMS

Why would you pay \$1,200 for a \$1,000 bond? Because the rate of interest the bond is paying exceeds current rates. The \$200 is called bond premium and represents the “flip side” of a discount. You might expect the tax treatment of premiums to mirror the treatment of original issue discounts or market discounts. But it is not so (providing a good, albeit minor, example of why our tax code is so much fun).

Among the significant differences between the tax treatment of discounts and premiums, consider:

- No distinction is made between “original issue” premium and market premium.
- Amortization of bond premium is elective (unless the bond is tax-exempt).
- The premium amortization rules apply equally to all taxable debt instruments.

REPORTING PREMIUMS

As with original issue discount, the tax rules have undergone frequent changes in how you report premiums. For the sake of clarity, we will focus on the current rules that apply to bonds purchased after 1987.

If you choose to amortize a bond’s premium annually, you must elect to do so on the first tax return that applies. For bonds acquired after 1987, the interest income from the bond is reduced by the premium deduction. On Schedule B of your tax return, above line 2, write “ABP Adjustment” and subtract the amount of bond premium being amortized. Your Form 1040 should include a statement showing your computation. The election applies to all bonds in a particular class purchased during that year and all subsequent years.

If you do not choose to amortize the premium, it will be treated as part of your basis in the bond and will reduce the taxable gain or create a capital loss on disposition.

If you purchase a tax-exempt bond at a bond premium, you must

amortize currently. This amortized amount is not deductible in determining taxable income (which is reasonable since the interest income is not subject to regular tax).

THE CALCULATIONS

For bonds issued after Sept. 27, 1985, the “constant yield” method is required to amortize bond premiums.

Example 7: John pays \$10,800 for a \$10,000, 10-year bond with a stated interest rate of 6% payable semiannually. His premium is \$800 and the yield to maturity is calculated to be 5% as follows:

$$[\$600 - (\$800 \div 10)] \div [(\$10,800 + \$10,000) \div 2]$$

Therefore, premium amortization in Year One is \$60 $[(\$10,000 \times 6\%) - (\$10,800 \times 5\%)]$. If John elects to amortize the premium annually, he would report the \$600 interest received as interest income and report the \$60 as a reduction in interest income. In Year Two, John would report \$600 as interest income and a reduction of \$63:

$$[(\$10,000 \times 6\%) - (\$10,740 \times 5\%)]$$

Treasury regulations state to use the method “regularly employed” for amortization of discounts and premiums as long as that method is reasonable. Presumably, this means that the easier-to-use straight-line method is available for pre-Sept. 28, 1985, bonds if it is your regularly employed method. See Example 6 for the straight-line method calculation applied to discounts.

SUMMARY

Take note that state tax rules have not been addressed in this article.

A general understanding of the tax treatment of debt-based securities will help you determine the right questions to ask regarding the tax consequences of your investment purchases. ♦